

# The OECD Discussion Draft regarding BEPS Action 8, 9 and 10 on Revisions to Chapter I of the Transfer Pricing Guidelines

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On 1 December 2014, the OECD released a discussion draft (the "Discussion Draft") on Action 8, 9 and 10 of the Base Erosion and Profit Shifting ("BEPS") Action Plan which proposes revisions to Chapter I of the OECD Transfer Pricing Guidelines<sup>(1)</sup> and a number of special measures for public consultation. This article provides a critical overview of the proposals and analyses how these may change the application of the arm's length principle.

## 1. Introduction

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.

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. Chapter I of these Guidelines provides general guidance on the application of the arm's length principle and is, therefore, relevant for each and every transfer pricing analysis.

Part I of the Discussion Draft contains a proposed revision of Chapter I of the OECD Transfer Pricing Guidelines. The new guidance focuses, in particular, on the relevance and allocation of risk and sets conditions where re-characterization and non-recognition of transactions would be appropriate. Part II of the Discussion Draft outlines five options for potential special measures to address perceived BEPS concerns relating to intangible assets, risk and over-capitalization. More than 800 pages of public comments have been provided by multinationals, business associations and other interested parties, most of which express serious concerns about the proposals made in the Discussion Draft. The concerns expressed in the public comments have been reinforced during public consultations on 19 and 20 March 2015.

## 2. A revised Chapter I of the TP Guidelines

Part I of the Discussion Draft proposes substantial additions and modifications to Chapter I of the OECD Transfer Pricing Guidelines which clearly go beyond what is needed to tackle BEPS. The proposed guidance redefines the way in which related party transactions are to be analysed, affecting virtually all transactions between related parties.

### • Contractual terms vs. actual conduct

According to the OECD Transfer Pricing Guidelines, contractual terms should be a part of the functional analysis. When the actual conduct and economic substance of a transaction differ from its form, the economic substance takes precedence over the form. However, the Discussion Draft appears to go beyond this when stating 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 scrutinize every

nuance of the intercompany relationship. Hence, the role of contractual arrangements would almost be completely abandoned and replaced by an analysis of actual conduct, without introducing an analytical framework for it.

The authors believe that the proposed language is not needed to ensure that both contractual and factual circumstances are considered. The proposed guidance will likely be used by 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-characterized.

### • Identifying risks in controlled transactions

The Discussion Draft provides additional guidance relating to the identification of risks and makes some useful observations in this respect. Nevertheless, the Discussion Draft is missing pragmatism and seems to require a disproportionate level of detail regarding the analysis to be performed through the introduction of highly theoretical concepts such as "moral hazard" and "risk-return trade-off". Notably, the guidance provided in Chapter IX, as adopted in 2010, strikes a more careful and appropriate balance in regard to the issues of control and risk than the proposed language in the Discussion Draft. This raises the question as to whether different guidance on the same subject may be included in different chapters of the Transfer Pricing Guidelines. In particular, the very subjective principles in the Discussion Draft as to when it would be possible to a transaction as structured by a taxpayer may be disregarded or re-characterized would add to the number and magnitude of controversies and substantially increase the risk of double taxation.

### • Introduction of theoretical concepts

The Discussion Draft contains many statements regarding how it believes unrelated parties to a transaction divide and govern their function, assets and risks, and how, in contrast, it believes related parties conduct themselves. Here, the Discussion Draft seems to make too much of the notion of adversity of interests between unrelated parties, and over-interprets the relevance of moral hazard. However, arm's length business relationships cannot be characterized by a pure "adversity of interests" since unrelated parties with an on-going business relationship have a substantial commonality of interests similar to what exists between related parties.

The Discussion Draft tries to use the notion of "adversity of interests" and "moral hazard" to draw very bright lines between unrelated parties, and then contrasts that with related parties, which it asserts to have a commonality of interests by virtue of common ownership. It then goes on to suggest that these differences should influence transfer prices, and perhaps even the choice of transfer pricing method, tilting the field toward the profit split among related parties. However, unrelated parties rarely "split profits" as their method of remunerating each other. Another concern is the strong emphasis on the notion of "options realistically available". While this notion is already used in the current version of the OECD Transfer Pricing Guidelines, the proposals in the Discussion Draft seem to suggest a requirement to analyse any other options available in more detail.

