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Ref: OECD DISCUSSION DRAFT: BEPS ACTIONS 8, 9 AND 10, REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES)

Dear Andrew,

BIAC thanks the OECD for the opportunity to provide comments on its three Discussion Drafts covering elements of Actions 8, 9 and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan issued on 16 & 18 December 2014 (the Discussion Drafts). We acknowledge and thank you for the huge amount of effort that you and others have put into these drafts.

There is no doubt that transfer pricing issues, along with deductible payments, lie at the heart of the BEPS project. Governments have expressed concerns about aggressive structures in certain contexts, lack of clear (or any) guidance in others, and the perceived inability of the fact-driven arm's length standard to deal with new situations in still others. BIAC agrees that all of these areas should be examined, and that the legitimate concerns of governments fully and swiftly addressed. However, BIAC also believes that the arm's length standard, properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to "real-world" economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated, however, then we will see a further acceleration in a worrying trend already apparent in the transfer pricing audit practices of several countries, where a broad interpretation of "BEPS principles" is used to justify new unilateral theories, and the automatic application of non-arm's length approaches in routine situations.

So, elements of the proposed guidance in currently unclear areas such as risk or commodity transactions are greatly to be welcomed – but such guidance should build upon established concepts rather than upon new ones (such as, for example, "moral hazard"). Likewise, profit splits may well be appropriate in certain difficult cases – but the default position, nevertheless, should be application of the arm's length standard, with profit splits only being applied where the default

position cannot be. Recharacterisation, or “special measures”, which recast a contract or other legal arrangements from the form agreed by the parties into a new and different form, may be justified in egregious cases – but only when other alternatives, most particularly, the proper application of intercompany pricing principles, have been tried and failed. While it may sometimes be more time-consuming to run through a full functional analysis, than to move swiftly to a recharacterisation, such a functional analysis (the elements of which are broadly agreed and widely understood) not only provides more commercial certainty for taxpayers, but also benefits governments because there will be fewer instances of double taxation as different countries seek to apply different rules with no commonly-agreed standards.

Finally, and as noted in my comments on Action 14, particularly if dispute resolution is not improved, then business may return to a more adversarial relationship with tax authorities and, especially in the complex area of Transfer Pricing, seek new ways to mitigate double taxation in the face of risk from ad hoc recharacterisations, and non-arm’s length practices. A return to this type of cat and mouse game would be to neither the advantage of governments nor the vast majority of responsible, unaggressive taxpayers.

In each of our three sets of comments, we give much more detail on where we think the new proposals will eliminate BEPS-related issues, and/or provide new and helpful guidance. Likewise, in our comments we also present what we hope are constructive alternatives, where we disagree with proposals made in the three Discussion Drafts. To reiterate, however, while we acknowledge weaknesses and gaps in the current rules, and are supportive of moves to rectify both, we also strongly advocate that the arm’s length standard, and the legal form adopted by taxpayers, remain the starting point – if not always the ending point – for dealing with the matters raised in Actions 8-10.

We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next several months.

