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Transfer Pricing Times

Making Sense of the Final Releases of the OECD BEPS Project

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On October 5, 2015, the OECD released its final BEPS deliverables. This special edition of the Transfer Pricing Times focuses specifically on two final reports: Action Item 4 - *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* and Action Items 8-10 – *Aligning Transfer Pricing Outcomes with Value Creation*. Given that these final reports totaled nearly 300 pages, this article cannot provide an exhaustive summary of the content in those reports. This article focuses on the most material changes relative to discussion drafts released largely at the end of 2014. Many of the changes were made in response to the public written commentary received following the issuance of the draft and the public consultations, both of which Duff & Phelps participated in actively.

Action Item 4 – Limiting Base Erosion Involving Interest Deductions and Other Payments

Even though the final report on Action Item 4 will not change the related transfer pricing guidance, it is nonetheless transfer pricing-related because it may limit the deductibility of interest payments. While the discussion draft included several potential approaches that might be applicable to limit BEPS opportunities through interest deductions, the final report identifies a single “recommended approach” (also referred to as the “best practice approach”), centering on a fixed ratio rule. The rule caps an entity’s net deductions for interest and financial equivalents at a percentage of EBITDA (earnings before interest, tax, depreciation, and amortization). The implementing country would choose a point in the range of 10.0 percent to 30.0 percent of net interest/EBITDA. Note that the rule would apply to both intragroup and third-party interest.

The Final Report gives countries the option to supplement this fixed ratio rule with a group ratio rule, inclusion of which would allow an entity to exceed the limit set by the fixed ratio in certain limited circumstances. For example, an entity with a net interest/EBITDA above the target, could deduct net interest up to the net interest/EBITDA ratio of the worldwide group (in cases where the group’s ratio is greater than that of the specific entity). An earnings-based group ratio rule can be replaced by an alternative such as the “equity escape” rule, which is based on assets.

The recommended approach also includes the optional inclusion of 1) a de minimus monetary threshold to prevent overburdening low risk entities; and 2) the ability to carry forward disallowed interest expense or unused interest capacity from year-to-year. The approach can be buttressed by targeted rules to address specific risks (i.e., protect fixed ratio and group ratio rules from aggressive planning initiatives).

The Final Report notes that additional Action 4 work is needed to develop suitable and specific rules for the banking and insurance sectors, and flesh out details on implementation. Also, the Final Report recommends limiting the amount of interest payable to group companies lacking economic substance to no more than a risk-free return on funding provided, and notes more generally that further work on transfer pricing issues of financial transactions is needed and will be undertaken in 2016 and 2017.

Action Items 8 through 10 – Aligning Transfer Pricing Outcomes with Value Creation

This report includes substantially all of the revisions to transfer pricing guidance that came out of the BEPS project. Changes were fragmented into several discussion drafts on various topics during the commentary process, and that fragmentation is followed in the discussion below. The final deliverables associated with all items were collapsed into a single document, now called "Aligning Transfer Pricing Outcomes with Value Creation."

Risk, Recharacterization and Special Measures

The discussion draft on Risk, Recharacterization, and Special Measures generated perhaps the largest and most vocal response of all of the transfer-pricing related BEPS discussion drafts. This is because, under the language of that discussion draft, it appeared as though:

- Tax authorities could assert entity characterizations that yielded inappropriate risk and residual profit allocations due to the vague nature of the associated guidance.
- Governments could routinely alter the transactions as structured by the taxpayer based on a vague moral hazard framework to inform whether third parties with adverse interest would enter into certain types of transactions.
- Contracts might be ignored, even where those contracts had substance.
- "Special measures" might be imposed that would, in certain instances, override or replace the application of the arm's length standard.

The final deliverable addresses many of the more problematic aspects of the discussion draft. In particular:

- The final report is more specific about what is necessary for risk allocations to be respected, and adopts language that is consistent with the framework contained in the business restructuring guidelines (Chapter IX), but more detailed. Under the final guidance, parties assuming the risk must have control, and they must have the financial capacity to bear the risk in order for that risk assumption to be respected.
- The special measures have been discarded.