### • Recharacterization

According to the OECD Transfer Pricing Guidelines, the examination of a controlled transaction should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them. Furthermore, a tax administration should only in exceptional cases disregard the actual transactions or substitute other transactions for them. Instead, potential non-arm's length behaviour should be dealt with through transfer pricing adjustments. Part of the new guidance has the character of anti-avoidance rules and would significantly reduce the threshold for tax administrations to not recognize transactions as structured by the taxpayers. This would be another source for uncertainty and disputes between taxpayers and tax administrations as well as disputes between the tax administrations of different countries, given that these may classify and, therefore, price the same transaction differently.

## 3. Potential special measures

Part II of the Discussion Draft outlines options for potential "special measures" to address perceived BEPS concerns relating to hard-to-value intangibles (option 1), inappropriate returns for providing capital (options 2 and 3), minimal functional entities (option 4) and ensuring appropriate taxation of excess returns (option 5). These special measures could be means to determine transfer prices. The Discussion Draft states that the special measures are considered because it is assumed that the proposed changes to Chapter I of the OECD Transfer Pricing Guidelines may not be sufficient to re-align transfer pricing outcomes with value creation.

Unfortunately, there seems to be no coordination with the other BEPS Actions. The lack of clear policy direction becomes evident when considering, for example, the proposed special measures regarding over-capitalization (here, too much equity funding is the BEPS concern) and BEPS Action 4 relating to interest deductions and other financial payments (here, too much debt funding is the BEPS concern). This proves that more time would be required to produce overall consistent and coordinated guidance to tackle perceived BEPS behaviour.

## 4. Deviation from the arm's length principle

The OECD and the countries participating in the BEPS Project expressed their continued support for the arm's length principle as the international standard for the determination of transfer prices. However, throughout the BEPS Project there have been a number of proposals that are not consistent with the arm's length principle and would be a shift to formulary apportionment.

Several proposals in the BEPS project represent a significant move away from the arm's length principle to formulary apportionment. Examples include BEPS Action 4 aiming at the limitation of interest expenses proposed rules which are clearly not consistent with the arm's length principle. The country by country reporting (BEPS Action 13) is as such not jeopardizing the arm's length principle but may motivate tax authorities to tax multinational enterprises selectively with some kind of formulary apportionment. This problem will be exacerbated by the emphasis on the profit split method within the BEPS Project.

The proposals regarding the revision of Chapter I of the OECD TP Guidelines is yet another example of proposals that pose consistency issues with the arm's length principle. Furthermore, a movement to special measures for transfer pricing matters would depart from the fundamental reliance on the arm's length principle and should be thoroughly considered before any recommendations are made. As such, special measures would create additional uncertainty for taxpayers and tax administrations and inevitably result in double taxation and tax disputes, since it is unlikely that these measures would be applied consistently by all tax administrations. In the authors' view, tax administrations have already sufficient tools available to apply the arm's length standard in all cases (non-recognition, transfer pricing adjustments, etc.).

## 5. Conclusion and outlook

The Discussion Draft proposes significant changes to the existing guidance on the application of the arm's length principle provided in Chapter I of the Transfer Pricing Guidelines. The authors believe that part of the proposed guidance is not consistent with the arm's length principle (in particular, the "special measures" considered in the Discussion Draft). In any case, this guidance would create substantial uncertainty in regard to nearly all transfer pricing exercises, even in the absence of any BEPS concern. Therefore, the question may be asked whether it makes sense to re-write all the general guidance on transfer pricing for the purpose of addressing what is likely a limited set of circumstances.

