WNTS Insight

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Recent OECD transfer pricing initiatives portend significant consequences for multinationals

In brief

The OECD recently issued several updates and consultations regarding OECD projects relevant to transfer pricing that could have important consequences for multinational enterprises (MNEs). These updates are part of the OECD's continuing efforts to provide more guidance and reach international consensus regarding the increasingly complex issues facing MNEs. This WNTS Insight discusses the most important topics addressed by the following developments:

- On November 20, the OECD published a release regarding "The OECD Work on Base Erosion and Profit Shifting";
- On November 12-14, the OECD held a public consultation to discuss comments to its June 6, 2012, discussion draft on intangibles; and
- In mid-October, the OECD released its revised discussion draft on permanent establishments (PEs).

OECD Work on Base-Eroding Profit-Shifting

In its release regarding base erosion and profit-shifting (BEPS), the OECD states that there is a "growing perception" that governments lose substantial corporate tax revenue because of tax planning aimed at eroding the taxable base or shifting profits to lower-tax jurisdictions. The OECD notes that statements concerning BEPS have been made by G-20 leaders in the group's June 18-19 meeting; in a joint statement by

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the United Kingdom, Germany, and France; and in President Obama's "Framework for Business Tax Reform" proposal.

Key areas of focus for the OECD regarding BEPS include:

- International mismatches in entity and instrument characterization, including hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- The tax treatment of related-party debt financing, captive insurance, and other intra-group financial transactions;
- Transfer pricing, particularly in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- The effectiveness of anti-avoidance measures, particularly general anti-abuse rules, CFC regimes, and thin capitalization rules; and
- The availability of preferential regimes for certain activities.

The OECD will deliver a progress report to the G-20 in early 2013 to address these issues. The OECD also plans to address whether current tax rules adequately account for the modern business environment and the increasingly digital economy.

Observation: There seems to be overlap between the OECD's BEPS initiative and other OECD initiatives. For example, many business commentators noted that the updated discussion draft on intangibles had a strong anti-abuse theme. Members of Working Party No. 6 have stated that anti-abuse was not a focus of the intangibles discussion draft. However, the continued use of the vague definition of intangibles may indicate a desire to ensure tax administrators have flexibility in seeking to prevent abusive transactions.

Update on OECD Discussion Draft on Intangibles

The treatment of intangibles for transfer pricing purposes continues to be a point of extensive discussion. The OECD is considering such fundamental questions as the definition of an intangible for transfer pricing purposes, the functions and roles entitled to a return on the intangibles, and the role of contractual terms in transfer pricing analysis.

The OECD on June 6 invited comments on its discussion draft on intangibles, revising Chapter VI of the Transfer Pricing Guidelines. These comments were discussed by Working Party No. 6 of the Committee on Fiscal Affairs at its meeting on November 12 and at a public consultation held November 12-14 in Paris, which included more than 120 business commentators. Commentators were each allowed seven minutes to propose changes to the discussion draft. Materials from the public consultation -- including the agenda, commentators' presentations, and a list of participants -- have been published on the OECD's transfer pricing webpage. The OECD has recently confirmed that it will publish a revised discussion draft for further consultation during the calendar year 2013.

At the public consultation, the OECD clarified some key issues raised by the intangibles draft. First, it is the OECD's view that an investor should be rewarded with a risk-weighted return for its investment in intangibles; however, such a return would naturally be increased if the party incurring the financial risk was also directly responsible for the functions related to the intangible development. Ambiguity regarding whether investment alone should be reward was attributed to the early stage at which the draft was released. Therefore, contractual terms and the resulting development risk continue to remain key factors in determining the appropriate intangible-related return. Currently, there is no consensus among Working Party members regarding the appropriate amount of the return to a party for its investment in intangibles. Second, the OECD clarified that there should be no divergence between OECD Transfer Pricing Guidelines Chapter VI and Chapter IX (addressing business restructurings) regarding functions, control, and performance standards.

Working Party No. 6 also clarified that the current intangibles discussion draft does not represent a consensus and that many aspects to the draft need to be discussed and agreed to by the delegates. Overall, the business community reiterated its desire for broad, clear, and easy-to-implement principles that are in line with the current OECD Transfer Pricing Guidelines. The desire for consistency and simplicity was expressed across several important topics under discussion.

