BEPS MONITORING GROUP

Comments on BEPS Actions 8, 9, and 10: Revisions to Chapter I of Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures)

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations 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. This paper has not been approved in advance by these organizations, 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.

This paper has been prepared by Jeffery Kadet and Sol Picciotto, with comments and input from Veronica Grondona, Attiya Waris and Yansheng Zhu.

We are grateful for the opportunity to contribute these comments, and would be happy to participate in the public consultation on this issue.

SUMMARY

We applaud this discussion draft (DD) as an attempt to reconsider the basic approach, which has too long dominated transfer pricing regulation, that taxation of a multinational corporate group must treat its various component parts as if they were independent entities and focus on the pricing of transactions between them. This independent entity assumption runs totally counter to the current reality existing within these centrally-managed groups, and produces a system which is terribly subjective, often very discretionary, and impossibly difficult to administer.

To examine the details of intra-firm transactions, this independent entity assumption requires tax administrations to use specialist staff, normally in short supply in developed countries and often non-existent in developing countries, with legal expertise in complex structures and transactions, economic analysis capabilities, and specific knowledge of the characteristics of each business sector.

Despite this willingness to reconsider the basic approach, the draft still clings to that mistaken independent entity assumption by continuing to require that inter-affiliate transactions should be the starting point. These transactions are then evaluated in terms of the functions performed, assets owned and risks assumed by the affiliated entities, and the draft attempts to analyse these three factors: Functions-Assets-Risks (F-A-R), especially Risks. The draft rightly recognizes that in an integrated multinational corporate group 'the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control'. We cannot agree more with this, since the greater competitiveness and generally higher profits of a corporate group operating in an integrated way derives from the benefits of synergy, so that the whole is greater than the sum of its parts. It is generally difficult or impossible to decide what proportion of the total profits to attribute to particular F-A-Rs within the various group members, especially when central control allows a multinational to transfer at its sole discretion intangible assets, functions, and risks amongst group members solely for purposes of tax minimisation.

Hence, we agree with the analyses in the draft, for example that concerning 'moral hazard', which suggests that a contract between associated enterprises in which one party contractually assumes a risk without the ability to manage the behaviour of the party creating its risk exposure is clearly a sham. Following the approach of the DD, this means that non-recognition or other adjustments must be made to appropriately interpret the actual

transaction as accurately delineated. Our preferred approach, however, is to begin from the assumption that contracts between associated enterprises cannot be likened to market transactions between independent parties, for that very reason, so that the starting point should be an assumption that contracts between related entities should be disregarded.

Our preference, as we have urged in our separate comments on another report, is that the profit split method should be regularized and systematized, by clarifying the methodology for defining the aggregate tax base to be split, and specifying definite concrete and easily determinable objective allocation keys for all commonly used business models, also including the principles for choosing such keys for new business models as they appear in the future.

Part II proposes some 'special measures' which could be applied in defined 'exceptional circumstances', which in effect attempt to deal with some of the gaping wounds of the current transfer pricing system. We generally support these as at least an improvement on current formulations: particularly Option 1 (Hard to Value Intangibles); Option 2, first variant (Independent Investor); and Option 4 (Minimum Functional Entity). While we support Option 3 (Thick Capitalisation), in our view it must not form part of the Transfer Pricing Guidelines but belongs in the rules on Controlled Foreign Corporations, which are being separately considered. We detail strong reasons for this view.

We consider that there is merit in the concept of Option 5 (Ensuring appropriate taxation of excess returns), but as presently described it would be counter-productive and only continue to encourage BEPS behaviour, particularly if x% (the defined 'low-tax rate') is below the general corporate tax rate in the home country and is both the trigger for application of the CFC rule and the rate of tax to be applied under the CFC rule in the home country of the MNE. We propose that the trigger for applying this Option 5 should be an average effective rate of tax defined as a percentage that is very close to the general corporate tax rate in the home country. In particular, we recommend that it be no less than 95% of that home country rate.

Overall, these amendments to the Transfer Pricing Guidelines, although extensive, would for that very reason make them even more complex, subjective, and, for the most part, impossible for most countries' tax authorities to administer. These and other drawbacks mean that the overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair. In the immediate term, we therefore strongly urge a clear shift towards a systematised and regularised application of the Profit Split method. A next step is a fundamental reappraisal of the Guidelines, and a complete rewriting especially of chapter 1. It should begin by a reversal of the independent entity assumption and an acceptance of the principle that each multinational corporate group must be considered according to the business reality that it operates as an integrated firm under central direction.

