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PwC's Comments on BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)

Introduction

PricewaterhouseCoopers LLP ("PwC"), on behalf of its international network of member firms, welcomes the opportunity to comment on the OECD *BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* released on December 19, 2014 ("Discussion Draft"). As a global professional services business with a network of firms throughout the world, we have worked with tax authorities around the world over many years regarding the development of transfer pricing rules that affect multinational entities ("MNEs") in their cross-border transactions. As a result, we have extensive experience with the wide range of issues relevant to both taxpayers and tax authorities.

General Comments on Discussion Draft

Given the complexity of the subject and the difficult issues the OECD is attempting to address in the Discussion Draft, it is useful to set forth an overview of some concerns we wish to be addressed that are necessary to preserve some fundamental tenets of transfer pricing and the arm's length principle:

- We note that other portions of the existing OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Transfer Pricing Guidelines") (e.g., Chapter VI addressing Intangibles and Chapter IX addressing Business Restructurings) already provide a reliable framework to ensure the sanctity of the arm's length principle in the context of risk characterization and allocation. In addition, many domestic tax regimes have robust anti-abuse rules and the capacity to enact legislation to recharacterise transactions where the economic substance of a transaction differs from its form. In this regard, PwC believes it is most productive to adhere to the existing framework that has been vetted among OECD countries and generally accepted as preserving the arm's length principle. Furthermore, not taking into consideration relevant law and regulations already in place would lead to confusion and uncertainty for tax authorities as well as taxpayers as they try to reconcile the potentially inconsistent guidance prescribed by the Discussion Draft with rules already enacted or promulgated under domestic tax regimes.

- The arm's length standard is meant to provide broad parity of tax treatment for members of MNE groups and independent enterprises. By placing associated and independent enterprises on a more equal footing for tax purposes, the arm's length standard avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. We are concerned that the Discussion Draft deviates significantly from the arm's length standard, and that many of the provisions of the Discussion Draft suggesting legal

agreements as a mere starting point to reconcile perceived conduct by the parties to a cross-border transaction may cause significant uncertainty with regard to the application of the arm's length standard. The OECD has put a great deal of effort into establishing the arm's length principle as a near-worldwide standard for determining the pricing of transactions between associated enterprises. As a result, most tax regimes have followed suit and incorporated the arm's length principle as the cornerstone of domestic transfer pricing regulations. Establishing that common framework has been a great boon to economic growth, as it minimizes the disputes and double taxation that can hinder cross-border trade and investment. It has also helped to satisfy taxpayers' need for certainty with respect to how cross-border transactions will be treated by various tax authorities. We are concerned that the proposals in the Discussion Draft unnecessarily jeopardize that consensus. Several proposals in the Discussion Draft seem to be designed simply to enable tax authorities to more easily disregard contractual allocations of risk, to recharacterise legitimate business transactions, and to utilize special pricing measures inconsistent with the arm's length principle. Implementing such proposals would, therefore, contradict existing domestic tax laws, causing confusion as to how the new Guidelines should be implemented in the context of countries' existing legal frameworks. PwC believes the objective of the Discussion Draft should be to improve upon the arm's length principle and provide better pricing of transfers of risk among related parties.

- The revisions to the Discussion Draft should consider how other aspects of the Action Plan will impact MNEs and the issues that the OECD is addressing in the BEPS project. We recommend that the OECD view the revisions to the Discussion Draft in the context of the BEPS action plan as a whole. Also, it may be the case that other workstreams address transfer pricing issues sufficiently such that the arm's length principle does not need to be radically altered.

- PwC reiterates that the Transfer Pricing Guidelines already address risk and recharacterisation. Providing guidance that may not be consistent with the arm's length principle would be a significant modification to the Transfer Pricing Guidelines. In addition, the Discussion Draft, in its current form, places a heavy burden on domestic tax authorities to determine what is commercially reasonable instead of providing clear instructions on how to analyse related party business transactions and structures. Any changes should be recommended only after considerable deliberation and consideration, and only on a consensus basis.

