The OECD releases the 2017 Revision of its Transfer Pricing Guidelines

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On 11 July 2017, the OECD released the 2017 Revision of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"). Several chapters of the OECD Guidelines have been significantly amended as a result of the OECD's work on the Base Erosion and Profit Shifting ("BEPS") Project. This article provides a clear and concise overview of the most important changes of the OECD Guidelines.

I. Introduction

The OECD Transfer Pricing Guidelines reflect the consensus of OECD member countries towards the application of the arm's length principle as provided in Article 9 (1) of the OECD Model Tax Convention. The arm's length principle is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations.

The arm's length principle requires that, for tax purposes, the terms and conditions agreed to between related parties in their commercial or financial relations should correspond to those that one would have expected in transactions between unrelated parties. When the terms and conditions agreed upon in controlled transactions differ from the arm's length standard, tax administrations may, for tax purposes, perform transfer pricing adjustments.

When the OECD launched the BEPS Project in 2013, the OECD considered transfer pricing as one of the key pressure areas in international taxation. Notably, 4 of the 15 Actions of the BEPS Action Plan focused on transfer pricing and related documentation requirements:
- Action 8 focusing on intangibles,
- Action 9 focusing on risk and capital,
- Action 10 focusing on other high risk transactions, and
- Action 13 focusing on transfer pricing documentation.

The ultimate purpose of the work of the OECD was to ensure that transfer pricing outcomes are in line with "value creation". The 2017 Revision of the OECD Guidelines reflects the wording provided in the Final Report to Actions 8 – 10 (Aligning Transfer Pricing Outcome with Value Creation) and the Final Report on Action 13 (Transfer Pricing Documentation) released in October 2015.

II. Arm's length principle (Chapter I)

1. Contractual terms vs. actual conduct

As a rule, the accurate delineation of the actual transaction is based on an analysis of the written contracts and the actual conduct of the parties. When there is a discrepancy between the written contracts and the actual conduct of the parties, the actual transaction should be delineated in accordance with the conduct of the parties.[1] While this principle was already applicable under the previous version of the OECD Guidelines, the new guidance states several times that contractual provisions may not be relied on to identify ("delineate") the transaction or define the functions, assets and risks assumed by the related parties involved in a transaction. This seems to suggest that taxpayers and tax authorities should scrutinise every nuance of the intercompany relationship. The proposed guidance may likely be used by some tax authorities (i) to frustrate even ordinary, routine transfer pricing exercises, (ii) to induce a more extensive use of profit splits and (iii) to expand the circumstances in which the transactions may be disregarded or re-characterised.

2. Identifying risks in controlled transactions

The guidance provided in Chapter I, Section D ("Guidance for applying the arm's length principle") of the OECD Guidelines has been significantly extended and amended as a result of the work performed by the OECD under Action 9 of the BEPS Project. The objective of Action 9 was to tackle contractual risk allocations that lack commercial rationality of uncontrolled transactions.

In this regard, new guidance included in the OECD Guidelines requires that transactions be appropriately delineated so that the transfer pricing outcome is consistent with each entity's contribution to value creation. However, while the aim sounds plausible, the new guidance creates severe uncertainty and seems in parts even to deviate from the arm's length principle. The OECD Guidelines emphasise the importance of the examination of risks within the functional analysis.[2] The assumption of risks significantly influences the prices and other conditions between the associated enterprises. However, practical experience shows that analysing risk in relation to controlled transactions is more intricate than analysing functions and assets.

Typically, in the open market, the assumption of increased risk should also be compensated for by an increase in the expected or anticipated return, although the actual return may or may not increase depending on the degree to which the risks are realized.[3] Hence, tax authorities cannot expect a taxpayer that assumes a higher risk to earn higher returns in a scenario in which the risk has materialised and negatively affected the income situation of the taxpayer.[4]

The 2017 Revision of the OECD Guidelines provides significant guidance on the examination of risk within the functional analysis. However, it is explicitly stated that the detailed guidance in relation to the analysis of risks as part of the functional analysis (covering functions, assets and risks) should not be interpreted as indicating that risks are more important than functions or assets. Instead, the detailed guidance on risks is an indication for the practical difficulties presented by risks.[5]

3. Non-Recognition of the accurately delineated transaction

While the accurately delineated transaction should generally be considered for transfer pricing purposes, the OECD Guidelines provides guidance as to when a tax administration may, in exceptional circumstances, disregard the accurately delineated transaction. The OECD is conscious of the high likelihood of double taxation in case of non-recognition and the adverse consequences for international trade and business that go with it. Therefore, the OECD Guidelines emphasise that the actual transaction should be recognized and must not be substituted by other transactions in the transfer pricing analysis unless exceptional circumstances apply.[6]