1. GENERAL REMARKS

A. The Basic assumption

1. These proposals represent a long-overdue reconsideration of some of the foundations of the Transfer Pricing Guidelines. Part 1 proposes some considerable rewriting of chapter 1 of those Guidelines, while Part 2 puts forward some options for additional 'special measures' which at this stage are only broadly outlined. These proposals result from a realisation that the relations between related entities within a multinational corporate group are fundamentally different from those of unrelated firms in market transactions. There is and can be no 'market' in the normal sense within a business firm under common ownership or control, since the central characteristic of such firms is that their activities are coordinated

and directed by central management. Certainly, different functions and activities will be assigned to various entities under their own management teams, whose performance will be incentivised and evaluated. However, such administrative systems are quite different from market mechanisms, since they are designed to ensure that the parts contribute to the greater good of the whole.

2. Unfortunately, the Transfer Pricing Guidelines start from the opposite assumption, based on what we believe is a misunderstanding of article 9 of the model tax treaty. This provision, dating from 1935, allows national tax authorities to adjust the profits of associated entities if 'conditions are made or imposed' between them which 'differ from those which would be made between independent enterprises'. However, the Guidelines (para. 1.6) mistakenly assert that this provision requires that **the profits be adjusted** 'by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances' – the famous 'arm's length principle'[1]. This suggests a focus on comparing the pricing of transactions between related enterprises with those in unrelated party contracts which is not required by article 9. They continue by saying that this means that 'attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions'. This approach requires a detailed analysis of the nature of the activities of the relevant parts of an integrated corporate group and the relations between them, before any conclusion can be reached about whether and how they differ from those between unrelated parties engaged in similar activities and transactions. In our view this is mistaken, unnecessary and undesirable. Instead this should be reversed. **The presumption must be that transactions between associated enterprises are irrelevant since they are never negotiated between independent entities dealing at arm's length**. The focus should directly be on the profit attributed to the local entity in relation to its activities, in comparison with those of the whole firm of which it is part.

3. The current discussion draft (DD) is essentially concerned with attempting to remedy the defects resulting from this mistaken assumption. However, it leaves untouched the first three sections of Chapter 1, which state and firmly entrench the assumption. Part 1 of the DD then proposes a rewrite only of section D. The result is to make the Guidelines contradictory and incoherent. Tax authorities are expected to begin by respecting the assumption that related entities should act as if they were independent, but then to challenge that assumption by investigating the actual facts and circumstances to understand the reality, in each and every individual case. Worse, the focus on transactions dictates that the starting point should be the contracts between affiliates (DD para. 3), but these must be 'clarified and supplemented' by identifying the 'actual commercial or financial relations' (para. 4).

---

[1] Article 9 can be interpreted to imply the arm's length principle, but this is not its literal meaning. Nor could such an interpretation have been intended when it was drafted, since it resulted from the well-known Carroll report for the League of Nations, which extensively examined national practices. Carroll found that where national tax authorities were dissatisfied by the level of profit reported by a local branch or subsidiary, they evaluated the profits by comparison with those of similar but independent local firms, or by considering the relative profits and costs of the affiliate and its parent. Thus, the focus was on the level of profit, and not on the pricing of inter-affiliate transactions on a transaction-by-transaction basis. The adjustment of such inter-affiliate transaction prices was simply the means of reaching what could be considered an appropriate level of profit. Furthermore, Carroll found that in a substantial proportion of cases tax authorities used 'empirical methods', consisting of applying a 'normal' rate of profit to an appropriate factor (e.g. turnover). Others (e.g. Spain) preferred 'fractional apportionment', on the grounds that this dispensed with time-consuming and intrusive audits, the substitution of often arbitrary figures, and taxation on the basis of largely imaginary accounts.

4. Applying this approach, a tax authority must choose either to accept the accounts and profits declared by the company concerned, or to embark on a detailed 'facts and circumstances' analysis. The focus of such an analysis is now understood to be the functions performed, assets employed and risks assumed by each entity. This focus on 'functions, assets and risks' (F-A-R) features at various points in the existing Guidelines, and was given more prominence in the proposed rewriting of chapter VI on Intangibles (see especially proposed section B2 (shaded) of proposed *Amendments to Chapter VI* released in September 2014). One would have expected to find clear statements of these three concepts in this proposed revision of Chapter 1. Instead, we find uncertainty and doubt. For **functions**, proposed Section D.1.1 begins by explaining the need for functional analysis, but then points out that:

> 'an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialisation, secure in the knowledge that the fragmented activities are under common control for the long term and are co-ordinated by group management functions.' (para. 21).