While the definition of intangibles caused a substantial amount of debate among the commentators, most commentators took the position that the draft paper's definition of intangibles is overly broad. The draft's current definition of intangibles is "something which is not a physical asset or a financial asset and which is capable of being owned or controlled for use in commercial activities." In particular, the emphasis in the intangibles discussion draft is on the ability to generate premium economic returns rather than defining a specific intangible. In this sense, the discussion draft is consistent with United States Treasury's focus on "platform" rather than "specific" intangibles in which the platform is comprised of any "resource, capability or right" related to intangible development. Business commentators also agreed that contractual arrangements are only the starting point for a transfer pricing analysis and that transactions on paper must have economic substance. The allocation of income associated with an intangible must address which party:

- Performs and controls important intangible-related functions and/or controls other intangible-related functions performed by related and unrelated parties;
- Bears and controls risks and costs related to developing and enhancing the intangible; and,
- Bears and controls risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

At the same time, business commentators also agreed that the current intangibles draft overly focuses on abusive tax behavior, a topic best addressed in Chapters I and IX of the OECD Transfer Pricing Guidelines.

Business commentators also made plain that a balance must be sought in recognizing financial risks versus requiring active control to be entitled to intangible-related returns. Finally the business commentators agreed that the draft's discussion of the different transfer pricing methodologies, valuation techniques, and the concept of "options realistically available" need to be more in line with current OECD Transfer Pricing Guidelines.

OECD Discussion Draft on Permanent Establishment

OECD Working Party No. 1's revised proposal on the "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention" reflects comments received in response to the October 31, 2011, discussion draft, including subsequent discussions from a public consultation on September 7, 2012.

Working Party No. 1 has asked the business community to submit comments on the revised draft by January 31, 2013, and will meet to discuss public comments in February 2013. Given that Working Party No. 1 is asking for comments only on the drafting of their recommendations, as opposed to the underlying substance, it seems unlikely that the scope and substance of the revised draft will change. It is expected that the revised draft will form the basis for revisions to the Commentary to Article 5 of the OECD's Model Tax Convention on Income and on Capital in 2014, when the Model Tax Convention is anticipated to be revised.

(For further discussion of the issues raised by the discussion draft on permanent establishment, see Tax Policy Bulletin, "OECD releases new discussion draft on the meaning of 'beneficial owner'," May 2011.)

PE background

Under Article 5 of the Model Tax Convention (and under most income tax treaties), a resident of one contracting state is not taxable on its business profits derived from the other contracting state unless the resident has a PE in the other state and the business profits are attributable to the PE. For more than four years, the OECD has worked to clarify the definition of a PE under Article 5.

For a PE to exist, Article 5 states that there must be a "fixed place of business through which the business of an enterprise is wholly or partly carried on." Article 5 sets forth specific inclusions and exclusions from the definition, but the scope of what constitutes a PE remains open to interpretation, with many tax authorities taking an expansive view of its scope.

The Commentary to Article 5 elaborates that a "fixed place of business" must be "at the disposal of" the enterprise before a PE is created. The "at the disposal of" language is not found Article 5 itself; instead, it is found only in the Commentary to Article 5 to define a "place of business through which the business of an enterprise is wholly or partly carried on." While the Working Party considered deleting the "at the disposal of" standard and providing more direct guidance on Article 5's "wholly or partly carried on" language, Working Party No. 1 concluded that such a course would "create a number of problems."

Observations

Overall, the Working Party No. 1 seeks to establish a more up-to-date approach that is cognizant of the fact that MNEs operate in a global environment with more seamless interactions than ever before. While the revised draft has made some clarifications to the Commentary and addresses issues of importance to MNEs -- such as contract manufacturing, strip-risk distributors and secondments -- certain aspects of the revised draft leave troubling questions for MNEs. This is particularly the case with more controversial PE issues that arise from activities having a transitory or intermittent nature.

While both the existing and proposed Commentary to Article 5 contain subjective standards, the OECD is striving to provide clear guidance on many issues facing MNEs. Questions remain due to the lack of international consensus regarding emerging issues. As more countries develop transfer pricing regimes, the increased acceptance of the arm's length standard should be helpful to companies. However, consensus regarding emerging issues may be increasingly difficult to obtain, making it more important for the OECD to continue its efforts.

"At the disposal of"

The "at the disposal of" standard is intended to help explain the "place of business" requirement, beyond the limited guidance currently contained in the Commentaries. After much debate within the business community, the Working Party now is proposing a three-prong test for the "at the disposal of" standard:

- the "effective power to use" the location that belongs to another (or a number of other enterprises);
- the nature of the relevant activity (the performance of business activities); and
- the extent of actual presence (on a continuous basis over an extended period of time).