- The moral hazard framework has been discarded.
- Contracts are recognized as the starting point to understanding the assumption of risk. Contracts that are clear in fully characterizing the assumptions of relevant risks will be helpful to taxpayers so long as their conduct is consistent with the contract (and the parties have the financial capacity to bear the risks they are being assigned by the contract and also control those risks).

The final deliverable repeatedly stresses that recharacterization should be rare, and that transactions that have substance should not be recharacterized simply because they are hard to price. Unfortunately, there are still a few areas where the guidelines are vague enough to create concerns about potential abuse by tax administrations and/or potential double taxation that could be difficult to resolve. In particular, it is still the case that:

- The final deliverable stresses that mere capability does not equate to the control of risk without the actual performance. It also notes that more than one entity might be found to control a risk, but that the party which assumes the risk under contractual arrangements will be assigned that risk so long as it has the financial capacity, and actually exercises its control (at least in part) over that risk. With that said, at other points in the final chapters (including the portions of the final report addressing profit splits), parties controlling the risks may still be profit split participants even if they are not assigned the risk for transfer pricing purposes. Consequently, companies with highly decentralized decision-making structures may be particularly exposed to potential misapplications of profit splits and double tax cases under this interpretation.
- Even though the discussion on recharacterization repeatedly stresses that non-recognition should be a rare exception rather than the rule, the vague language around recharacterization in the final draft could still leave the door open for inappropriate non-recognition by aggressive tax administrations. In particular, the guidelines state "The key question….is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable circumstances." We have some concerns that the final guidance on non-recognition is still potentially open to potential misapplication.

Note that the changes to Chapter I would likely substantially limit the tax benefits associated with cash boxes or minimally functional entities if adopted in domestic transfer pricing regulations.

Correlative Adjustments to Chapter VI

When the Action Item 8 report was released in September of 2014, a substantial number of final revisions were made to the guidance on intangible transfer pricing in Chapter VI. At that time, the changes made reflected the partial culmination of a project on intangibles that began in 2012. That release also included several sections left in draft that were integrally related to the work being done around risk and recharacterization. The revised guidance in Chapter I establishes the appropriate delineation of the transaction, including the identification of the parties assuming risk in controlled transactions. That delineation process has necessary repercussions for which entities will be entitled to intangible-related profits (or losses). The new final portions of Chapter VI (relative to the September 2014 release) largely focus on coordinating the intangible guidance with the concepts reflected in the final risk draft. The Chapter VI revisions also include guidance related to hard-to-value-intangibles, which was the subject of a separate discussion draft and consultation.

Hard-to-Value Intangibles (HTVI)

The final guidance on HTVI retained clauses stating that tax administrations be permitted to apply a behavioral standard to HTVI transactions, imposing contingent payment mechanisms when they determine that independent enterprises would have agreed on the inclusion of such a mechanism to address the high uncertainty in similar circumstances. This behavioral standard may be hard to conclusively assess, and could lead to double tax cases that are difficult to resolve.

The HTVI sections of the final report adopted several changes requested by public commentators as it relates to the application of a pricing adjustment for HTVIs based on ex-post results. Specifically, the “exemption” clauses clarified below:

- More detail provided surrounding the types of information taxpayers should be able to supply to tax authorities with regard to their projections if they want to qualify for an exemption from ex-post adjustment.
- The exemption for “unforeseeable events” has been expanded to include exemptions for situations in which the difference between actual and expected outcomes is due to the playing out of the probabilistic occurrence of foreseeable outcomes, where the probabilities were not significantly overestimated or underestimated at the time of the transaction.
- Exemptions will apply if the pricing consequences of projected vs. actual results are within some boundary, or once they are within those boundaries for a five year period after commercialization, or when the HTVI transfer is covered in an APA.