In other words, separation of functions within an integrated firm is fundamentally different from functional specialisation developed by independent firms in competition. This essentially reverses the basic assumption of 'independent entity'. For **property**, Section D.1.2 simply incorporates unchanged three existing paragraphs, which discuss the many characteristics which may make a material difference to the nature of an asset or service when deployed in an integrated firm. As regards **risk**, a substantially new Section D2 is proposed. On this, the DD asks a number of questions, focusing on 'the extent to which associated enterprises can be assumed to have different risk preferences while they may also in fact be acting collaboratively in a common undertaking under common control' (Box p.13). This suggests that there are fundamental doubts about the stated assumption, which indeed we share. These doubts will be elaborated in our response to those questions in section 2 of these comments. First we will make some further comments about the unsuitability of the underlying approach.

B. Unsuitability of 'facts and circumstances' analysis of functions, assets and risks

5. The drawbacks of the approach proposed should be self-evident. Firstly, the principles are muddied with on the one hand continued adherence to the separate entity principle, but on the other hand the recognition in many parts of this DD and others, that a holistic approach is needed to deal effectively with multinationals. This, of course, reflects their total freedom within our legal and tax environment to structure themselves through multiple entities with contractual relations and capital structures designed to minimize taxation. Consequently, virtually every multinational situation requires a time-consuming and highly subjective case-by-case ad hoc analysis. Such analyses are intrusive, and require detailed audits of the internal workings of complex businesses, based on detailed documentation and reviews of physical operations including product flows and what personnel are actually doing, which may be different from the relevant documentation. Although referred to as a 'comparability analysis', a more accurate term would be 'non-comparability analysis', since the inappropriate nature of the separate entity approach explained above will inevitably mean that, on close examination, relationships within a corporate group are not truly comparable to those between independent entities. The present DD indeed provides considerable new material discussing factors and considerations which it quite rightly points out mean that the formal legal structures of separate entities and contracts do not reflect the business reality. Para. 85 illustrates this eloquently by noting, in part:

> … the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.

This makes it hard to understand why the draft continues to maintain that the starting point for the analysis should be those structures and contracts.

6. Secondly, this is an incalculable waste of human talent and resources. The approach is a significant cause of the exponential growth in the past two decades of the tax departments of large multinationals, not to speak of the legions employed by the major accounting, law, and other tax advisory firms also involved. If the firm's advisers produce the detailed explanations and documentation of the way the business has been structured, the tax authority must decide whether to accept or challenge them. A challenge requires resource-constrained tax authorities to apply equally enormous resources involving both legal and business specialist knowledge of potentially a very wide range of businesses. This is daunting for any state, but it is of course a special challenge for developing countries, which can ill afford to devote the sophisticated specialist personnel and other resources needed to operate this highly subjective and nuanced methodology. Even the United States Internal Revenue Service was recently reported to have hired outside consultants at a cost in the millions of dollars to work on a transfer pricing audit of a major U.S.-based multinational corporation. The changes proposed in this DD will add to the complexity and sophistication of the analysis required, which will exacerbate this problem. The new section D.2 on risk alone will add forty paragraphs covering ten pages, containing sophisticated discussion of the nature of various kinds of business risk, to be taken into account by tax officials. The new draft chapter 6 on Intangibles, which still awaits further revisions, and uses the same F-A-R approach, is also extensive and complex.

7. Thirdly, consideration of business reality also demonstrates the unreliability and unsuitability of attributing profits to entities based on the functions performed, assets owned and risks assumed. The greater competitiveness and generally higher profits of a corporate group operating in an integrated way derives from the benefits of synergy, so that the whole is greater than the sum of its parts. Hence, if analysis of functions, assets and risks is used to attribute a 'comparable' profit to each of the parts, it will fail to capture all the profits, leaving some residual profit, often very substantial, in a low-taxed group member specifically structured by the multinational for this purpose. Take for example internet-based retailing by a multinational which operates websites aimed at customers in many countries in the local language, as well as order fulfilment and customer support, all through different affiliates. Customers are attracted by the combination of these functions: ease of purchase through a well-functioning website backed by customer support and data-mining of customers and their preferences, combined with rapid delivery from the locally-based distribution network. Another example is the pharmaceutical industry, which combines laboratory research, drug development including trials and approval, and extensive marketing efforts. Profitability largely depends on the successful integration of these functions, and cannot appropriately be attributed to one or another.

