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VIA EMAIL

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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)

Dear Mr. Hickman,

USCIB¹ is pleased to have this opportunity to provide comments on OECD's discussion draft on risk, recharacterisation and special measures.

General Comments

Special Measures

USCIB is very concerned about the proposed special measures. The special measures presented in the discussion draft are only described at a very high-level and it is therefore impossible to analyze them and comment on them in any detail. Before adopting any of these options it would be necessary to publish comprehensive drafts with more specific detail and permit an extended period of stakeholder input into those comprehensive proposals.

USCIB believes that none of the special measures should be adopted until the other BEPS measures have been fully implemented and the need for any additional special measures to target specific issues can be assessed. The discussion draft asserts that residual BEPS risks will remain even after other proposals are implemented and that this expectation justifies special measures.² The BEPS proposals are intended to align returns with value creation. The various measures that are being developed in an attempt to achieve that goal will impose significant new administrative burdens on taxpayers to comply with more onerous rules. It is also expected that those new rules will increase the tax cost faced by MNEs. If the BEPS proposals succeed in aligning profits with value creation and reducing unintended double non-taxation, then it would seem both perverse and counterproductive to permit tax authorities to ignore or override those results through the adoption of special measures. Special measures should only be considered if the BEPS proposals, when implemented and their effectiveness evaluated over several years, fail to address the issues of aligning returns with value creation and continuing unintended double non-taxation. In that case, the need for special measures would be clearer and the appropriate scope of any special measures would be easier to determine.

¹ USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

² Discussion draft, Part II, Special Measures, paragraphs 2 and 3, page 38.

If tax authorities are permitted to ignore the proper alignment of profits with value creation that may facilitate a revenue-grab by some tax authorities because they are disappointed with their tax collections even though the results are entirely appropriate. Such a result is also likely to create double taxation since the country to which profits are properly attributable is unlikely to cede taxing jurisdiction. Given the lack of binding dispute resolution, these disputes are unlikely to be resolved.

The likely end result of most of the proposed special measures would be to realign “source” and “residence” taxation.³ The BEPS project is not intended to address the realignment of so-called “source” and “residence” taxation. Thus, special measures that seek to achieve such realignment should be considered outside of the scope of this project and should be rejected. USCIB believes that all of the special measures other than the first option (a commensurate with income proposal) could result in significant realignment of taxing rights between source and residence countries and should be rejected.

Non-recognition

The current Transfer Pricing Guidelines (TPGs) describe two circumstances in which transactions may be disregarded. The first of these is if the substance of the transaction differs from its form.⁴ This standard has been deleted from the proposed new section on non-recognition and replaced by a lengthy exposition on the delineation of the actual transaction. As USCIB reads the discussion draft, rather than continuing to be rare (as might be intended by the drafter), recharacterisation/non-recognition would become routine. That is, the first circumstance in which it is appropriate to recharacterise the transaction has been disregarded and replaced by the ability of the tax authorities to “deduce, clarify, or supplement” the contractual terms in virtually every case as they see fit. The overall tone of the discussion draft could lead to an interpretation that the contract is essentially irrelevant, and that tax authorities price the transaction that they perceive to have occurred. USCIB concerns with this standard are discussed in more detail in the specific comments section of this letter.

The new section on non-recognition⁵ applies to the transaction between the parties “as accurately delineated.”⁶ OECD describes the need for non-recognition and the rule as follows:

“Attributes of non-arm’s length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.”⁷

And:

“Since the resulting transactions derive from the environment created by the MNE group, it should not follow that this environment alone determines where profits arise for transfer pricing purposes. Instead it should be determined whether the resulting transactions have arm’s length attributes.”⁸

And:

³ USCIB believes that the distinction between so-called “source” and “residence” taxation is meaningless because when countries use these terms they have no consistent meaning. For example, while most countries take the position that the “source” of services income is the place of performance, many others assign source based on the place of consumption. If the country of consumption asserts a greater right to tax services, has taxation been realigned to the source jurisdiction or away from the source jurisdiction? Countries assert that they are the “source” jurisdiction because under traditional international tax principles, the “source” jurisdiction has the primary right to tax and the “residence” jurisdiction has a residual right to tax. This primary right to tax is based on the source jurisdiction being the origin of the income – as opposed to a destination based tax such as a VAT. USCIB’s comment letter on the OECD’s discussion draft on the digital economy goes into detail on this and is relevant here. See pages 1 and 2 and 12 and 13 of the USCIB comment letter on the digital economy discussion draft.

⁴ OECD Transfer Pricing Guidelines paragraph 1.65, page 51. Hereinafter OECD TPGs.

