
OECD Public Consultation on BEPS Actions 8 through 10 reveals planned revisions to transfer pricing drafts

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In brief

During the July 6-7, 2015 public consultation on BEPS Actions 8 through 10, the OECD Working Party 6 announced planned revisions to its proposed changes to the Transfer Pricing Guidelines, including its December 2014 papers on Risk, Recharacterisation and Special Measures and Use of Profit Split Methods and its September 2014 draft on Intangibles. The OECD also received feedback from speakers who had submitted written comments to the drafts on Cost Contribution Arrangements and Hard to Value Intangibles (proposed changes to Chapter VI of the Transfer Pricing Guidelines on Intangibles). In providing the updated status of the various transfer pricing workstreams, the OECD also confirmed the delivery timetable for the transfer pricing work.

The extent of potential changes to the Transfer Pricing Guidelines has been scaled back and appears to be more aligned with the arm's-length principle of the Guidelines. This follows previous public consultations and the hundreds of pages of comments and feedback received from industry and representatives. Further, this scaling back may be attributable to an effort to reach consensus among the various taxing authorities participating in the Working Party 6.

The OECD further confirmed its determination to broadly deliver the overall transfer pricing package by the September deadline (in advance of the G-20 Finance Ministers meeting in October). The package includes items under Actions 8-10 on Intangibles, Low Value-Adding Services, and Commodities, together with the final package under Action 13, Documentation and Country-by-Country Reporting (CbCR). Further, the OECD noted that BEPS work in some areas will be deferred to 2016 and 2017, including financial transactions, attribution of profits to permanent establishments, use of profit split methods, and implementation of hard-to-value intangibles.

Also, the OECD secretariat shared that the UN and the IMF have given a mandate to the OECD to develop a toolkit to assist "lowest income countries" in implementing the outcome of the BEPS project. As an example, the actual addressing of solutions in case of lack of comparables was mentioned.

The OECD's planned revisions and confirmed timeline will have a significant impact as companies consider changes to transfer pricing policies as well as the impact of the new documentation and CbCR requirements.

In detail

Treatment of risk

Proposed changes to the Transfer Pricing Guidelines, including those contained in the Risk, Recharacterisation and Special Measures draft, will be significantly revised (referred to in common parlance as “the identification of the actual deal”). The “recognition of the accurately delineated transaction” will replace the previous title on “non-recognition.” The OECD confirmed that contractual arrangements should form the starting point of the analysis. Beyond this preliminary step, other relevant facts also should be considered, including an assessment of whether the parties’ conduct contradicts the contractual terms. This information may be used to fill in any gaps in the contractual arrangements and to interpret the contract for transfer pricing purposes.

The treatment of risk will be based on more practical guidance and will be part of the Functions, Assets and Risk (Functional Analysis) framework, rather than being a separate section within the Guidelines. *The message here is that taxpayers need to be more explicit on risk when conducting a Functional Analysis.*

Acknowledging that risk gives rise to practical difficulties, the OECD will introduce a materiality threshold based on “economically significant” risks. These risks need to be identified with specificity. *Based on comments received, the concept of moral hazard will be dropped and a risk-return trade-off concept will be recognized.* Financial capacity to assume a risk will be included as a criterion on equal footing with control in the analysis on assumption of risk.

The OECD also noted the uniqueness of the financial services industry and will recognize the special character

with regard to risk and transfer pricing. The interaction between the proposed guidance and the future work on financial transactions (under Action 4) also was recognized.

New framework for analysis

The OECD announced a new six-step analytical framework on treatment of risk:

- Identify economically significant risks with specificity.
- Identify contractual assumption of the specific risk.
- Functional analysis - establish conduct and other facts.
- Examine (i) whether the contractual assumption of risk is aligned with the conduct and the other facts of the case; and (ii) whether the party assuming the risk under the contract is exercising control and if it has the financial capacity to assume such risk.
- If the party assuming the risk does not control the risk or does not have the financial capacity to assume the risk, then allocate the risk to the group company having most control and having the financial capacity to assume the risk.
- Price the risk, taking into account the full functional analysis of the transaction, including the analysis on risk.

There will be significant emphasis on the decision-making process in assessing a party’s control over risk. *The OECD has incorporated the notion that risk mitigation and preparatory work relating to decision-making may be outsourced.* If such activities are outsourced, the group company in control of the risk should set the objectives of the

outsourced activities, assess whether the objectives are met, and hire or fire the service provider. However, certain actions - such as the mere formalizing of a decision in the form of, for example, minutes of a board meeting and signing of the documents of a board meeting - do not qualify as exercising a decision-making function sufficient to demonstrate control over risk.

Treatment of cash box

The appropriate treatment of a “cash box,” - an entity the OECD defines as “capital rich” with “no or low functionality” - continues to be a major objective of the OECD and BEPS Actions. Under the new framework regarding delineation of actual transactions and control and management of risk, if a cash box entity is not exercising control over the financial risk that is connected with the provision of the funding, then the risk will be allocated to the group entity that is performing such control functions. Through the Guidelines, non-recognition rules may be applicable to a cash box which is an “artificial” structure. *It was announced that a cash box shall receive no more than (and presumably no less than) a risk-free rate of return for the funding itself.*

Other measures that will impact treatment of a cash box include the BEPS Actions on interest deductibility, CFC rules, minimum standard on treaty abuse, and application of domestic anti-abuse rules. *Therefore, the OECD stated that at this stage, no special measures were deemed necessary.* It was added that the practical monitoring of the project will be key going forward, particularly as the work on Action 4 and the relation between functions and funding is still ongoing.