Tax administrations should use every effort to determine pricing for the actual transaction as accurately delineated under the arm's length principle.[7] In this regard, it is explicitly stated that non-recognition should not be used simply because determining the arm's length price is difficult.[8] Evidently, non-recognition will not apply in case of transactions that can also be found between independent parties. Nevertheless, MNEs have the ability to enter, for sound business reasons, into a variety of transactions that cannot or hardly be found between independent parties. In this regard, the OECD Guidelines explicitly state that the mere fact that a controlled transaction may not be seen between independent parties does not as such mean that it should not be recognised.[9]

Non-recognition and replacement of a controlled transaction by an alternative transaction should only be considered by tax administrations when the transaction overall differs from what might be expected from independent enterprises behaving in a commercially rational manner. Hence, it needs to be established by the tax administration that the actual transaction prevents the determination of a price that would be acceptable to both parties to the controlled transaction, taking into account their respective perspectives and the options realistically available to each party at the time they enter into the controlled transaction.[10]

In light of the above, the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between third parties under comparable circumstances. In contrast, whether or not a controlled transaction can be found between unrelated parties is wholly irrelevant in this respect.[11] In case a controlled transaction is not recognized in accordance with OECD guidance, tax administrations should replace the actual transaction by a transaction that is as much as possible consistent with the facts and circumstances of the actual transaction while achieving a commercially rational expected result.[12]

III. Transfer pricing documentation (Chapter V)

Chapter V of the OECD Guidelines contains a revised standard for transfer pricing documentation which has been developed under the work on Action 13. According to the new guidance, multinational enterprises (MNEs) are requested to prepare a master file[13] regarding their global business operations and a local file[14] in each country. In addition, a template for country-by-country reporting (CbCR) is contained in the Annex to draft Chapter V. The new template requires MNEs to report their income, earnings, taxes paid and accrued as well as certain measures of economic activity (for example, employment, capital and tangible assets in each tax jurisdiction) to the tax administrations of the countries where they operate. It has been agreed to review the adequacy of the scope of the information required no later than the end of 2020. While it has been expressly stated that the compliance burden and costs to businesses should be limited, it will be extremely burdensome and costly to implement the new transfer documentation on a global basis. Moreover, although the declared purpose of the country-by-country reporting is to provide tax administrations with a risk management tool to better understand, control and tackle perceived BEPS behaviours, businesses may fear that tax administrations will use the information in order to selectively apply some kind of formulary apportionment where it appears to be more beneficial from a tax revenue perspective.

The simultaneous application of the arm's length principle and the formulary apportionment method would likely entail double taxation and long-lasting disputes with the tax administrations involved.[15] Last but not least, there is a risk relating to data protection and confidentiality when multinationals provide detailed and commercially sensitive information relating to their operations.

IV. Intangibles (Chapter VI)

Chapter VI of the OECD Guidelines provides guidance on the determination of arm's length conditions for transactions involving the use or transfer of intangibles. Chapter VI has been completely rewritten as part of the OECD's work on Action 8 and requires members of an MNE group to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation ("DEMPE" functions) of intangibles.

The guidance contained in this Chapter is intended to ensure that:
- Legal ownership of intangibles alone does not determine entitlement to returns from the exploitation of intangibles;
- Associated enterprises performing important value-creating functions related to DEMPE functions can expect appropriate remuneration;
- An associated enterprise assuming risk in relation to DEMPE functions must exercise control over the risks and have the financial capacity to assume the risks;
- An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, could generally only expect a risk-adjusted return on its funding;
- If the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return;
- The pricing of hard-to-value intangibles upon a transfer between associated enterprises has to be carefully analysed.

Overall, the new guidance seems to give tax administrations a lot of tools to challenge controlled transactions involving intangibles, resulting in massive legal uncertainty. Going forward MNE groups have to more than ever take care of how they develop and manage IP assets, giving attention to substance, operational management and commercial rationale.

V. Intra-group services (Chapter VII)

The new Chapter VII of the OECD Guidelines provides additional guidance on a particular category of intra-group services referred to as "low value-adding services" and proposes a simplified approach for the determination of arm's length charges, including a simplified benefits test.

Low value-adding intra-group services are particularly performed by a member of a group on behalf of one or more other group members where such services:
- are of a supportive nature;
- are not part of the core business of the group;
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk.[16]

According to the OECD guidance, a simplified charge mechanism can be applied in case of low value-adding services. The basic benefits of using the simplified approach are:
(i) A reduction of the compliance effort of meeting the benefits test[17] and in demonstrating arm's length charges;
(ii) Providing greater certainty for MNE groups that the price charged for the qualifying activities will be accepted by the tax administrations that have adopted the simplified approach when the conditions of the simplified approach mentioned in paragraph 7.45 of the new Chapter VII have been met; and
(iii) Providing tax administrations with targeted documentation enabling efficient review of compliance risks.

