The **BEPS** Monitoring Group

Submission on

Revision of Chapter VII of the Transfer Pricing Guidelines on Special Considerations for Intra-Group Services

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organisations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Sol Picciotto, with contributions and comments from Jeffery Kadet and Tommaso Faccio.

We appreciate the opportunity to provide these comments, and are happy for them to be published.

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GENERAL COMMENTS

Although the issue under consideration here seems a simple one, it raises problems which demonstrate the failure of the continuing adherence by many OECD members to a rigid interpretation of the arm's length principle (ALP). The OECD set out on this wrong path in 1995 with the adoption of the Transfer Pricing Guidelines (TPGs). They resulted from conflicts among OECD members due to the US adoption of the comparable profits method. OECD members agreed to include in the TPGs a version of this, the transactional net margin method (TNMM). They also included a new one, the profit split method (PSM). These methods were described as 'transactional', which is misleading. Regrettably, no further work was done on the PSM, which has remained a fall-back, generally used only after other methods have been applied. During the BEPS project only a scoping note for future work on the PSM was published. There have been two discussion drafts and consultations since 2015, and no final report on the PSM has yet been released. It seems that any agreed report on this will be of limited scope, due to these continued disagreements.

Rules on transfer pricing concern the allocation of profits of MNEs. This central aim was obscured when the 1995 TPGs became focused on the pricing of transactions. The mandate from the G20 for the BEPS project was to reform the rules to ensure that profits of multinational enterprises (MNEs) could be taxed 'where economic activities occur and value is created'. By failing to address this issue directly in the actions on transfer pricing, the OECD has clearly failed to meet this objective. This seems due to the continued reluctance among many specialists on transfer pricing to accept the need to agree objective criteria for apportionment of profit. This need is even more urgent in today's digital world, where attempting to decide an appropriate allocation of profit by focusing on the pricing of transactions is simply fruitless.

This present consultation concerns attribution of costs, not profits. An integrated MNE by its nature engages in many activities which benefit the whole group, and hence entail joint or overhead costs. Yet it is clearly inconsistent to seek to adopt an approach which would apportion costs while profits continue to be attributed by transactional methods. This is especially so when the method used is a one-sided one (cost-plus, resale-minus, and the TNMM, which is the most commonly used). Since these methods attribute profits by reference to those of comparable independent enterprises, it is simply inappropriate to allow a further deduction of central service costs.

Indeed, this fundamental point applies more widely. The adoption of the functional analysis / transactional approach in the 1995 TPGs required all joint production functions to be treated not as costs to be charged, but as separate transfer transactions to be priced. This includes the main profit drivers of an MNE: capital, research and development (R&D), and risk-taking. MNEs exert centralised control over all these activities, and they benefit (or harm) the firm as a whole. Also, they entail largely non-physical activities, responsibility for which can easily be attributed to an entity located anywhere. This is recognised as the main source of BEPS. It cannot be adequately tackled while there is a continuing insistence on basing transfer pricing on functional analysis, treating all affiliates of a MNE as independent entities transacting with each other at arm's length.

There was an attempt during the BEPS project to depart from this approach, in Action 4 on the limitation of interest deductibility. The initial proposals, that the MNE's third party interest costs should be apportioned among affiliates, recognised the reality that the treasury function is highly centralised, and affiliates are often loaded up with debt to maximise interest deductions. We supported the apportionment approach, even in the absence of a similar treatment of profits, as the only practical way of dealing with excessive interest deductions, which are a major source of BEPS. In other areas, the continued insistence on functional analysis has meant that the BEPS project outcomes have made the TPGs far more complex and obscure.[1]

Hence, we do not agree with the premise in the request for comments that the concern is only about the practical application of the guidance in chapter VII, and not the theoretical basis. Unless and until Working Party 6 faces up to the fundamental difficulties of the current interpretation of the ALP, none of the problems of transfer pricing will be resolved. This will no doubt be covered up by further revisions to the TPGs, using language which may be approved by consensus, but conceals continuing differences. This particularly disadvantages smaller countries which lack the resources to develop convincing technical arguments to justify a preferred interpretation. It also leaves smaller and middle-sized MNEs that might not have the resources to invest in comprehensive functional analyses at increased risk. Overall,

[1] This is shown in detail in the most authoritative account of the BEPS project outcomes on transfer pricing to date, by J. Andrus and R. Collier, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017. They trace in detail how the TPGs have been made more complex and unclear on the key points: (i) the notion of control of risk ('very complex', para. 6.35; 'most confusing' para. 7.32; imposing 'only limited burdens on MNEs desiring to transfer risk to tax advantaged locations' para. 7.13, and leaving 'clear potential for heated disagreement' para. 7.16); (ii) the returns which can be attributed to a cash-box entity ('quite mysterious' para. 6.46, 'most confusing' para. 7.32, will 'give rise to substantial amounts of controversy' para. 7.31, and leaving 'a rather confused muddle, at least for now' para. 7.42); and (iii) how to allocate the difference between projected and actual returns from an intangible ('far from clear, para. 7.56, 'manifestly inadequate' para. 7.58). They conclude that the result has been to make the transfer pricing process 'far more complex' (para. 7.70), mostly due to the 'level of factual detail' now required for the functional analysis (para. 7.71).

however, no-one (save the army of transfer pricing consultants) gains from the ad hoc and subjective rules resulting from the transactional approach to the TPGs, which foment confusion and conflict.

Tax advisers are as much to blame for this as the government representatives on WP 6. While business pleads for simpler rules to provide certainty, a large majority of tax advisers continue to defend fundamentalist interpretations of the ALP, which lead to increasingly confused and complex elaborations of the TPGs.

SPECIFIC COMMENTS

The present chapter VII is built on unsound foundations. It begins by using language referring to charging of costs, which seems to accept that these are joint costs or overheads to be apportioned. However, the discussion is based on the independent entity fiction, and attempts to identify the charge 'which would have been made and accepted between independent enterprises in comparable circumstances' (TPGs 2017, para. 7.19). Section B.2 dealing with determining the charge begins by suggesting that a direct charge method is preferable, but quickly accepts that this 'may not always be appropriate'. This is hardly surprising, since it will be inherently impossible to identify a truly comparable price from an independent supplier for services which a MNE has decided should be performed internally. Hence, it suggests that 'indirect charge methods' should be allowed, in plain words 'apportionment'. Yet the discussion of calculation of the compensation in Section B.2.3 reverts to pricing based on the transactional approach in chapters I, II and III of the Guidelines. The incoherence of the approach is starkly revealed in the discussion section B.2.3.2 of whether a profit element can be included. While it makes sense to apportion joint costs, the notion of adding a profit element adds to the confusion created by the transactional approach. To avoid both this incoherence and confusion, we strongly suggest that the profit element concept for these intra-group be completely eliminated from Chapter VII

In our view, it makes no sense to consider the allocation of costs separately from the method used to attribute profit. The most commonly used methods under the current approach are one-sided methods (cost plus, resale minus, or TNMM), since it is rarely possible to identify a true CUP. These methods are based on functional analysis, under which MNEs generally endeavour to characterise affiliates as limited risk' producers or distributors. Where profits have been determined on such a basis, it does not seem appropriate to make charges to an affiliate deducting a proportion of costs incurred elsewhere from profits calculated on the basis of costs prior to such a deduction. Where an affiliate's profits have been determined on such a basis, it is simply not appropriate to make any additional intra-group charges against that affiliate. We suggest that Chapter VII be amended to reflect this.