- PwC recommends the revisions to the Discussion Draft focus on providing objective advice to MNEs. We believe the Discussion Draft includes many subjective terms that may be pejorative and, therefore, interpreted differently by rational decision makers.

- PwC further recommends that more time and consideration be devoted to the drafting and refinement of special measures. These proposals are at odds with the arm's length principle and could fundamentally change the existing transfer pricing rules as implemented by many countries. The proposals are very briefly described and we believe there is simply not enough time in the remaining few months of the BEPS project to give them serious consideration and to develop them in a reasonable manner.

These concerns related to the interlinking of this Discussion Draft and the overall complexity of the proposals are the key themes in our recommendations below. Overall, additional details are needed regarding the principles and suggestions presented in the Discussion Draft. Our detailed comments are presented below in a format that parallels the Discussion Draft's structure.

Part I – Guidance for Applying the Arm's Length Principle

Part I's proposed revisions to Section D of Chapter I of the Transfer Pricing Guidelines emphasize the importance of accurately delineating the actual transactions in accordance with the substantive

commercial and financial relationships of the parties, in particular, adhering to a "commercial rationality test" one that requires "consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner." (See para. 88). The proposed revisions include guidance on the relevance and allocation of risk, determining the economically relevant characteristics or "fundamental economic attributes" of the controlled transactions, and recharacterisation or the non-recognition measures resulting as a consequence of the determination that the risk does not align with the contractual allocations in the transactions. Overall, we suggest to narrow the language in the Discussion Draft such that it only describes commercially rational solutions that would primarily rely on written contracts, only to be supplemented by the factual circumstances and course of dealings between the parties, and only subject to override if there is strong evidence of a lack of substance or other tax avoidance motives.

Identifying the Commercial or Financial Relations

Paragraph 1 of the Discussion Draft recognises that "a 'comparability analysis' is at the heart of the application of the arm's length principle…" and that the "commercial or financial relations" between associated enterprises must be properly identified and delineated. The broad concept of commercial or financial relations could potentially encompass a wide range of relationships. Further clarification regarding what is considered a commercial or financial relationship (i.e., the scope of such relationships) in the context of the Transfer Pricing Guidelines would need to be established to prevent an analysis from potentially expanding beyond the tax and transfer pricing arena.

In the business environment common to many global MNEs, commercial contracts are often the cornerstone of the commercial and financial arm's length relationship between independent enterprises. We are concerned, however, that the Discussion Draft treats contracts as a starting point subject to overriding perceptions of arm's length behavior, instead of as the guiding factor in an arm's length transfer pricing analysis. Paragraph 3 states that in situations where there is no written contract, or where the conduct of the parties demonstrates that the contractual terms are ambiguous, incorrect, or incomplete, the delineation of the transaction should be "deduced, clarified, or supplemented" with a review of the actual conduct of the relevant parties. The concept of deduction introduces a level of subjectivity into the analysis. Additional details on what level of deduction is permissible would be required, as many legal authorities rely on written contracts. We are concerned that the Discussion Draft allows tax authorities to more easily disregard transactions through the process of "accurately delineating" the transaction, rather than doing so only when a transaction lacks economic substance.

While we appreciate that recasting a transaction is intended as a last resort in the Discussion Draft, the language in Paragraph 3 raises the concern that such a consequence could occur by default. For example, under many domestic legal regimes, the contract itself is examined to make a determination of whether the terms are ambiguous or incomplete before any evidence of conduct is considered. Disregarding existing contracts is therefore extremely concerning and additional guidance on how to reconcile domestic law's reliance on contracts with the Discussion Draft's proposals to move away from this approach would be necessary to avoid uncertainty and confusion. For example, the relationship between the existing contractual terms and how they could potentially be overridden by a subjective concept of how independent parties should act or how the associated enterprises are actually dealing with each other would need to be considered further. We are concerned that the current wording in the Discussion Draft gives tax authorities wide latitude, on a subjective basis, to judge what is commercially reasonable and to second guess legitimate business transactions. This latitude may have serious implications for the certainty the arm's length principle seeks to achieve and could make administration of transfer pricing issues chaotic.