8. Finally, as noted above, the ad hoc analysis is inevitably terribly subjective. This makes it highly prone to generate conflicts, both between tax authorities and taxpayers, and among tax authorities when conflicts reach the MAP stage or in APA negotiations. This has indeed led to a rapid growth of international tax disputes, especially relating to transfer pricing, referred to tribunals in some countries, notably India. However, these court decisions are also ad hoc

and have not facilitated predictable and stable outcomes; by nature the decisions are based on specific factual situations such that there will seldom be any useful precedential value. Where a publicly disclosed court case is not involved, conflicts are usually dealt with by a relatively closed group of participants, who can develop shared understandings of what is acceptable, sometimes described as 'cooperative compliance'. This places great pressure on the professionalism and probity of public servants, especially given the great imbalance of resources between tax authorities and large multinationals. It also lacks legitimacy, as shown by the widespread public concern about suspected 'sweetheart deals' resulting from discretionary rulings taken in secret. We only have to note the recent Luxembourg leaks scandal to understand the extent that multinationals have made use of such rulings.

9. **These drawbacks of the proposed system mean that the overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair.** This has been made very clear by developing countries in their feedback on the BEPS project. Some countries have developed their own more simplified systems, such as the Brazilian fixed margin method, or the 'Sixth Method' for commodity pricing (now the subject of another report in the BEPS project). Indeed, some of the other reports being produced in the BEPS project have now proposed simplified methods. Unsurprisingly to us, these are based on the recognition that in business terms a multinational corporate group operates as a unified firm. Thus, a 'simplified method' for apportionment of charges for central services has been proposed, although this is understandably limited to low-value-added services, since other such charges can be used for profit-stripping. A more comprehensive approach has also been proposed for apportionment of interest costs, which we consider could be an enormous step forward in dealing with this intractable problem in a relatively simple manner. These several instances deal with apportionment of consolidated costs, which is perhaps easier to accept, especially for the home countries of multinationals, than apportionment of profits. Proposals have nevertheless also been put forward for developing the Profit Split method and expanding its use. However, these are so far cautious and limited, apparently intended only for special cases. As we have urged in our separate comments on that report, the profit split method should be regularized and systematized, by clarifying the methodology for defining the aggregate tax base to be split, and specifying definite concrete and easily determinable objective allocation keys for all commonly used business models, and including as well the principles for choosing such keys for new business models as they appear in the future.

10. For these reasons we can give only a very limited welcome to this report since, although it identifies many of the difficulties caused by the separate entity principle, it does not clearly articulate an alternative. In our view, what is needed is a fundamental reappraisal of the Guidelines, and a complete rewriting especially of chapter 1. It should begin by a reversal of the presumption and an acceptance of the principle that each multinational corporate group must be considered according to the business reality that it operates as an integrated firm under central direction.

2. SPECIFIC COMMENTS

Part 1 Questions

> *Under the arm's length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?*

We agree with and support the articulated concept of moral hazard and the point that contracts between unrelated parties aim to place risks in the hands of the parties that control

those risks. The DD rightly states that between associated enterprises 'the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other'. The reason given, that 'associated enterprises may act collaboratively in order to ensure that MNE group profits are maximised' is understated. Entities within an efficient and well functioning integrated MNE **must always** act collaboratively to maximize overall profits, and their managers are generally incentivized to do so. Hence, a contract between associated enterprises in which one party contractually assumes a risk without the ability to manage the behaviour of the party creating its risk exposure is clearly a sham. Following the approach of the DD, this means that non-recognition or other adjustments must be made to appropriately interpret the actual transaction as accurately delineated. Our preferred approach, however, is to begin from the assumption that contracts between associated enterprises cannot be likened to market transactions between independent parties, for that very reason.

Question 2

> *How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?*

This is clearly another good reason to doubt the validity of a purported transfer of risk in contracts between related entities. In our view it is pointless to begin by considering such contracts; they should simply be disregarded. If an approach based on analysis of functions, assets and risks is to be adopted, such an analysis should be applied directly to the activities of the entities concerned.