⁵ Discussion draft paragraphs 83 et seq., page 25.

⁶ Discussion draft paragraph 83, page 25.

⁷ Discussion draft paragraph 85, page 25.

⁸ Discussion draft paragraph 87, page 26.

“An arrangement exhibiting the fundamental economic attributes of arrangements would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted ... basis, compared to other opportunities realistically available to them at the time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them, then the transaction would not be recognized for transfer pricing purposes.”⁹

Despite some language cautioning against routine non-recognition of the delineated transaction,¹⁰ USCIB is very concerned that this standard will be essentially impossible to apply in practice in a coherent way. Parties “are not always able to protect or enhance their position”. For example, MNEs may shrink or discontinue lines of business. These decisions may be taken in consultation with the affected entities, but for legitimate reasons, may not protect or enhance the positions of the individual entities. Shrinking one entity may occur at the same time that another entity is expanding. These decisions are business – not tax – driven. Such a decision obviously does not protect and enhance the position of both parties to the transaction. Companies may close a plant that is no longer efficient and establish a new plant in a new location elsewhere. That plant may be owned by a different entity in the group and run and staffed by different personnel. Tax authorities routinely challenge the business decisions of MNEs. Companies **are** challenged on issues as fundamental as the choice of where to locate a plant or where to locate a function. They are also challenged on other issues as well; a local service provider should have been hired. That is, tax authorities often assert that rather than centralizing legal and accounting services MNEs should engage a local firm.

The UK’s proposed Diverted Profits Tax is essentially the UK government telling business that its decision to centrally locate distribution and manufacturing functions in Ireland (instead of the UK) for its customers in the European Union is tax avoidance despite the fact that there may be good business reasons for centralizing those functions and for locating in Ireland. Ireland is typically a first choice of US companies to locate in for a variety of reasons. These reasons include: cost of business including headcount and facilities, a business friendly environment and infrastructure, well educated workforce, English language, EU membership, etc. The continued attack on commissionaire structures by the French tax authorities is more of the same. Tax authorities assert the realistic alternative would be a full-fledged distributor. Essentially, tax authorities generally assert that the realistic alternative would be to put more functions in the local jurisdiction, ignoring the actual transaction, when it suits their purposes. Allowing transactions to be ignored based on such a vague standard, will lead to routine non-recognition of transactions that are entered into and performed in good faith for valid business purposes.

The discussion draft would also permit tax administrations to disregard transactions in which an entity trades a risky stream of income for an equivalent, but less risky, stream of income. This is based on the notion that unrelated parties would not engage in these transactions. That unrelated parties would always seek to enhance or protect their position. While it may be true that parties seek to enhance or protect their position, they may not have the power to do so. That is, unrelated parties are rarely bargaining from positions of equal strength and that will affect the outcome of any negotiation. In unrelated transactions, one party may need to make concessions it does not want to make in order to get or keep any business at all. For example, if one party to a transaction provides routine distribution services which could be provided by another person, then the manufacturer whose goods are being distributed may be able to negotiate more favorable terms because of the ability to find another distributor. The manufacturer may be able to retain all or most of any premium profits because of this flexibility. The distributor may have more difficulty substituting other products and thus may be willing to accept a return that does not share in the risk related return even though it may in some sense assist in managing the risk.

Another concern with this standard and with the notion of realistic alternatives is that these concepts are at odds with another focus of the BEPS project -- that is to understand the global value chain and how the interaction between related parties contributes to the overall generation of value. The non-recognition and realistic alternative concepts seem to focus on maximizing the return to the particular entity as distinct from the group, while the focus on the global value chain seems to require a group wide analysis. If the principles of the discussion draft on profit splits are adopted such that the return to the particular entity in fact reflects the contribution to the global value chain, then it will be impossible to apply these other standards which are focused on maximizing the profit in the individual entity.

⁹ Discussion draft paragraph 89, page 26.

¹⁰ Discussion draft paragraph 84, page 25.

USCIB agrees with the BEPS Monitoring Group's comments on the OECD's Dispute Resolution (Action 14) discussion draft. The most important element in dispute resolution is avoiding disputes. It is most effective to avoid disputes in the first instance by adopting clear and simple rules that can routinely be applied. The proposed guidance will lead to disputes that will be very difficult to resolve, as Competent Authorities will not agree on the transaction that is being priced. One country may accept the original transaction, while the other may substitute its own characterization.