Paragraph 7 introduces the concept of synergies that may have been created through "deliberate concerted action" or through other means such as know-how provided through seconded employees. The concept of synergies and their role in value creation is a complicated and highly debated subject in transfer pricing. Therefore, any conclusion that synergies exist based on a deduction derived from the

conduct of the parties should be guided by a specific framework. For example, the definition of "deliberate concerted action" should be clarified. Furthermore, an important point for clarification would be to understand how tax authorities should differentiate synergies that are created by deliberate concerted action versus common group synergies that naturally occur as a consequence of an associated enterprise's status as a member of a controlled group. It would be useful if a methodology were provided to ensure that synergy recognition is consistent with the arm's length principle and prevent drifting towards a formulary apportionment approach. The concepts of "synergies", "interdependencies", "coordination", and "integration" seem to be used inappropriately in the Discussion Draft to view an MNE as a "single firm", justifying recharacterising transactions and disregarding contractual allocations of risk. In addition, guidance on how to apportion synergies within a group, if it has been determined that there is value from synergies that should be recognised, would be a useful clarification to include.

We agree with the Discussion Draft's identification of functions performed, risks assumed, assets used, and other relevant economic characteristics identified in Paragraph 11 used to delineate a transaction for transfer pricing purposes. In addition to these factors, in Paragraph 12, the Discussion Draft identifies "options realistically available" to the parties as an economically relevant characteristic that should be utilized when examining how independent parties would evaluate potential transactions. While we agree with the Discussion Draft that in general, independent enterprises do compare the options realistically available, it would be useful to have some guidance as to the scope of realistically available options permissible for tax authorities to consider, as consideration of every possible alternative may obfuscate a focused analysis based on the contractually agreed transaction. It would also be useful to clarify whether the options realistically available are a comparability factor in the economic analysis or whether they are to be taken into account in another fashion.

The section on the functional analysis introduces the concept of "capability" as a factor in identifying the economic circumstances of the commercial and financial relations (Paragraphs 17-19). We are concerned that this introduces an unnecessary and inappropriate step into the functional analysis. First, in many cases, it would be challenging to assess and quantify the actual capabilities of different associated enterprises consistently. Additional guidelines on what factors would be considered when determining capability as well as measurement methods to be used would be needed. Second, the complex decision-making process of MNEs would need to be factored into any analysis related to capabilities. Parties can voluntarily allocate less than their actual capabilities to other associated enterprises for a wide range of business reasons, such as future perceived capabilities. Finally, we are concerned that this concept is incorrectly described and that it proposes that there be different pricing for the same transaction based upon the "capabilities" of the parties.

We agree with the Discussion Draft that business strategies are another factor that should be considered when delineating a controlled transaction and determining comparability for transfer pricing purposes (Paragraphs 10 and 31). However, business strategies can vary widely, and it is possible that even within a specific industry, a wide range of business strategies could be implemented by the various participants. Without further specific guidance and definition, an analysis of business strategy and its impact on a controlled transaction could lead to a subjective analysis of risk. More clarification on the structure and relative importance of such an analysis would be appreciated.

