UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

May 31, 2019

VIA EMAIL

UN Transfer Pricing Subcommittee

Re: USCIB Comment Letter on the update of the UN Practical Manual on Transfer Pricing for Developing Countries

USCIB[1] is pleased to have the opportunity to comment on the draft of the update of the UN Practical Manual on Transfer Pricing for Developing Countries ("the Manual" or the draft Manual").

Financial Transactions

USCIB believes the appendix on financial transactions is generally thoughtful and will provide appropriate guidance to countries making use of the toolkit. Our main concern is that the discussion of capital structures may lead to inappropriate recharacterization of debt as equity. This concern is discussed in detail below.

Capital Structure

Many valid factors impact an entity's choice of debt vs. equity financing, and, subject to anti-abuse provisions that should only apply in exceptional circumstances, taxpayers and not tax authorities should determine an entity's capital structure. In particular, for most non-financial-services companies, the sole objective of intercompany financing is cash management and the internal Treasury group's desire to avoid equity investments in affiliates because it is very difficult to pull equity capital out of an affiliate. Companies do not want to trap cash in their affiliates; therefore, debt is preferred. The existing OECD Model Income Tax Treaty and Commentary under Article, which the UN Model adopts,[2] permits some testing of capital structure. The OECD Commentary provides: "the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment"[3]. This statement should be put into context.

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[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] UN Model Income Tax Treaty between Developed and Developing Countries, Commentary, Article 9, paragraph 6.

[3] OECD Model Tax Convention on Income and Capital, Commentary on Article 9, paragraph 3(b). The Commentary grew out of an OECD report on "Thin Capitalization" adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full of version of the OECD Model Tax Convention at page R (4)-1, hereinafter "Report" or "Report on Thin Capitalization".

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The OECD's Report on Thin Capitalization identifies the problem (thin capitalization), identifies country practices to address it, discusses the relevance of tax treaties, addresses the practical application of the ALP to thin capitalization, and reaches conclusions. In addition to the Commentary quoted above, an important conclusion of the Report was that Article 9 "does not prevent the application of national rules on thin capitalization insofar (but only insofar) as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation."[4]

The draft Manual[5] provides that "[t]ransfer pricing rules do not serve to determine what capital structure is optimal for a company." This implies that transfer pricing rules should not be determinative of whether a company's capital structure is appropriate. USCIB agrees with this implication. Clearly, transfer pricing rules are relevant to determining the arm's length interest rate and the debt burden of a company may be excessive, but there are better tools than the arm's length standard for determining whether debt is excessive.

The Report on Thin Capitalization, in the context of discussing country approaches, mentions hybrid financing[6] and debt/equity ratios for disallowing interest expense.[7] These were alternatives to Article 9 approaches to addressing thin capitalization. As part of the BEPs project, Final Reports under Actions 2 and 4 provide comprehensive best practices for dealing with hybrid financing and the deductibility of interest expense and target the problem of thin capitalization. The UN should, therefore, consider the impact of these developments in addressing the capital structure of related entities in the Manual. As a result, recharacterization under Article 9 and the Manual should be extremely rare and should be limited to tax consequences only. The draft Manual seems to be so limited.

In USCIB's view, if a country were to adopt the best practices of Action 4, then Article 9 may still apply to determine whether a prima facie loan should be regarded as a loan or a contribution to equity capital (or something else), but it should only apply to address problems that cannot be addressed using those other tools and then only in exceptional circumstances. This is so because the fixed ratio and group ratio best practices of Action 4 are intended to prevent base erosion through excessive interest deductions; that is, they address the problem of thin capitalization. The ratios function as both a cap on the deductibility of interest and a safe harbor; a company whose interest deduction is within the caps set by the ratios is determined not to have an excessive amount of interest relative to earnings. Or to state this affirmatively, a company with interest expense below the caps determined under the Action 4 best practices has a level of interest to earnings that is within an acceptable range and that company therefore has adequate capital. The Action 4 ratios are intended to simplify the problem of excessive interest deductions by eliminating the need to analyze each situation on a case-by-case basis. If a full Article 9 analysis is nevertheless undertaken with respect to all related party debt of a company – including debt that is essentially blessed under Action 4 best practices – then the certainty that those rules are intended to provide would be undercut.

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[4] Report, paragraph 84(c), page R(4)-32.

[555] Manual B.9.1.1.2.

[6] Report, paragraph 23, page R(4)-10.

[7] Report, paragraph 25(ii), page R(4)-11 and paragraph 79, page R(4)-30. Although the Report is discussing debt/equity ratios rather than interest expense to EBITDA, the Report provides that unless the fixed ratio included an option for a taxpayer to prove its capital structure is arm's length, "the majority of countries consider that the results would undoubtedly be inconsistent with the arm's length principle".