Risk

The discussion draft raises issues concerning the global nature of risk. The discussion draft allocates returns from risk to those managing the risk. The managing of global risk is one of the principal functions of senior management and the Board of Directors. Management is responsible for identifying the direction of the business, deciding which ventures to pursue and which to abandon, and developing or acquiring new products or businesses which they believe will be successful. These basic decisions determine whether a company will become and remain successful and by definition must be centrally managed to be effective. All businesses must continuously evaluate and manage these risks. These risks are not managed in a contract manufacturing entity or a contract research and development facility because these entities have no insight into the broader risks facing the entity. Managing risks is the key to the continuing vitality of any business.¹¹ Any approach that either ignores these risks or allocates them on the basis of a formula would fundamentally misallocate business risk. This approach would divorce taxation from business and economic realities; a result that appears contrary to the goals of the OECD. Additionally, formulaic apportionments carry significant risks of creating their own base erosion problems.

Another fundamental problem with the discussion draft is the notion that unrelated parties do not accept risk that they do not manage. Unrelated parties routinely do this, in some cases because they are willing to accept the risk in exchange for the possibility of high returns (e.g., the passive investor in the hedge fund), and in other cases because they perceive that their interests are generally aligned with the other party. For example, a hotel owner may pay an unrelated management company a fee based on revenues. In this case, both the hotel owners' and the management company's interests are served by maximizing revenue from the hotel. An owner of retail real estate may accept rents based on sales in the knowledge that the lessee will be attempting to maximize sales. A pharmaceutical company may license intellectual property for a percentage of revenue. Both the pharmaceutical company and the licensee wish to maximize sales, so their interest are aligned and the licensor would be willing to take on that risk since the licensee will be attempting to maximize its sales to the benefit of the both the licensor and the licensee. These types of arrangement are common. Returns in these types of arrangements reflect assumption of risk by both parties and the return to both parties ought to reflect that shared-risk. That is, both parties should be entitled to an entrepreneurial return.

The discussion draft generally limits contributors of capital, either in the form of ownership of assets or cash, to a routine financial return unless they are also managing the risk related to those assets. This misunderstands investment. Investors are quite willing to invest in valuable assets without the ability to manage those assets and rely on others to manage those assets.¹² This is ultimately what corporate shareholders do; that is shareholders invest in a company that they do not control in order to earn the premium returns that a risky business investment may make rather than the more secure financial return of a risk free investment. Fundamentally, corporate risk is borne by ultimate shareholders (individuals) and creditors of the MNE. Shareholders are likely to have very little say about the management and control of risk of the entities in which they invest having deferred that function to the Board of Directors, but ultimately they bear the losses and earn the premium returns. If the BEPS project is about preserving the corporate tax base, then it is necessary to look at the overall purpose and function of the corporate tax. To the extent that the corporate income tax serves as a backstop to the personal income tax, then that should inform the decisions particularly on risk and special measures.

Specific Comments

Update of section D of Chapter 1

¹¹ Even companies that have been successful over a long period can fail because they fail to manage business risk and change. Kodak is a prime example of the sort of failure.

¹² This is why special measure 2 is simply wrong. The independent investor would in all likelihood prefer an investment in the asset owning entity, especially if that asset is unique and valuable. Personnel can always be found to manage the asset.

Section D has been substantially revised. Rather than starting with the notion of comparability, the discussion draft starts with a lengthy section¹³ that is largely new on accurately delineating the commercial or financial relations between associated enterprises. This step takes place before the comparability analysis. Even though the language is new, USCIB understands that the OECD does not believe that the process is new; rather this is how transfer pricing is routinely conducted today. The contract is an element of the transaction, but it is also necessary to examine the conduct of the parties including all the facts and circumstances in delineating the transaction. USCIB believes that if the conduct of the parties is consistent with the contract, the contract should be respected. The fact that the contracts are between affiliates should not affect this fundamental determination.

D.1 Identifying the commercial or financial relations

The discussion draft describes the process of identifying the commercial and financial relations between associated enterprises as involving a very detailed analysis of the contractual terms, the conduct of the parties, their role in the global value chain, and the precise identification of the functions each party actually performs, the assets each party actually employs, and the risks each party actually assumes and manages.¹⁴ The terms of the transactions are merely the starting point. If no written terms exist or where the conduct of the parties shows the terms are ambiguous, incorrect or incomplete, "the delineation of the transaction should be deduced, clarified, or supplemented base on the review of the commercial or financial relations as reflected by the actual conduct of the parties."¹⁵ "Where conduct is not fully consistent with contractual terms, further analysis is required to identify the actual transaction."¹⁶

USCIB's is concerned with the level of detail at which transactions are expected to be analyzed. Throughout the draft there is an emphasis on precision (see the quotes above). This is appropriate in high-risk cases, but is probably impractical in routine cases and will permit countries to challenge virtually any transaction, and will lead to proliferating disputes. See for example paragraph 2 which requires examination of all the facts and circumstances, how that interaction contributes to the global value chain, the precise identification of functions, assets and risks. The facts and circumstances should also be taken in context. For example, a term may not be precisely defined in an intercompany agreement because all internal parties to the contract understand precisely how a term is to be applied because that concept is the subject of an internal accounting policy. As such it was considered redundant by the company to define that term in the agreement. A tax examination that considered the context of the relationship would avoid many needless and time consuming disputes.