Cost Contributions Arrangements (CCAs)

The final guidance on the appropriate delineation of transactions and the allocation of risk in those transactions has consequences for CCAs associated with the development of intangibles. Specifically, in order to be consistent, a CCA participant that is purported to be bearing the risk of intangible development must have the financial capacity to bear that risk, and also needs to control the risks associated with the intangible development activity being undertaken under the CCA in the manner set forth in Chapter I. Otherwise, they cannot be considered a participant to the CCA. Similarly, the guidance on HTVI has obvious repercussions for intangible development CCAs that include the contribution of pre-existing HTVI to the arrangement. HTVI constructs for adjustments when actual results are substantially different than projections are also applied to enable adjustments to cost contribution shares unless exemptions similar to those in the HTVI guidance apply. In addition to provisions related to these coordinating provisions, the changes reflected in the final CCA guidance:

- Modified the discussion draft provision that "outcomes for transfer pricing purposes for CCA participants should be consistent with those which would have arisen if the parties made similar contributions on similar terms outside of a CCA" to instead read that the streamlining of flows under a CCA does not affect the appropriate valuation of contributions;
- Explain that ongoing performance of the activities covered by the CCA may be valued at cost so long as the opportunity cost of the pre-existing resources performing those activities (e.g., an R&D workforce) are recognized as a contribution to the CCA and appropriately valued, and paid for, on that basis. However, the contributions of pre-existing contributions generally cannot be measured on a cost basis.

Transactional Profit Splits

The discussion draft on profit splits did not contain substantive new proposed guidance, but rather asked a series of questions around a series of examples that delegates had seen tax administrations apply in order to solicit commentary on the appropriateness of the transactional profit split as a reliable method for analyzing the examples. The profit split material included in the BEPS release similarly does not provide substantive revisions to the current profit split guidelines. Rather, the OECD will be publishing draft guidance in 2016, with expected finalization in the first half of 2017. A public consultation on the draft guidance is expected to be held in May of 2016. Consequently, the discussion on profits split in the final BEPS release is described as a "scope of work for guidance on the transactional profit split method" rather than actual guidance.

Within this scope of work, the OECD provides a brief discussion, referencing profit splits that are elsewhere in the guidelines, noting in particular that the guidance suggests that profit splits may be appropriate when:

- Important functions are outsourced and Comparable Uncontrolled Transactions (CUTs) are not available to appropriately price the performance of that important function; or
- No CUTs are available for analyzing the transfer of an intangible.

The statement of work also suggests that the revisions to Chapter I may prompt consideration of profit splits when multiple parties control economically significant risks in a transaction or when multiple parties contribute to group synergies through deliberate, concerted action. The remainder of the statement of work highlights other areas for further development based on the first public consultation.

Commodity Transactions

The final changes to Chapter II regarding application of the Comparable Uncontrolled Price (CUP) method for commodities pricing largely adopted several proposals in the discussion draft, including:

- A clear statement that the CUP method would generally be an appropriate transfer pricing method for commodities;
- Clarification that quoted prices may form the basis of an application of the CUP method for commodities so long as the source of quoted prices are routinely used in the ordinary course of business to negotiate prices for uncontrolled transactions
- Reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable. Characteristics requiring adjustments might include differences between the tested and comparable transaction related to physical features and quality of the commodity, volumes traded, shipping cost differences, insurance and currency terms.
- The pricing date will be determined by reference to the pricing date actually agreed by the parties where that date can be reliably determined, and so long as the conduct of the parties was consistent with whatever evidence was used to establish the pricing date. If the conduct of the parties was inconsistent with the evidence of the pricing date, tax administrations may determine a pricing date consistent with the facts and with what independent enterprises would have agreed to under comparable circumstances. If there is no reliable evidence of the pricing date, tax administrations may deem the pricing date on the basis of the available evidence.

Low Value Services

The OECD's final release of Chapter 10 includes a few key changes to its draft release of low value-adding services in 2014. These are highlighted below:

- The OECD specifies that the activities listed as excluded from applying the simplified approach does not imply they are high-value in nature. Instead, a comparable analysis is required to justify the profit mark-up applied to the excluded activity;
- The draft release in 2014 introduced a range of profit mark-ups of 2 - 5 percent when applying the simplified approach. The OECD removed the range in its final release and specified that a 5 percent mark-up be applied.
- The final release introduced support for a threshold that could be adopted by tax administrations (which could, for example, be based on the ratio of intercompany

service charges to total costs or turnover), above which a simplified approach cannot be applied and full functional and comparable analysis be used to support the intra-group service charge.

- A new section recommends tax administrations apply withholding tax only to the profit element of the service charge when withholding taxes are being applied.

For more information, please contact:

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