The existing guidance in Chapter I of the Transfer Pricing Guidelines acknowledges that transfer pricing is not an exact science and strikes an appropriate balance between thoroughness and practicality. In contrast, the proposed guidance in the Discussion Draft would advocate an approach that each transfer pricing analysis should be one of extreme detail and precision, creating extensive new requirements for transfer pricing documentation and making transfer pricing an exceedingly burdensome exercise for taxpayers and tax authorities. The proposed guidance would further result in a wide-spread use of the profit split method and expand the circumstances in which transactions may be disregarded or re-characterized by the tax authorities.

The proposed guidance would introduce additional room for subjectivity which would create additional uncertainty for taxpayers and lead to increased controversy between taxpayers and tax administrations. Although it is evident that the proposals are primarily targeted at multinational enterprises (MNEs) that adopted global supply chain business models, the new guidance would have an impact on all related party transactions. Therefore, the OECD should carefully consider the concerns expressed in the large majority of public comments and produce more balanced guidance.

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1) The OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations.

## Laurent Dassault invité d'honneur du Club des Leaders Luxembourg

Laurent Dassault, directeur général délégué du groupe industriel Marcel Dassault était, le 30 mars dernier, l'invité d'honneur du Club des Leaders Luxembourg dans le cadre d'un dîner au Cercle Munster.

Accompagné d'une dégustation de Château Dassault, grand cru de saint-émilion, les éminents invités ont pu échanger en toute amitié avec Laurent Dassault. Présidé par M<sup>me</sup> Brigitte Louise Pochon, l'antenne du Club des Leaders Luxembourg a été lancée en novembre 2014. Créée par Jean-Sébastien Robine, le Club des Leaders fête sa 5<sup>ème</sup> année, compte 340 membres répartis sur 5 antennes à Genève, Gstaad, Monaco, Luxembourg et Londres. Les trois axes du Club sont l'économie, la culture et la philanthropie.

Les prochains rendez-vous du Club auront lieu le 16 avril au Dorchester de Londres avec Sarah Fabergé, héritière de la maison éponyme et le 27 avril au Beau Rivage de Genève avec Stéphane Garelli, président du journal Le Temps et ancien directeur du World Economic Forum de Davos.

Site internet: [www.clubdesleaders.com](http://www.clubdesleaders.com)



TABEAU DE BORD AGEFI Luxembourg	30/04/2015	31/03/2015	DIFF%		
EUR 1=	1,1202	1,0735	4,35%	\$	= le dollar augmente par rapport à l'euro, (+) = l'ancienne devise augmente par rapport au \$
\$1=	36,01	37,58	-4,17%	LUF/BEF	Francs luxembourgeois/belges
\$1=	5,86	6,11	-4,17%	FRF	Francs français
\$1=	1,75	1,82	-4,17%	DEM	Deutsche Marks
\$1=	1,97	2,05	-4,17%	NLG	Gulden (florins)
Pétrole brut (coût de production): 1 litre=	0,33	0,29	17,42%	EUR	West Texas Intermediate (prix en euro par litre)
Gaz naturel: 1 m³=	0,0812	0,0864	-6,00%	EUR	Natural gas Henry Hub (prix en euro par m³)
Gaz naturel: 1 MWh=	7,8302	8,3298	-6,00%	EUR	Natural gas Henry Hub (prix en euro par MWh)
Gaz naturel: 1 MMbtu=	2,5700	2,6200	-1,91%	\$	Natural gas Henry Hub (prix en \$ par MMbtu)
Or: 1 Kg=	33874	35550	-4,71%	EUR	Fixing \$ de Londres après-midi (prix en euro par kg)
Argent: 1 Kg=	474	497	-4,63%	EUR	Fixing \$ de Londres (prix en euro par kg)
Argent: 1 oz=	16,52	16,60	-0,48%	\$	Fixing \$ de Londres (prix en \$ par once)

Ce tableau de bord, une exclusivité d'AGEFI Luxembourg, permet au lecteur:

1° de convertir le dollar dans son ancienne devise;

2° de connaître le coût de production de plusieurs produits pétroliers en euro, à comparer avec le prix au détail.

3° de connaître le prix de l'or et de l'argent en kilo et en euros.