There needs to be balance between the risk associated with the transaction and the transfer pricing analysis required. Even if the conduct of the parties does not conform in all respects to the contract, in most cases third-party business functional analogues will exist to define the parameters of the relationship and transactions. For example, if the ultimate third party transaction is the sale of products into a jurisdiction, then the affiliates involved should be evaluated within the boundaries of a marketing and distribution chain. USCIB supported the recent discussion draft on low-value adding intra-group services and the prior work on MOUs encouraging Competent Authorities to extrapolate from agreed cases to broader guidance that may be made applicable to taxpayers generally. The current discussion draft also does not reference the OECD's recent work on risk assessment. There should be a balance between the cost and burden on taxpayers and (tax authorities) and the benefits to governments. The discussion draft should be modified to reflect this balance.

The example in paragraph 4 concludes that because the contract does not mention "marketing and advertising services" that the contract is incomplete and therefore the transfer price should be based on the conduct of the parties. USCIB believes that this analysis is incomplete. Before concluding that the transfer price must be determined based on a different transaction, the tax authorities should understand the context of how independent parties operate in the particular industry. It may be that independent parties enter into similar contracts under which equivalent functions are performed under similar terms. That is, the marketing and advertising are considered part of the distribution function and available information on comparable distribution chains should provide parameters for pricing transactions within this relationship. The tax authorities should not jump to the conclusion that because the contract is silent or

¹³ Discussion draft, paragraphs 1 – 15, pages 4 – 8.

¹⁴ Discussion draft, paragraph 2, page 4.

¹⁵ Discussion draft, paragraph 3, page 4.

¹⁶ Discussion draft, paragraph 5, page 5.

incomplete, that additional compensation must be paid. If in fact the taxpayer has identified comparables that are functionally comparable then an adjustment should not be necessary simply because the contract is deemed "incomplete" by the tax authorities.¹⁷

Paragraph 5 of the discussion draft is based on existing paragraph 1.53 of the TPGs. It has, however, a much more skeptical tone. It starts with the sentence "It should not be assumed that the contracts accurately or comprehensively capture the actual commercial relations between the parties."¹⁸ This is followed by an emphasis on detailed analysis of the actual conduct of the parties. "Where there are differences between contractual terms and factual substance, the conduct of the parties in their relations with one another, and what functions they actually perform, the assets they actually employ, and the risks they actually assume and manage, in the context of the consistent contractual terms, should ultimately determine the delineation of the actual transaction."¹⁹ As explained above, it is important that this precision be balanced with the notion of risk assessment and burden. Every transaction is not worth this level of attention. The OECD should consider some materiality thresholds before requiring this level of analysis.

Under the discussion draft there are no longer only two cases in which recharacterisation is appropriate. Rather delineation of the transaction would replace the substance over form standard and the second standard would be modified. Delineation of the transaction could amount to a recharacterisation/non-recognition of the transaction because the transaction as described in the contract does not conform exactly to the transaction that took place in the opinion of the tax authorities. This could cause many transactions to be recharacterised without the protection of current TPGs which state that such recharacterisation should only apply in exceptional cases. This comment is related to the precision comment above. Care needs to be taken that good faith transactions are not ignored simply because they deviate from the written contract in certain non-essential terms. Delineating the transaction should not be a license for governments to reconfigure every intra-group transaction. Adopting this standard could effectively read Article 9 out of the Model Treaty and result in an Article 7 analysis for all related party transactions.

Paragraph 6 seems to have an example that would involve recharacterisation of the transaction under the current TPGs²⁰, although this is not labeled as recharacterisation or non-recognition in the discussion draft. The license is essentially ignored and the transaction that is priced is the transaction that the tax authorities believe took place. USCIB believes that by whatever name is applied this is a recharacterisation of the transaction and should, as under the current TPGs, only occur under exceptional circumstances. S's license could and should be respected and P should be compensated for its services to S.

Paragraph 7 of the discussion draft involves the application of the transfer pricing rules to commercial or financial relations that "may not have been identified by the taxpayer, but that nevertheless may result in a transfer of value".²¹ In such a case, all aspects of the transaction would need to be deduced from available evidence of the conduct of the parties. In particular, the discussion draft mentions technical assistance, creation of synergies through deliberate concerted action and the transfer of know-how through the secondment of employees or otherwise.