The simplified charge method for low value-adding intra-group service costs is to allocate among members of the group the costs in the cost pool that benefit multiple members of the group. The taxpayer will select one or more allocation keys to apply for this purpose which are appropriate for the nature of the services.[18] According to Section 7.61 of the OECD Guidelines (as amended), service providers should generally apply a profit mark-up of 5% on their costs in relation to the rendering of low value-added services. Notably, this profit mark-up of 5% does not need to be justified by a benchmarking study.

VI. Business restructuring (Chapter XI)

Chapter XI of the OECD Guidelines deals with the application of the arm's length principle in case of business restructuring. The guidance on non-recognition in case of business restructuring provided in Chapter XI of the OECD Guidelines has also been updated in the revised version of the OECD Guidelines in order to be consistent with the guidance provided in Chapter I (Arm's length principle). Accordingly, the commercial rationality of a transaction should be established considering the options realistically available to the parties at the moment they enter into a controlled transaction or business restructuring.

VII. Conclusion

The 2017 Revision of the OECD Guidelines follows the Final Reports on Actions 8 – 10 and 13 of the OECD BEPS Project, amending, extending and replacing previous guidance on the application of the arm's length principle. Unfortunately, some of the new guidance introduces additional room for subjectivity and challenges by tax administrations (options realistically available, reallocation of risks, non-recognition of the accurately delineated transaction, etc.) which creates additional uncertainty for taxpayers and may lead to increased controversy between taxpayers and tax administrations. Likewise, the CbCR, which does not as such jeopardise the arm's length principle, may motivate tax administrations to tax multinational enterprises selectively with some kind of formulary apportionment. This problem will likely be exacerbated by the increased emphasis on the profit split method in the post-BEPS environment.

Luxembourg anticipated the update of the OECD Guidelines and implemented as early as 1 January 2017 a new Article 56bis of the Luxembourg Income Tax Law that complements Article 56 (arm's length principle) and replicates some of the guidance provided in Chapter I of the OECD Guidelines. Moreover, on 27 December 2016 the Luxembourg tax authorities released a new Circular on the tax treatment of finance companies, setting out a transfer pricing regime that is consistent with the 2017 Revision of the OECD Guidelines. All this cements the increasing importance of transfer pricing and related documentation for Luxembourg tax and risk management purposes.

Ultimately, MNEs and international investors should review their transfer pricing against the backdrop of revised version of the OECD Guidelines with a view to detect potential pressure areas and to ensure compliance with documentation requirements. In the current international tax environment of heightened transparency and scrutiny, companies would be wise to integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their corporate structure and intra-group transactions.

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1) See Paragraph 1.120 in Chapter I of the OECD Guidelines.
2) The 2017 revision of the OECD Guidelines introduced a new framework for the analysis of risk allocation which has been developed as part of the OECD's work on its BEPS Project (Action 9).
3) For example, an entrepreneurial manufacturer cannot always be expected to earn profits, or higher profits, merely because the entrepreneur assumes economically significant risks. Instead, it is possible that the return could be low or even negative depending on the degree to which the risks undertaken are realized and have a negative effect on the returns of the manufacturer; see Sunny Kishore Bilaney, "Understanding Risk in the Era of the OECD/G20 Base Erosion and Profit Shifting Initiative", Bulletin for International Taxation, October 2016, p. 577.
4) See Paragraph 1.56 in Chapter I of the OECD Guidelines.
5) See Paragraph 1.59 in Chapter I of the OECD Guidelines.
6) See Paragraph 1.122 in Chapter I of the OECD Guidelines.
7) See Paragraph 1.121 in Chapter I of the OECD Guidelines.
8) See Paragraph 1.122 in Chapter I of the OECD Guidelines.
9) See Paragraph 1.122 in Chapter I of the OECD Guidelines.
10) See Paragraph 1.122 in Chapter I of the OECD Guidelines.
11) See Paragraph 1.123 in Chapter I of the OECD Guidelines.
12) See Paragraph 1.124 in Chapter I of the OECD Guidelines.
13) In the master file MNEs would be required to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies.
14) In the local file MNEs would be required to provide more transactional transfer pricing documentation, identifying relevant related party transactions, the amounts involved in those transactions and the company's analysis of the related arm's length character of the transfer pricing.
15) While there is an expressive statement of OECD Member States that the arm's length principle should be the sole standard to be applied for the pricing of intra-group transactions, it cannot be ruled out that the tax authorities of some countries may base transfer pricing adjustments on the information provided in the country-by-country reporting.
16) See Paragraph 7.45 in Chapter VII of the OECD Guidelines (as amended).
17) Tax administrations should generally refrain from reviewing or challenging the benefits test when the simplified approach has been applied as described in the new Chapter VII of the OECD Transfer Pricing Guidelines; see Section 7.45 of the OECD Guidelines (as amended).
18) See Section 7.59 of the OECD Guidelines (as amended).