However, we also doubt the usefulness of attempting to attribute profits based on such an analysis of functions, assets and risks. This new section is replete with reasons to doubt the validity of any purported transfer of risks within an integrated MNE. Since associated enterprises always collaborate with the overriding objective of maximising total group profit, it should be assumed that any purported transfer of risk which carries an attribution of profit is designed for BEPS purposes.

This question points at simply one more reason why many more related party situations should be using the profit split method. In a separate comment letter responding to the *BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, we have strongly recommended the use of the profit split method applied with concrete and easily determinable objective allocation keys to allow all countries to better deal with BEPS issues and otherwise difficult transfer pricing problems. Firstly, this approach would be much easier to administer. Secondly, it is clear that any allocation of profits of a complicated corporate structure that results from a theoretically correct and complete assessment of functions, assets and risks will by its inherently subjective nature only result in a very wide range of possible profit allocations. The use of simple-to-apply concrete allocation keys that are appropriate for the particular business model used will result in profit allocations that will virtually always fall within this wide range. The reduction in BEPS behaviour, the ability of tax authorities in all countries to actually administer and collect taxes, and the reduction in conflicts will result in a much more robust and effective system.

We recommend:

- Where the discussion within the Guidelines dwells on highly subjective issues such as relative risk, the relative contributions of different intangibles, etc. (i.e, highly

subjective situations with no useable comparables available), that mention be made that a profit split method may be the most appropriate one to apply.

Question 3

In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm's length principle?

We agree that the moral hazard found within the example is a part of the reason why the discussion of the example in paragraph 91 concludes that the "sale and license back" transaction should not be recognized under the non-recognition rule. We applaud the recognition of "moral hazard" in the discussion draft as a possible indication that a transaction lacks the fundamental economic attributes of arrangements between unrelated parties. This is one more reason why, as we argue in section 1 above, the starting point should be an assumption that contracts between related entities should be disregarded.

Question 4

Under the arm's length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?

We believe that the answer is an emphatic "NO". Contractual risk shifting between associated enterprises is typically tax motivated and will often run counter to what unrelated enterprises would do.

MNEs have full control over their structuring. Paragraphs 85 – 87 summarize in excellent fashion the total freedom that MNEs possess within our legal and tax environment to structure themselves through multiple entities with contractual relations and capital structures fine tuned to minimize taxation within the jurisdictions within which they operate. The following brief summary is from paragraph 87:

> '…MNE groups can control the environment in which transactions occur, including the number of separate legal entities, their capital structures, legal ownership of assets, and contractual arrangements, and … the resulting transactions derive from the environment created by the MNE group…'

With this sort of freedom to fine tune the taxable position that they wish to present to each tax authority, there is no reason whatsoever to allow a contract to be recognized that simply shifts risk and that serves no purpose but to manage the profitability level of each group member.

Again, this is further evidence that our section 1 overall recommendation should be pursued.

Question 5

In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm's length principle?

On a combined basis, which is economic reality and not the independent treatment under the arm's length hypothesis, there is no altering of risk; only some increased expenses due to some duplication of costs.

Viewing each subsidiary S1 and S2 separately, we believe that the description of the effects on relative risk factors as explained in paragraph 91 is an excellent summary. We have nothing further to add.

Question 6

> *In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm's length principle?*

Let's discuss this briefly through an example.

Assume that X, resident in country A, manufactures a product in country A and sells that product around the world. Due to increased demand in Asia that cannot be met by the limited capacity of X's manufacturing facilities in country A, X conducts significant research of possible sites for a green field manufacturing facility within Asia. After deciding on a specific site in country B, X establishes Y as a wholly owned subsidiary resident in country B to acquire the site and construct a new facility using X's manufacturing processes and procedures that will manufacture the product using all of X's relevant intellectual property. X will train Y's personnel and oversee and control all aspects of Y's manufacturing operations. Sales, whether of product manufactured by X or by Y, will be made through the same independent distributors that have previously served X. All sales as well as the network of independent distributors will continue to be controlled and managed by X personnel.

In this example, X will continue its historical control and management of its business. The addition of Y is adding to product capacity.

From a perspective of risk-return trade-off implications, X's intellectual property is being used and X is managing and controlling virtually all elements of risk. Irrespective of how X and Y's contractual relations are structured (whether through a license of intellectual property, a contract manufacturing service agreement, etc.), it is clear that X should receive a return that is related to the significant risks it is managing and controlling. Y, with the few risks it is responsible for, should receive a return that is relatively lower.