USCIB has two comments on paragraph 7. First, as a practical matter the transfer of know-how may be impossible to track. If engineers employed by five different entities located in five different countries hold a conference call to resolve a technical issue, they may share how-know among the members of the group. It is not clear how even the most compliant taxpayer could track this exchange of information and price it. The intangibles report distinguishes valuable know-how from other know-how that is not entitled to a premium return that distinction should be clearly adopted here.

Second, the OECD should be clear about the distinction between an employee's special skills and company know-how. For example, a welder may have a special skill that makes him valuable and seconding such an employee would

¹⁷ It is unlikely that a contract whether between related or unrelated parties would cover every conceivable circumstance. If contracts between related parties are required to do so to avoid challenge, then related party contracts will look like transfer pricing reports and be much more difficult to administer than unrelated party contracts.

¹⁸ Discussion draft, paragraph 5, page 5.

¹⁹ Discussion draft, paragraph 5, page 5.

²⁰ OECD TPGs paragraph 1.65.

²¹ Discussion draft, paragraph 7, page 6.

potentially provide his skill set to the enterprise to which he is seconded. This should not, however, be considered a transfer of know-how. Know-how ought to be limited to something that the company has an interest in protecting, such as a trade secret that the individual may have knowledge of, rather than an individual's skill set.

Integration and fragmentation

The discussion draft's functional "analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities include decision-making, including decisions about business strategy and risk management In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution the parties make to value creation."²²

The introduction also focuses on the ability of a MNE to fragment even highly integrated functions "secure in the knowledge that the fragmented activities are under common control for the long term and are co-ordinated by group management functions."²³ "When conducting a functional and risk analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and if so, the nature of the interdependencies and how the commercial activity to which the parties contribute is co-ordinated."²⁴

The options realistically available analysis requires each separate entity to consider alternative transactions that would produce the best result for that individual entity. Thus, the discussion draft seems to require several different ways of looking at each actual transaction, plus the necessity of considering alternative transactions that might change the profit allocation. In reality most alternative transactions presented by tax authorities profess to put additional risks and functions into their jurisdiction. In conjunction with that shift tax authorities immediately jump to the conclusion that the shift creates additional local profit without any consideration of the additional expenses that the local entity would be responsible for due to duplication of efforts across multiple entities. An accurate review of alternative transactions must consider both. The burden posed by these requirements is essentially infinite and there is no guarantee that on audit the tax authorities will still not reject the transaction and substitute another. Again, there needs to some notion of balance, that this level of analysis should only be required in the most complex and financially significant cases. Again, the OECD should consider some materiality thresholds before requiring this level of analysis.

D. 2 Identifying risks in commercial or financial relations

The discussion draft makes a number of points concerning the identification of risks. These include: "identifying risks goes hand in hand with identifying functions and assets"²⁵; identifying risks is critical because of the allocation of risks affects how profits and losses are allocated²⁶; risks can be hard to identify²⁷.

In identifying the allocation of risk attention should be paid to how the parties actually manage the risk.²⁸

The discussion draft states that "between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic".²⁹ The discussion draft gives two reasons for this. First, it would be difficult for the party assuming the risk to determine the additional return necessary to accept the risk. Second, that allocation would create moral hazard that the person with the ability to control the risk would have no incentive to do so. The discussion draft concludes that "it generally makes more sense for the parties to be allocated a greater share of those risks over which they have relatively more control."³⁰ This is emphasized further later in the discussion draft

²² Discussion draft, paragraph 16, page 8.

²³ Discussion draft, paragraph 21, page 9.

²⁴ Discussion draft, paragraph 21, page 8.

²⁵ Discussion draft, paragraph 36, page 12.

²⁶ Discussion draft paragraph 37, page 12.

²⁷ Discussion draft paragraph 38, page 12.

²⁸ Discussion draft paragraph 38, page 13.

²⁹ Discussion draft paragraph 38, page 13.

³⁰ Discussion draft paragraph 38, page 13.

which provides: "to the extent that ability to control a risk is lacking in a group situation, then the arrangements would not support the contractual allocation of that risk for transfer pricing purposes."³¹

USCIB believes that companies accept risks that they do not control on a regular basis and price that risk into their contractual agreement with the other party. They may attempt to hedge those risks to minimize the potential downside, but the notion that parties need to control risk to accept it is flawed. Companies will certainly try to understand the risks they are accepting but in many cases will accept risks that they can neither identify nor understand. As a recent example, the price of oil and gas has fluctuated dramatically. That fluctuation is due to geopolitical events beyond the control of any MNE, companies across industries may be harmed by or profit from these fluctuations. To some extent the price fluctuations may be managed by hedging but to some extent companies are simply exposed to this risk and that risk is part of doing business. Some companies may fail as the result of these price swings which are beyond their control.