Observation: The delineation/recognition and risk construct still

leaves open the question as to whether an entity with low functionality that has risk of loss and is able to exercise control over the financial capacity to accept the risk is entitled to remuneration greater than a risk-free return under the arm's-length principle. It was added that there is no ready-made solution and countries will be urged to carefully address facts and figures of the case at hand.

Intangibles

With respect to Chapter VI of the Guidelines on intangibles, the OECD believes no fundamental changes to the 2014 guidance are needed. Consequently, there will be only minor changes in the final report to be released in October 2015, which will be based on the new guidance on risks and recognition of the accurately delineated transaction.

Further, additional guidance on the allocation of the difference between the actual and the expected profits will be forthcoming. This allocation will be determined based on the way the risks that were assumed by group companies play out. Finally, information asymmetry issues and risk of mispricing will be addressed through the guidance on hard-to-value intangibles (likely in 2016).

Use of profit split methods. Following the March 2015 public consultation and the numerous comments to the December 2014 draft, the OECD announced that the goal should be to identify the most appropriate method for the case, under the framework of the arm's-length principle. Useful guidance should be to clarify this framework and likely will be dramatically different and scaled back from the earlier draft.

Dispute resolution: Action 14. The OECD announced that there will be two building blocks. First is a mandatory minimum standard and an associated monitoring process.

Second is a voluntary commitment to mandatory and binding arbitration. The secretariat added that 24 countries have expressed commitment (or will do so) on mandatory and binding arbitration. Amendments to the applicable double taxation treaties will likely be necessary through the multilateral instrument (under Action 15).

An important point is that the minimum standard recognizes that access to MAP should be provided for transfer pricing cases even if Article 9(2) is missing in a treaty. It was noted that 90% of the existing inventory of MAP cases (according to the OECD statistics) would be covered when the countries that expressed a commitment to mandatory and binding arbitration implement this commitment.

Observation: Both a mandatory minimum standard and a voluntary commitment to mandatory and binding arbitration are useful only to the extent actually implemented, which cannot take place until tax treaties are renegotiated and ratified. Consequently, the OECD's announcement can be viewed at this stage only as an agreement in principle to improve dispute resolution mechanisms, with such work remaining before actual improvements to dispute resolution mechanisms become effective.

Timing and next steps

The current papers that are expected to be completed in this process are the new changes to Guidelines Chapter I, Commodities (Chapter II), Transfer Pricing Documentation (Chapter V), Intangibles and hard-to-value intangibles (Chapter VI), Low Value-Adding Services (Chapter VII), and Cost Contribution Arrangements (Chapter VIII).

Work for 2016-17 will cover financial transactions, use of profit split

methods, and implementation of hard-to-value intangibles. The work on attribution of profits to permanent establishments is expected to be completed by the end of 2016, with a focus on commissionaires and the specific activity exemptions.

In terms of next steps, the OECD Working Party 6 meetings resumed immediately following the July 6-7 public consultation and adjourned on July 10. Re-drafting and finalization of the above-mentioned Actions 8-10 papers likely will take place prior to August, with formal approval of the final documents by the OECD Committee on Fiscal Affairs in September.

The approved papers will then be presented to the G20 during the October 8, 2015 G-20 Finance Ministers Meeting, followed by the G-20 Leaders meeting in November. Typically, papers are released publicly just before the G-20 Finance Ministers and/or Leaders meetings.

The takeaway

Important details still to be completed by Working Party 6 include treatment of risk and recognition of the accurately delineated transaction. Key interpretative questions remain regarding the pricing or measurement of risk, differentiating between control over assuming risk itself and control over financial capacity to assume risk, and the interplay between Chapters I and VI and Chapter VIII on Cost Contribution Arrangements.

Further, even though "risk" is not allotted more weight than "functions" and "assets" respectively in the Functional Analysis, the fact that the guidance on risk is now part of the guidance on the functional analysis suggests an important message to taxpayers to take action. Taxpayers will need to be explicit about what the actual risks are, what the contract stipulates, and whether the parties

actually are living the contract. This is where the link with Action 13 on Transfer Pricing Documentation is very clear: taxpayers are urged to provide qualitative documentation on roles and responsibilities.

Given the OECD's goal of finalizing these papers over the coming months with a possible October 2015 publication, together with the new transfer pricing documentation and

CbCR requirements, now is the time for companies to assess the impact of BEPS on transfer pricing policies and the related risks to be considered by taxing authorities as a result of the disclosure and increased transparency. Finally, as the OECD's work to revise the Transfer Pricing Guidelines will not be fully completed in 2015, interested stakeholders should consider how best to express

their views on the important work that has been deferred until the 2016-2017 time period, which includes issues regarding financial transactions, attribution of profits to permanent establishments, use of profit split methods, and implementation of the guidance on hard-to-value intangibles.

Let's talk

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