In this example of X and Y, the risk-return balance follows the activities of the two enterprises.

In the example of S1 and S2, there is no conformity of responsibility and contractual risk. There is a complete mismatch. Further, as explained in paragraph 92:

> "The scenario set out in this example suggests that the transaction lacks the fundamental economic attributes of arrangements between unrelated parties; the arrangement does not enhance or protect the commercial or financial position of Company S1 nor of Company S2."

The heart of this conclusion is based on this mismatch since independent parties would simply not act in this manner. As such, in response to this Question 6, "how should risk-return trade-off implications be taken into account under the arm's length principle", our response is that they should not be respected unless they are supported by an appropriate factual situation such as that described in the above X/Y example.

The specialist legal and business knowledge, effort, and resources required for a tax authority to analyse group members to truly understand their actual operations and how they compare to their contractual relationships means that MNEs may be comfortable that there will be few tax audits of sufficient depth to uncover situations such as described in this Question 6. Again, we suggest that our section 1 overall recommendation should be seriously pursued.

Question 7

> *Under the arm's length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk?*

Consistent with our response to Question 6, any transaction that shifts risk to an associated enterprise without also transferring the actual management and control of that risk should not be respected for transfer pricing purposes. Having said this, we have not responded to sub-questions 7 a) and b).

Question 8

> *Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?*

Yes, the general discussion of risk does apply to financial services activities. Considering the fact that financial industry MNEs and financial management within non-financial sector MNEs are among the most serious BEPS players with their many financial machinations and common use of tax havens, the concepts discussed in this discussion draft should apply fully to them. There should be no distinctions made.

Part I Other Comments

Part I, Paragraph 82

> 'However, in exceptional circumstances the transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties, with the result that the transaction is not recognised for transfer pricing purposes.'

The BEPS process generally and the Luxembourg leaks revelations in particular have shown that major tax avoidance by many if not most MNEs has been occurring through distortion of the separate entity principle. With the general need under the Guidelines for each situation to be judged on its own facts and circumstances, it is inappropriate and misleading to include in paragraph 82 language that suggests that structures 'lacking the fundamental economic attributes of arrangements between unrelated parties' will only be found in 'exceptional circumstances'. As such, this language about 'exceptional circumstances' should be deleted in favour of more neutral language that focuses on a taxpayer's actual conduct. We suggest that this sentence be amended to read as follows:

> Where it is found that a transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties, then that transaction will not be recognised for transfer pricing purposes.

PART II POTENTIAL SPECIAL MEASURES

Part II, Paragraph 6

> 'It should also not be assumed that, if special measures are introduced that go beyond the arm's length principle, double taxation may result. The main aim of these special measures is to create transfer pricing outcomes in line with value creation and to limit BEPS risks for governments. It is recognised that consideration needs to be given to the way in which these special measures will be part of the global transfer pricing standards and the way in which double taxation will be prevented.'

We suggest that when future discussion drafts on these options are released that the language make clear that while the intent is to avoid instances of double taxation, actual instances of double taxation will likely arise only where MNE groups have engaged in aggressive BEPS planning and structuring. Such planning and structuring will have created the mismatches of value creation and transfer pricing outcomes that these Part II options are meant to overcome.

As such, if an MNE group is subjected to some level of double taxation in the future, it will very likely be the self-created BEPS structure that is to blame. MNE groups will have to live with this risk if they persist in creating such structures.

Option 1 – Hard-to-Value Intangibles

We believe that Option 1 is a necessary addition to the Transfer Pricing Guidelines.

The discussion draft lists two circumstances: (i) lump sum or fixed royalty rate without any contingent payment mechanism, and (ii) no contemporaneous documentation of projections made available to tax authorities. Although this might not be the intention of Working Party 6 and the OECD Committee on Fiscal Affairs, but as presently drafted, Option 1 would only be effective in situations where **both** of these two circumstances exist.

Option 1 should be effective in all situations where **either of these two circumstances exist** since either circumstance is clear evidence of potential serious BEPS behavior. The word "and" that now connects the two circumstances must be changed to "or". Future drafted language that would be added to the Transfer Pricing Guidelines to reflect this Option 1 must include the word "or" to make this clear.

Part II, Option 2 – Independent Investor

We believe that Option 2 is a necessary addition to the Transfer Pricing Guidelines.

Of the two approaches listed in Option 2, the much better approach is the first, under which the capital would be deemed to have been contributed to the company providing the more rational investment opportunity with the result that it directly owns the asset. This approach is significantly better than the second approach, which would place ownership of the asset in the parent company.