The draft Manual sets out three possible standards for determining whether a loan should be accepted as a loan for tax purposes.[8] Although these standards vary in the presumption of correctness accorded to the loan transaction, they all essentially come down to whether the transaction is commercially irrational. USCIB believes it is extremely unlikely that a loan that is within the caps established under Action 4 would be considered commercially irrational. USCIB also believes that a case-by-case analysis of commercial irrationality would be harder for tax administrations to apply – particularly those with low capacity. On the other hand, the Action 4 standards mainly place the burden of compliance on the taxpayer. The taxpayer would have the burden of computing the required ratios and determining whether interest expense ought to be limited under those rules.

As noted above, the Report on Thin Capitalization also discussed the use of hybrids. The Action 2 Final Report addresses the use of hybrids, including hybrid financial instruments. In cases in which a financial instrument has characteristics of both debt and equity (and therefore might be a hybrid financial instrument) using the best practices of Action 2 to disallow a deduction to avoid the deduction/no inclusion result would be less disruptive than recharacterizing a debt instrument as equity. Applying the Action 2 best practices is intended to achieve "the alignment of tax outcomes that should take some pressure off the distinction between the use of debt and equity in cross-border investment."[9] The Action 2 Final Report also notes that: "this consistency is important for achieving the overall design objectives, which are to create a network of domestic rules that comprehensively and automatically neutralize the effect of cross-border hybrid mismatch arrangements in a way that minimizes disruption to domestic laws and the risk of double taxation."[10] Focusing on the deduction/no inclusion outcome eliminates the need to characterize or recharacterize the instrument as debt or equity and thus avoids the consequences – which may be largely unintended – of recharacterizing the debt instrument. Thus, if the country in question has adopted best practices from Action 2 and Action 4 there should be little scope left for recharacterizing debt as equity under Article 9.

The Manual should have a sense of proportionality. Challenging capital structures under Article 9 should be exceptionally rare, with deference to the parties' contractual terms, and the discussion draft should make that clear. Countries would be better advised to adopt best practices under Actions 2 and 4 and limit the application of Article 9 to capital structures that are not caught by those Actions 2 and 4 and yet are considered abusive in some fashion. That is likely to be a very small number of cases.

Multinational enterprises enter into very many financial transactions, not all of which should be analyzed under a full-blown transfer pricing analysis. It would be administratively impractical to require that commercial credit rating methodologies be applied to all related party financing transactions. Consequently, we recommend that the Manual suggest that tax authorities consider the materiality of the transactions.

Profits Splits

Complexity

USCIB is concerned that the guidance on profit splits may underestimate the difficulty of method and that countries may see it as a simpler alternative to other transfer pricing methods. Although the draft Manual

[8] Manual B.9.2.1.
[9] Action 2 Final Report, paragraph 303, page 99.
[10] Action 2 Final Report, paragraph 305, page 100.

points out that complexity is a weakness of the profit split method, USCIB believes these concerns are understated.

In many cases, the profit split will be a residual profit split and thus it will still be necessary to find appropriate comparables for the routine portion of the transaction.

Profit to be split

The draft Manual is reasonable clear that profits to be split should also include losses. However, on page 18 of the draft in the box concerning the residual analysis, the second step should refer to splitting both profits and losses.

The Manual requires a split of profit from "transactions," but does not define that term. The Manual could provide clarity by taking an approach similar to the United States Treasury Regulations and defining the profit to be split as that derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available.

Paragraph 38 states that the relevant financial data will need to be put on a common basis and paragraph 39 states that financial data will need to be segmented in accordance with the accurately delineated transaction. Putting financial data on a common basis and drawing up a transactional balance sheet may be difficult, time consuming and expensive. It also may not, in the end, be accurate. USCIB would like to re-emphasize that because of these concerns, it is unlikely that a properly applied transactional profit split will be able to address the administrative concerns that are reflected in the recent platform toolkit on addressing difficulties in accessing comparables.

Profit splitting factors

USCIB agrees that prescriptive rules for splitting profits are not appropriate because the proper split will depend on the facts and circumstances in each case. Paragraph 47 discusses relying on internal data. USCIB suggests that if it is necessary to rely on internal data, then management's judgment concerning the relative value of contributions to the business ought to be taken into account. Language along the following lines could be includes to make this point: "Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant profits, consideration should be given to management's judgment about the relative value of contributions to the business, as well as to internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits.

USCIB is concerned that references the Master File in paragraph 49 as a source of information for profit splitting factors may cause inappropriate results. The value drivers that may be identified in the Master File are global, not transactional, and therefore may bear no relationship to the transactional profit to be split. Value drivers are also not necessarily measurable. The ability to use high-level value drivers to allocate transactional profit may, therefore, be limited.

Hindsight

A few paragraphs relating to hindsight are "grayed-out" indicating they are under discussion in the subcommittee.

USCIB strongly supports limitations on the use of hindsight. We agree that how the relevant profits to be split should be split should ordinarily be determined based on information known or reasonably foreseeable at the time of or prior to the transaction. Applying any other standard puts taxpayers in an impossible position, how could they price a transaction based on information that is not known or reasonably foreseeable?

Please contact Carol Doran Klein (cdklein@uscib.org or 202-682-7376) if you have any questions or would like to discuss these issues further.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)