As another example, new technology routinely replaces existing technology and companies adapt or fail. We have already mentioned the failure of Kodak to adapt to the emergence of digital photography and the disappearance of film. How does a company control the risk that its business is obsolete? One response to this risk is to be continuously innovating. As pointed out above the choice of what new products or lines of business to pursue is within the purview of senior management, so that if that innovation is successful it is those decisions that are rewarded. The decisions of senior management need to be implemented by others, both those choices and directions drive premium profits and losses.

The issue of insurance and the contractual allocation of risk is discussed in paragraph 61. The OECD states that "a customer's contract with an unrelated insurance company ... could be perceived as a contractual allocation of risk from the perspective of the customer, but the insurance company will have the relevant capabilities to assess, underwrite, and manage the insurance risk." Thus, the OECD is not seeing the management of the risk as the avoidance of a claim on an individual policy, which would be within the customer's control (careful driving), but the managing of the overall risk to the company.

USCIB believes that the insurance example is inconsistent with how the OECD looks at the risk within the group. That is, within the group, it seems that "driving the car" gets a significant return because that entity is managing the risk. In fact, the function of senior management and the Board of Directors is more analogous to the insurance company. They assess the risk – by determining what business opportunities to pursue or reject, underwrite those businesses, and manage that risk. The discussion draft raises the issue of whether associated enterprises can have different risk preferences while acting collaboratively.³² As a first response to this point, separate legal entities have separate board of directors which have fiduciary duties to the particular company. MNEs are not monoliths, but rather are frequently the result of acquisitions that attempt to combine disparate cultures (both corporate and other). These factors result in company's within an enterprise having different approaches to business problems. Some MNEs may try to smooth out these differences, but some value the "diversity" of approach. We caution against developing theoretical approaches to transfer pricing concerns based on one interpretation of how an MNE might operate.

The issue of risk preferences also raises a more fundamental issue on risk that the draft does not address, which is that corporate risk is borne by ultimate shareholders (individuals) and creditors of the MNE. Shareholders are likely to have very little say about the management and control of risk of the entities in which they invest relying instead on the value judgment of the Board, but ultimately they bear the losses and earn the premium returns. (This would argue for integration of corporate income and personal income taxes rather than elaborate and perhaps unenforceable transfer pricing rules. Even though corporate/shareholder integration is not being considered, USCIB believes it is worthwhile to consider these issues because it should inform the choices on special measures.)

The discussion draft also raises issue of whether it is possible for the "risk-return trade-off" to be sensibly applied in a MNE group³³. The draft questions how the asset transfer can alter the risks assumed by associated enterprises.

³¹ Discussion draft paragraph 61, page 21.

³² Discussion draft, box, page 13.

³³ Discussion draft, box, pages 14 and 15.

USCIB believes that companies may accept a risk return trade off in the interest of protecting other assets. For example, if a risky asset is transferred and held in one entity and a third party creditor is looking only to that entity for the payment of its debt and the risky asset does not perform, then the other assets of the MNE group are protected from the claims of that creditor. If this arrangement is respected for corporate law purposes, it also ought to be respected for tax purposes. Shifting income between related parties may change the legal rights of unrelated parties. That is if a creditor is only entitled to proceed against only one entity in an affiliated group, changing the tax allocation may change the rights of the creditor and if so, should there be a concern with retrospective application?

D.2.1 The nature and sources of risk

In the transfer pricing context "it is appropriate to consider risk as the effect of uncertainty on the objectives of the business."³⁴ Every time money is spent or income is generated, uncertainty exists and risk is assumed. Risk has both positive and negative connotations. Management activities are directed at determining what risks the enterprise wishes to take on and how they are to be managed. Risk depends on the context, some risks are more essential to the company's profitability and long-term viability than others.

There are different categories of risk including: strategic risks or marketplace risks, infrastructure or operational risks, financial risks, transactional risks, and hazard risks.³⁵ (Para. 42, pages 16 and 17.) Some risks are externally driven and others internally driven. Externally driven risks can be a source of competitive advantage, depending on the company's ability to manage those risks. Like intangibles, "risks which are vaguely described or undifferentiated will not serve the purposes of a transfer pricing analysis seeking to delineate the action transaction and the actual allocation of risk between the parties." (Para. 42, page 16.)