Reasons for our belief include:

> Consistency with actual conduct of the parties. In situations where Option 2 is relevant, the real operating company is conducting business and is managing risks concerning the investment. Treating it as the owner most closely aligns actual functions and activities concerning the asset with ownership of the asset for tax purposes.
>
> Simplicity of administration. To place the parent company in the shoes of the capital-rich, asset-owning company is merely changing the players and is not eliminating in any way the terribly subjective transfer pricing problem. Under the second approach, there is still the need to calculate a risk-adjusted rate of return on the funding that the parent company is making under the re-characterization of this second approach. Under the first approach, there is simply no transfer pricing issue since the asset is considered to be owned by the company that is developing, using, and protecting it.
>
> Discouraging BEPS behaviour. Under the first approach, no return would be attributed to either the capital-rich, asset-owning company or the parent company that orchestrated the BEPS structure. This is the best approach since multinationals will be discouraged from conducting BEPS structuring, where clearly articulated consequences show that their time and expense to create such structuring will be wasted.

Option 3 – Thick capitalisation

We believe that Option 3 is a necessary addition to the BEPS deliverables and should be an important component of the recommendations to be made concerning CFC rules.

We believe that Option 3 is not in any way an appropriate addition to the Transfer Pricing Guidelines, which would require a corresponding adjustment to record interest expense on the books of the capital-rich company. We believe this for the following reasons:

> Where a capital-rich company is located in a low-tax or zero-tax country, the interest deduction will have little or no effect.
>
> Where a capital-rich company is located in a country where it conducts real operations, then there will be a lowering of that country's tax base that reflects conditions and factors occurring outside that country and over which that country's tax authorities have generally neither knowledge nor control. Further, requiring recognition of interest expense and the attendant analysis of and agreement by the local tax authorities with the interest computation made by the tax authorities of another country is the exact opposite of simplification.
>
> MNEs that structure thickly capitalized subsidiaries with BEPS objectives must be penalized for doing so. To grant them the benefit of an interest deduction within the capital-rich company is reducing their cost of paying increased taxes to their home country at the expense of the capital-rich company host country. MNEs will only discontinue BEPS activities if they are effectively penalized for doing so. They must pay the relevant taxes that accrue under the BEPS structures they have created. Yes, there will be some double taxation. And this is appropriate and necessary to make MNEs curtail their BEPS structuring.

Regarding the approach to determine the level of thick-capitalization, simplicity and reality strongly suggest using either the debt-equity ratio reflected on the MNE's consolidated financial statements or whatever "best practices" approach is eventually determined under BEPS Action 4 concerning interest deductions and other financial payments. Whichever is used should be readily available and will reflect actual borrowings from unrelated lenders. Only where there are peculiar situations such as regulatory requirements or non-recourse lending covering specific assets should there be potential adjustments to this approach.

Option 4 – Minimal functional entity

We believe that Option 4 is a necessary addition to the Transfer Pricing Guidelines.

We agree that minimal functional entities should be those entities that fail to meet either the qualitative test or the quantitative test. It would not be necessary for a tax authority to demonstrate that an entity meets both tests. Further, especially given the tax authority's limited resources and knowledge and the entity's extensive existing knowledge of itself (as well as the knowledge of the MNE group of which the entity is a part), the burden of proof should be on the entity to establish that it does not meet either test where a tax authority has raised this issue.

Regarding options for reallocation of a minimal functional entity's profits, we believe that the first approach using the profit split method would be best if the Transfer Pricing Guidelines, as finalized after all BEPS efforts this coming year, include clear and administrable approaches to applying the profit split method. Elsewhere, we have made comments on the profit split method discussion draft and encourage expansion of its use. Clear direction to apply the profit shift method rules in the case of any minimal functional entity would harmonize and coordinate rules.

If for any reason this profit split method approach is not recommended in a future discussion draft, then we believe the next best approach is the third bullet point under which the minimal

functional entity's profits would be re-allocated to the one or more companies providing functional capacity.

The second bullet point under which the profits would be re-allocated to the parent (or some higher tier company) would be completely inappropriate since that would place the profits in a company other than the company or companies that in fact provide functional capacity and conduct the operations that earned the relevant profits. It would be the exact opposite of aligning taxation with value creation.