Sincerely,



Will Morris
Chair
BIAC Tax Committee

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Executive summary

1. Transfer Pricing must be grounded in business reality and we welcome the Discussion Draft's focus on actual conduct and expanded consideration of risk. Businesses operate in today's fast-moving global markets and generally do not measure or manage themselves on a territorial basis. It is vital, therefore, that any Transfer Pricing requirements are practical, and capable of implementation and interpretation without creating a significant additional compliance burden for either MNEs or the tax administrations who audit them. We are concerned that the Discussion Draft attempts to insert highly theoretical concepts such 'moral hazard' and 'fundamental economic attributes' into the Transfer Pricing Guidelines¹ (the "Guidelines") and in doing so, shifts the balance away from practical reality and towards economic theory.
2. We question the practicality of requiring documentation to consider, for every transaction, all alternative options realistically available at the time the transaction is entered into. Not only does this impose a significant compliance burden - given that information available at a particular point in time is often incomplete or incorrect - it also encourages tax administrations to look at transactions with hindsight, as it is not possible to look back and know only what was known at the time of the transaction. In a similar vein the level of analysis required for consideration of risk appears to be very granular and it is questionable whether such a detailed analysis is feasible for MNEs with thousands of entities and transactions.
3. Certainty is a key concern for MNEs in their relationships with tax administrations and their reporting of financial results to the market and investors. Any change that increases uncertainty, for example the possibility that recharacterisation might be applied more frequently (as the Discussion Draft appears to lower the barrier to non-recognition), should be made with the utmost care and an understanding of the consequences, both for the counterparty tax administration and the taxpayer. We feel that the proposed Guidelines do not contain sufficient safeguards to prevent compliant taxpayers being erroneously swept into recharacterisation. This will undoubtedly give rise to increased cross-border tax disputes, with their consequent drain on resources for both tax administrations and taxpayers, and potentially double taxation. Wherever possible, we believe that pricing adjustments should be used before non recognition is contemplated.
4. We very much welcome the expanded consideration of risk and risk allocation, although we would note that this needs to be reviewed for consistency with Chapter IX of the Guidelines. We understand the theoretical assumption that third parties may be allocated a greater share of risks over which they have control. In practice, however, risk allocation among third parties is more complex, and can be driven by factors which do not align with this principle. Further consideration of this section is required, in particular the assumptions that certain risks are not transferred at arm's length and that risks cannot be transferred within an MNE group.
5. We find it difficult to understand the need for special measures options 1 – 5, given the existence of a comparability analysis, the availability of group-wide information that will be delivered via BEPS Action 13, and the possibility of applying non-recognition. We believe these tools should be sufficient to deal with all matters, using the arm's length principle. We

¹ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD July 2010

consider the arm's length principle remains the best available and most widely accepted basis for Transfer Pricing methodologies, a view we understand is shared by the OECD and the countries participating in the BEPS process. We are concerned that special measures represent a move away from this consensus view towards individual country interpretations of locally implemented rules, resulting in significantly more tax disputes and double taxation.

6. A move away from the arm's length principle can also be seen in the suggestion that a comparison of pre- and post-tax results is a factor to be considered in recharacterisation. We believe this is not relevant for the pricing of a transaction in accordance with the Guidelines.
7. The Discussion Draft rightly focuses on the contribution of people functions and the allocation of risk. However, it is largely silent on the role of capital. Capital is a requirement for all businesses, not only to allow business to invest and grow, but also to absorb losses in difficult times. We feel, therefore, that a greater acknowledgement of the role of capital is needed for all MNEs, but in particular for MNEs in regulated sectors where capital is an essential component of their business.

General comments

8. BIAC welcomes the opportunity to comment on the OECD's *Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)* (the "Discussion Draft"). We support the Discussion Draft's recognition that the delineation of Transfer Pricing transactions must follow business realities, encompassing the actual conduct of parties and the actual allocation of risk, and that contractual terms should reflect this reality. We also broadly support the methodology set out in Section D1 of the Discussion Draft as it reflects best practice for most MNEs when they define and implement their Transfer Pricing policies.
9. We support the ambition behind the substantially new Section D2 of the Discussion Draft, to augment the existing guidance on risk given in Chapter I of the Guidelines. That being said, we believe it is important to provide context to the Discussion Draft, to establish clearly what Transfer Pricing seeks to achieve in general terms. The Guidelines are a tool used by taxpayers and governments to translate highly-complex economic theory, through the use of the Arm's Length Principle, into a highly practical framework. In this regard, there is a fine balance to be struck between that theory, and practical realities. The Arm's Length Principle represents the best tool that we currently have for balancing those considerations. We do agree that the Guidelines must be economically correct in general terms, but they must also be capable of consistent application, and yield reasonably predictable results. We believe that the Discussion Draft has shifted this important balance towards economic theory, and away from practical reality. This may be driven by an expectation that Actions 8-10 are capable of tackling many issues that are also being addressed through other BEPS Actions – we believe that the scope of this Transfer Pricing work should be limited to proposals that are appropriate under the Arm's Length Principle, otherwise the Guidelines will become overburdened and impossible to apply.
10. Our concerns about the theoretical nature of the Discussion Draft extend to the analysis of "group value" and "risk allocation" – these concepts are highly complex, and very difficult to translate practically. This is illustrated through the lack of examples of their application. We also believe that the theoretical focus has resulted in an understatement of the returns that

should be due to financial investment, focusing too heavily on the expectation that control or management of risk must accompany the financial burden of a risk to justify returns.