USCIB would like it to be clear that these rules should be reciprocal. That is, tax authorities should not use vaguely defined undifferentiated risk as basis for transfer pricing adjustments.

D.2.2. Allocation of risk in contracts

If a written contract sets out a contractual allocation of risk, it must be determined whether that is consistent with the conduct of the parties. "Where differences exist between contractual terms related to risk and the conduct of the parties, the parties' conduct in the context of the consistent contractual terms should generally be taken as the best evidence concerning the actual allocation of risk." (Para. 43, page 17.)

Paragraph 44 gives an example where currency risk is contractually allocated to a US manufacturer, but the price for the goods is charged in euros, the currency of the distributor. USCIB assumes that the price referred to in this example is the price between the manufacturer and the distributor, not the distributor and the customer. A euro price to the customer would not result in currency risk to the distributor. The discussion draft concludes that the conduct of the parties is not consistent with the contract and therefore the transaction should be delineated by the actual conduct of the parties rather than the contract.

D.2.5. Risk management

Under the discussion draft risk management has three elements: "(i) the capability to make decisions to take on or decline a risk bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of risk mitigation."³⁶ The first two elements are essentially taken from paragraphs 9.23 and 9.24 of the current transfer pricing guidelines. The third element is not part of that guidance.

³⁴ Discussion draft, paragraph 41, page 15.

³⁵ Discussion draft, paragraph 42, pages 16 and 17.

³⁶ Discussion draft, paragraph 55, page 19.

Paragraph 55 of the discussion draft³⁷ acknowledges that risk mitigation can be outsourced, but requires the ability to "assess, monitor, and direct the outsourced measures that affect risk outcomes, together with the performance of such assessment, monitoring, and direction."

D.2.6. Actual conduct

Paragraph 60 of the discussion draft provides "the parties' assumption of risk does not in itself determine that they should be allocated the risk for transfer pricing purposes. It is relevant to enquire how the risks are controlled in the business, as well as which party's functions enable it to mitigate the risks associated with business activities."³⁸

This section runs through a number of scenarios including the insurance scenario described above, the unrelated party supplier taking advantage of its distributor, ownership risk, and the relationship between cash investment and risk.

Essentially, all of the examples separate the assets and the management of the risk. They seem to allow the legal owner of a tangible asset only a financing return.³⁹ This seems inconsistent with the insurance example where it is recognized that having the capital to bear the risk is an important part of risk management.

With respect to cash, the discussion draft recognizes that investors are sometimes willing to make cash investment in a risky business undertaking without any security or guarantee⁴⁰ and states that: "if no other risk mitigation measures are available, such as diversification, the investor may wish to be able to assess, monitor, and direct risk mitigation measures to protect its investment." The return to cash and the return to risk management are considered separately.⁴¹ The discussion draft also seems to downgrade the financial capacity to bear risk. Paragraph 66 states that "a low level of capital in a controlled enterprise, should not prevent the allocation of risk to the company for transfer pricing purposes where such allocation is justified under the guidance of this Chapter."⁴²

These rules seem to ignore that ultimately the premium returns ought to be earned by the ultimate individual shareholders and therefore the return to capital ought to be greater. That is after all what shareholders provide. Shareholders do not invest in corporate shares to earn a routine financial return but are willing to accept a measure of risk to earn a premium return. They could make much less risky investments if that were their goal, they invest for excess returns and that ought to be taken into account in whatever rules allocate apply to allocate premium returns.

D.4. Non-recognition

Non-recognition is intended to convey the same meaning as the term recharacterisation in the current TPGs.⁴³ The OECD recommends that "every effort is made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction".⁴⁴ Importantly, "where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized. The key question is whether the actual transaction possesses the fundamental economic attributes or arrangements between unrelated parties ... The non-recognition of a transaction that possesses the fundamental attributes of an arm's length arrangement is not an appropriate application of the arm's length principle."⁴⁵

The OECD justifies non-recognition because of the MNEs ability to control which companies own assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the

³⁷ Page 19.

³⁸ Page 20.

³⁹ Discussion draft, paragraph 63, page 21.

⁴⁰ Discussion draft, paragraph 64, page 22.

⁴¹ Discussion draft, paragraph 65, page 22.

⁴² Discussion draft, paragraph 66, page 22.

⁴³ Discussion draft, paragraph 83, page 25.

⁴⁴ Discussion draft, paragraph 84, page 25.