Option 5 – Ensuring appropriate taxation of excess returns

While the overall concept of Option 5 has merit, its terms as presently described are terribly counter-productive and will only encourage BEPS behavior. **It is absolutely counter-productive if x% is below the general corporate tax rate in the home country and is both the trigger for application of the CFC rule and the rate of tax to be applied under the CFC rule in the home country of the MNE on that income.** Where an MNE knows that profits shifted will ultimately be taxed at this lower x% rate instead of the higher home country corporate rate, it will be highly motivated to continue BEPS efforts.

We make the following points to transform Option 5 into an approach that will truly deal with BEPS behavior:

> We accept and agree that the trigger for applying this Option 5 should be a defined average effective rate of tax. However, this average effective rate of tax (x%) must be a percentage that is very close to the general corporate tax rate in the home country. While it would be best if x% were equal to the general corporate tax rate in the home country, we strongly suggest that x% be no lower than 95% of the general corporate tax rate in the home country. Any rate lower will be a strong motivation to MNEs to continue shifting profits.
>
> Where a CFC's average effective tax rate is below x% so that the CFC rule applies to currently tax the profits in the home country, then the tax rate to be applied under the CFC rule must be the home country's general corporate tax rate. If it is any lower, then there will be strong motivation to MNEs to continue shifting profits.
>
> We recognize that there will be situations where current taxation under the CFC rule at the level of the parent may present a hardship. In such cases, it is reasonable to provide for deferred payment of the taxes due, but there must be a reasonable interest rate charged for any period of deferral.
>
> We agree that there should be a foreign tax credit allowed for any foreign taxes paid on the profits currently subject to tax in the hands of the parent company under the CFC rule.
>
> For both simplicity and the prevention of profit shifting, we strongly recommend that there be no inclusion in the CFC rule of an 'excess returns' concept. Rather, there should only be a carve-out for local income from sales or services to unrelated persons for ultimate use or consumption in the CFC's country of tax residence.
>
> We wholeheartedly agree with the inclusion of a secondary rule. We recommend the following approach for overall consistency with the separate entity concept, good transfer pricing principles, and simplicity. The CFC and all relevant associated enterprises should apply the profit split method to apportion the CFC and the other enterprises' profits amongst themselves. If the CFC has legitimate operations, then it will be treated as earning an appropriate profit. If its operations are very limited, then most or all of its profits will be considered the profits of the associated enterprises.

Elsewhere, we have made comments on the profit split method discussion draft and encourage expansion of its use. Clear direction to apply the profit shift method rules in this secondary rule procedure will harmonize and coordinate rules.

Part II, Other Comments Concerning Options

The following additional comments are made to respond to certain of the questions included in the Discussion Draft on pages 39 and 40 in the box labelled "Framework for questions on all options".

Question 7

In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?

Overall Comment

Local country rules and judicial concepts that allow legal entities and transactions to be disregarded or re-characterized to reflect the true nature of enterprises and their activities must be applied first. Then, transfer pricing, CFC, and other relevant rules would be applied by each relevant local country. Where two or more countries recognize or disregard enterprises and their transactions in differing manners, the MAP process would be used to avoid double taxation where appropriate.

Options 1 – 4

No comments

Option 5

Under normal circumstances, the home country of the MNE would apply transfer pricing rules first in determining the profits that are earned by the CFC. Then it would apply its CFC rules. However, in this situation where the CFC is seen to be earning amounts of profits that are higher than its activities and assets merit, it would be appropriate to simply apply the CFC rules if application of the transfer pricing rules would reduce the amount of profits subject to the CFC rule. In this way, MNEs would be effectively penalized for any aggressive BEPS planning and structuring.

Question 8

Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?

Overall Comment

The answer is "No". There should be no automatically operating mechanisms for eliminating double taxation that has been caused by the positive BEPS planning and structuring conducted by MNEs. If there are any such mechanisms to eliminate double taxation that cause MNEs to be no worse off than if they'd done no such planning in the first place, they will have full motivation to continue BEPS planning and structuring. MNE groups will only act conservatively if they might end up worse off than they would be had they conducted no BEPS planning and structuring. Only in this way will there be a real behavioural change that will curtail BEPS efforts.

We can imagine that there may be cases where an MNE's legitimate non-tax motivated structuring is caught by certain BEPS measures. If local countries wish to provide on an exception basis discretionary relief to such cases though the MAP process, then that would be

appropriate. However, there must be no automatically operating mechanisms; that will only encourage BEPS behaviour to continue.