Identifying and Allocating Risks in Commercial or Financial Relations

We agree that the identification and allocation of risks is a crucial part of a comparability analysis. We observe that the framework provided for the analysis of risk in Paragraph 40 gives little importance to the role of financing the risk within the MNE group. In addition, Paragraph 66 indicates that "financial capacity to bear risk is a relevant but not determinative factor in considering whether a controlled party should be allocated a risk return." The role of financial risk is critical in transactions, and we believe it should not be disregarded as it is in the Discussion Draft. While we recognise that not every highly capitalised party carries risk, the Discussion Draft should acknowledge that the party assuming the financial risk contractually is usually in the best position to manage and control the risk, even if it does

not perform the day-to-day operational activities associated with the risk. For example, when a function is outsourced there are varying degrees of risk and control assumed by the contracting party. Therefore, a party could be performing risk management, but not necessarily managing or controlling the risk.

Page 14 of the Discussion Draft raises a question concerning the role that imputed "moral hazard" and contractual incentives should play with respect to determining the allocation of risk and other conditions between associated enterprises. The Discussion Draft asks how the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided should influence the allocation of risks between related parties. We believe that the issues of moral hazard and contractual incentives to guard against risk are already part of the functional analysis. By definition, a functional analysis under the arm's length principle determines how associated enterprises would function as if they had competing incentives regarding risk allocation; accordingly, such analysis would obviate the need to examine any incentives to insulate one party from the consequences of risk. It is not necessary for related parties to put in their contracts incentives or safeguards to align their interests, because their interests are already aligned. Consequently, it would not be appropriate to disregard transactions among related parties that do not include such incentives or safeguards, and the concept of imputed moral hazard is not helpful and could only confuse the analysis.

Under the risk management discussion, Paragraph 55 discusses outsourcing, which is a common business practice. The current discussion is too broad, and does not take into consideration the many unique factors that may ultimately lead a business to include outsourcing as part of its value chain. The Discussion Draft should recognise that outsourcing itself involves risk, and the fact that a company may decide to outsource does not result in that company losing control of the process or delegating all of the risk. Similarly, Paragraph 56 states that line management in business segments contributes to risk management, yet the Discussion Draft does not recognise that line management may not necessarily indicate that the top level reporting entity controls the risk, nor does it discuss how line management interplays with outsourcing risk.

Paragraph 61 states that a contractual allocation of risk may not be respected for arm's length purposes if a party does not have the ability to control the risk. This is supported by an example of a customer's contract with an unrelated insurance company. In addition to the fact that the example does not represent the circumstances faced by an MNE, the example fails to account for the risk that is taken by the customer (both transactional cost and the cost should the insurance not fully cover the damage cost). We believe that it would be useful to have an example that considers the issue of controlling risk versus contractual risk from the perspective of an MNE's allocation of risks.

In conclusion, with regard to allocating risk, it should be recognised that risk is contractually shared among associated enterprises, and even if there are reporting line structures, or competing capabilities that do not necessary align with the assumption of risk, such facts do not compel the conclusion that a transaction should be recharacterised because the associated enterprise possesses the top level reporting line or ability to control the risk. As a result, instead of disregarding written contracts, the Discussion Draft should prioritize written contracts as primary guides to the allocation of risk between associated enterprises and respect contractual allocations unless there is strong evidence of motives for organizing the form of a transaction contrary to substance.

Part II – Potential Special Measures

Part II of the Discussion Draft sets forth options for various special measures with regard to intangible assets, risk, and over-capitalization, as contemplated by the BEPS Action Plan released in July 2013. As indicated in the BEPS Action Plan, the main objective of the Transfer Pricing Guidelines is to align economic transfer pricing outcomes with value creation, in effect, to prevent "double non-taxation of income." To achieve this alignment, the Action Plan suggests with regard to Actions 8, 9, and 10 that "special measures, either within or beyond the arm's length principle, may be required…." The Discussion

Draft contains a series of questions relating to the options with a view toward taking the responses to these questions into account when considering the appropriateness and design of each option.