⁴⁵ Discussion draft, paragraph 84, page 25.

knowledge that the consequences of the allocation of assets, functions, and risks to separate legal entities is overridden by control.⁴⁶

The interaction of these rules needs to be considered in conjunction with the proposals on interest deductibility. MNEs may, in many cases, centralize third-party debt in the parent entity or an affiliate resident in the parent country. There are many reasons for this including the desire to borrow in the home country currency or creditors' desire to have the assets of the group available to fund the repayment of the debt. The proposals in the discussion draft, particularly the group wide ratio, would essentially require, to the extent possible,⁴⁷ MNEs to establish financing entities to manage their interest expense by pushing debt down to affiliated entities. The financing entities may neither need nor have full time employees. The discussion draft on risk, characterization and special measures may be read as not recognizing these transactions or applying special measures to them. Thus, the proposals in the two discussion drafts may be working at cross purposes. That is, if MNEs must, to the extent possible, establish financing entities to manage their interest deductions then those entities must be permitted to earn a time value of money return regardless of whether they are considered "minimally functional". Both the discussion draft on interest deductibility and the discussion draft on risk, recharacterisation and special measures should be clear that such entities earning a time value of money return do not raise issues under non-recognition or special measures notwithstanding their passive nature.

It should be noted that most MNE's make every effort to comply with the transfer pricing rules and regulations in every country in which they operate. Consider for a moment the consequences of failing to do so results in numerous extended tax audits, litigations of tax controversies, analysis and disclosure of tax provisions, discussions with the company's auditor and financial management, disclosure to Wall Street, etc. Taken as a whole there is more incentive for MNE's to be as compliant as possible than to be non-compliant. Given that perhaps it's the OECD's rules that need to be clarified to allow for more accurate MNE compliance.

The new test is supposed to clarify the application of the test of commercial rationality.⁴⁸ This paragraph also interprets the commercial rationality test as only having a single leg: that is the transaction is commercially irrational. The current test does require that structure practically impede the ability to find a price. The discussion draft essentially reads this out of current TPGs.

Paragraph 89 provides that an arrangement exhibits the fundamental economic attributes of arrangements between unrelated parties if it offers each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk adjusted basis, compared to other opportunities realistically available to them. If that is not the case, then the transaction would not be recognized for transfer pricing purposes. It is also relevant to consider whether the group as a whole is worse off on a pre-tax basis.⁴⁹

If non-recognition is appropriate, then "the replacement structure should be guided by the fundamental economic attributes of arrangements between unrelated parties and comport as closely as possible with the commercial reality of independent parties in similar circumstances."⁵⁰

This section seems to have some internal inconsistencies. If for example a MNE has a buy-sell distributor in a jurisdiction and wishes to convert that to a limited risk distributor, that would seem to be permissible under the axiom that if the relationship is found between independent parties then it should be recognized. It might also violate the rule that the distributor's position is not enhanced or protected. That is the distributor will be making less profit under the new arrangement (assuming the distributor has reduced risks and functions), such that the arrangement would not be recognized under paragraph 89. Is that what the OECD intends? How will these positions be reconciled? Does this give a premium to setting up a tax efficient structure to begin with? Or are economically inefficient business models the goal as long as they produce additional local tax revenues?

⁴⁶ Discussion draft, paragraph 85, page 25.

⁴⁷ See the BIAAC comment letter on the OECD's discussion draft on interest deductibility for detailed comments on why this is very difficult to achieve in practice.

⁴⁸ Discussion draft, paragraph 88, page 26.

⁴⁹ Discussion draft, paragraph 89, page 26.

⁵⁰ Discussion draft, paragraph 93, page 27.

We also refer back to the discussion in section of this letter covering non-recognition concerning this issue. Transactions in which one party accepts a less risky return can and do take place between unrelated parties because all parties to a transaction do not have equal say in the outcome of every transaction and the party in the stronger position may be able to negotiate a greater share of the more risky premium returns.

Part II Potential Special Measures

As we stated at the beginning of this letter, the special measures presented in the discussion draft are only described at a very high-level and it is therefore impossible to analyze them and comment on them in any detail. Before adopting any of these options it would be necessary to publish comprehensive drafts with more specific detail and permit an extended period of stakeholder input into those comprehensive proposals.

As we have pointed out throughout this letter, the discussion draft misunderstands the relationship between capital and risk, particularly the willingness of investors to accept risk that others manage. The special measures (other than the commensurate with income option) would potentially increase that disconnect.

We reiterate our belief that no special measures should be adopted until other BEPS Actions have been implemented and evaluated over a period of time, such that the need for those special measures is clearer and the appropriate scope of such special measures can be determined.

USCIB appreciates the opportunity to comment on the discussion draft and look forward to working with the OECD to achieve appropriate outcomes.

Sincerely,



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