The revised draft provides an example of a consultant who works at a client's headquarters for 20 months, during which she uses 10 different training rooms to train the client's staff. The consultant also is allowed to prepare for her training courses in one of the 10 rooms that is not being used. The Working Party No. 1 concludes that the "at the disposal of" test has been met and a PE has been established because (1) the consultant is allowed to use a location, even though she has no permanent training room or office; (2) the consultant is performing her core business activity of consulting via training; and (3) 20 months is a sufficiently continuous and extended period of time.

Observation: As illustrated by this example, the application of the three-prong test proposed by the Working Party sets a low threshold for the establishment of a PE. Moreover, note that the former draft required a "continuous *and regular* basis" time period test; the "regular" requirement has been removed. While the first prong creates concern regarding vagueness -- particularly in the business community, which sought more clarity and a bright-line test -- Working Party No. 1 provides additional guidance under the second prong, indicating that enterprises sending employees to visit the offices of a subsidiary typically would not create a PE.

Secondment and subcontractors

One significant issue addressed in the revised draft relates to the provision of services in a foreign country, particularly with respect to secondments and subcontractors.

Public comments on the October 2011 discussion draft requested that the revised Commentary explicitly state that a secondment does not create a PE for the employer that seconds employees to an affiliate in the host country. The revised draft recognizes that it is common practice for employees to be temporarily seconded within a multinational group. Such employees normally carry on the business of the company to which they are seconded, rather than the business of the seconding company. Thus, according to the revised draft, no PE should be created. This view contrasts with precedent in India, including that of the Indian Supreme Court in *Morgan Stanley & Co. Inc. v. Director of Income Tax*, 292 ITR 416 (SC), which held that the nonresident enterprise had a services PE under the United States-India

treaty because of the enterprise's formal employer status and its continuous control over seconded employees.

The revised draft retains changes initially proposed by the Working Party No. 1 to clarify that an enterprise may be regarded as carrying on its own business through subcontractors. However, the draft clarifies that a subcontractor's mere presence will not put the worksite "at the disposal of" the main contractor *per se*. The revised draft states that a subcontractor would create a PE of the enterprise only if it performs the work of the enterprise at a fixed place of business that is "at the disposal" of the enterprise. Accordingly, the draft provides that the presence of subcontractors will only create a PE for the enterprise if the other conditions of Article 5 are met, for example, *i.e.,* if the main contractor has the effective power to use that site. The draft then gives an example in which such effective power exists for an enterprise owning a small hotel, renting its rooms out through the internet and subcontracting the on-site operations of the hotel.

Observation: While these clarifications and examples recognizing the increasingly global nature of workforces are helpful, the revised draft does not define clearly when the worksite is "at the disposal" of the main contractor. Instead, the revised draft points to the need to analyze the specific facts and circumstances present. These factors include whether the main contractor has physical control and legal responsibility at the worksite, or whether it is the subcontractor that has a PE at the worksite.

PE time requirement

In most circumstances, a temporary place of business does not have a sufficient degree of permanence to constitute a PE. Without operating as an explicit rule, the current Commentary to Article 5 has been interpreted to establish a general guideline of six months before a PE can exist (with exceptions).

Working Party No. 1 suggests that rather than providing a general guideline, the OECD should adopt an explicit bright-line rule. The use of six months as a bright-line rule is not promoted; instead, the Working Party No. 1 points to the 12-month rule for construction project PEs and the 183-day rule of Article 15 (regarding employment taxes) as potential guideposts in determining the length of the proposed bright-line rule.

Working Party No. 1 recognizes that a bright-line rule would not be appropriate for every circumstance; therefore, clarity was sought for existing “subjective standards.” In particular, Working Party No. 1 analyzed situations in which activity does not last for six months at any one time but is of “a recurrent nature.” The revised draft includes an example in which an enterprise drills in the Arctic for only three months of the year due to weather conditions but expects to return every year for five years. Working Party No. 1 concludes that in such a case, a PE would be established.

Observation: Some commenters to the former draft addressed the timing of when a taxpayer in a recurring situation should be considered to have a PE. It was unclear whether an entity would have a PE in the first year in which the entity undertook the recurring activity or whether a PE would exist only beginning on the date when the aggregated time of the recurring activity equaled six months. The revised draft seems to indicate that an entity would have a PE in the first year of the recurring situation so long as the taxpayer “expects to return” a significant number of times (in the example’s case, five times for a total of 15 months).

Let's talk

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