First and foremost, any special measures need to be consistent with the arm's length principle. There are already many existing forms of guidance that provide direction on how transactions should be considered within the sanctity of the arm's length principle. These include other Chapters of the Transfer Pricing Guidelines (such as Chapters I, III, V, VI, and IX), the other BEPS Action Plan items (such as the CFC action item), and domestic tax laws. For example, where a transaction may require the consideration of special measures, it is likely that the transaction would lack economic substance and would therefore be subject to existing doctrines or domestic tax regulations aimed at prohibiting tax avoidance. In addition the special measures, in their current state, are undeveloped as demonstrated by their short length and lack of substantial guidance. Taking into consideration the BEPS initiative's timeline of finalizing its proposals by the end of 2015, we would recommend that a more reasonable, lengthened timeline be adopted for the special measures section. Doing so would also ensure that any such special measures would not be implemented until the other BEPS Action Plan items, including revisions to other sections of the Transfer Pricing Guidelines, are finalized. At this time, it would then be possible to determine what, if any, additional measures would be required and how they should be implemented.

Additionally, we note that if special measures are recommended which are outside of the arm's length principle, Article 9 of most income tax treaties would need to be renegotiated in order for countries to implement them. Instances of double taxation which arise from use of special measures inconsistent with the arm's length principle would not be eligible for resolution under the Mutual Agreement Procedure. We consider that to be another important reason for the Discussion Draft to be consistent with the arm's length principle, otherwise the unfortunate result will be an increase in intractable cross-border tax controversies, negatively impacting world trade and economic development.

Furthermore, generally governments have indicated a reluctance to recast or recharacterise transactions unless strict and defined rules are developed and implemented. We appreciate the sentiment that recharacterisation or non-recognition is exceptional; however, the current guidance is ambiguous as to what circumstances are exceptional, and when special measures should be utilized by tax authorities in such exceptional circumstances. Overall, additional elaboration is required on how these special measures would function in practice. There needs to be clear standards for such measures. Failure to clearly define and delineate such special measures could potentially add another layer of complexity to the existing treaty and mutual agreement process. In addition, failure to clarify the application of special measures could also cause discord between the interpretation of longstanding domestic country tax statutes and the arm's length standard, such as the "commensurate with income" statute in the United States Internal Revenue Code. While tax authorities and judicial bodies generally try to interpret statutes in a manner that ensures consistency with treaty principles such as the arm's length standard, adding this additional layer of ambiguity will only cause more uncertainty for taxpayers when it comes to reliance on their own domestic legal tax regimes.

Summary of key points

Our key areas of concern with respect to the Discussion Draft are summarised as follows:

- Other aspects of the existing Transfer Pricing Guidelines already provide a reliable framework to ensure the sanctity of the arm's length principle in the context of risk characterization and allocation. We are concerned that the Discussion Draft prescribes potentially inconsistent guidance with rules already enacted or promulgated under domestic tax regimes that rely on the existing Transfer Pricing Guidelines.

- With respect to applying the arm's length principle, we are concerned that the current wording in the Discussion Draft gives tax authorities wide latitude, on a potentially subjective and arbitrary

basis, to judge what is commercially reasonable and to disregard the terms of legal agreements between parties that are part of legitimate business transactions.

- The Discussion Draft introduces the concept of synergies that may have been created through "deliberate concerted action" but does not provide a specific framework on how such synergies would be identified. The concept of synergies and their role in value creation is a complicated and highly debated subject in transfer pricing. We are concerned that the concepts of "synergies", "interdependencies", "coordination", and "integration" seem to be used inappropriately in the Discussion Draft to view an MNE as a "single firm", justifying recharacterising transactions and disregarding contractual allocations of risk.

- Finally, governments have generally indicated a reluctance to recast or recharacterise transactions unless strict and defined rules are developed and implemented. We appreciate the sentiment that recharacterisation or non-recognition is exceptional; however, we are concerned that the current guidance is ambiguous as to what circumstances are exceptional, and when special measures should be utilized by tax authorities in such exceptional circumstances.

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On behalf of the international network of PwC Member Firms, we respectfully submit our response to the OECD BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures). For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

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