11. In extending the Guidelines, care is needed to ensure that compliant taxpayers are not inadvertently brought within the scope of onerous rules. In that context, we would note that the examples given in the Discussion Draft sometimes cover standard scenarios and do not always represent situations where contractual terms are ambiguous, incomplete or incorrect. Retaining the current examples may place too much focus on genuine commercial transactions that are already in compliance with the Guidelines. There is a risk that such examples would give rise to a broad interpretation, placing an additional burden on compliant taxpayers. We would therefore propose using alternative examples for greater clarity and would also welcome examples that are more clearly aimed at situations that are targeted by the BEPS project. At the inception of the BEPS project, governments appeared to be focused on such specific examples, which should be included in the Discussion Draft to reduce ambiguity, and to ensure that genuine transactions are not unnecessarily caught up in overly-burdensome requirements.
12. We would be grateful if the revised Guidelines could contain a clear statement that they apply with effect from the date they are issued, and not retrospectively. This clarity around application would reduce uncertainty for MNEs already engaged in tax audits, or with significant numbers of past open years.
13. We appreciate that the objective of the Discussion Draft is to encourage a review of actual conduct and risk allocation, and there is no policy intention for this work to result in an increase in the frequency of recharacterisation. However, we are concerned that the new standards set out in the Discussion Draft, such as the proposed principles for identifying risks under D2, are onerous and even compliant taxpayers making their best efforts could fail, or be seen to fail, to comply with these new standards, and hence, will face an increased risk of re-characterisation. To assist tax administrations, we would be grateful if there was a more forceful statement of how to review intercompany transactions, so that it can mirror the work that MNEs carry out when analysing such transactions.

The order should be as follows:

- The primary analysis is to identify/delineate the transaction
- The starting point for this is the contract, or the functional analysis performed by the taxpayer if there is no contract
 - i. only after this review has been completed, and only if necessary, is it then appropriate to ask if the transaction makes economic sense: if the transaction makes economic sense but is not properly priced based on the arm's length principle, the right price shall be assessed.
 - ii. if the transaction does not make economic sense, recharacterisation should occur in exceptional circumstances.

Specific Comments

Identifying the commercial or financial relations

14. We welcome the statement in Paragraph 3 that where a contract exists, it should be the starting point for delineating a transaction, and that actual conduct should be reviewed in the context of this written agreement. Taxpayers require certainty, and should be able to rely on legal agreements they have entered into with related parties as well as third parties. Only where contractual terms are absent or ambiguous in the context of actual conduct, should they be clarified or supplemented by the tax administration.
15. At arm's length, it is common for an agreement to be varied slightly in practice without recourse to a full re-negotiation or amendment of the existing contract; this does not mean that the entire contract is invalid. Tax administrations should accept that this may also happen between related parties, and, where that is the case, significant supplementation or clarification should not be required. An acknowledgement that slight variations can exist without the need for significant additional review would be helpful. For example, a group company may enter into a multi-year agreement with a group procurement centre, where prices would be fixed for the duration of the contract. However, if the costs borne by the procurement centre significantly deviate because of fluctuations in the underlying commodities prices, or, conversely, if prices to be paid by the group company significantly differ from market prices because of a drop in commodities prices, the parties may agree to change the pricing mechanism of the contract without entering into full re-negotiation of the contract. This decision may be impacted by the magnitude of the financial impact for the parties. This often happens with third party suppliers and should not be regarded as being non-arm's length behaviour. Another example would be where a Research and Development ("R&D") centre has entered into a contract with group companies in order to undertake R&D activities, and has also agreed to handle the registration of the licenses deriving from the R&D activities, even though this activity was not initially included in the contract. Such a slight variation of the scope of R&D services, would probably not be subject to an amendment to the contract in an unrelated party context, even if the registration of the license might also be regarded as a key element of the valuation of the licenses.
16. We have commented in Paragraphs 18 to 23 below, on the examples given in Section D1 of the Discussion Draft. Whilst the inclusion of carefully drafted examples may assist MNEs in formulating and implementing Transfer Pricing policies, and help tax administrations in auditing those policies, we feel that the examples proposed are overly simplified and reflect common commercial situations where the Transfer Pricing is relatively straightforward. We feel that alternative examples would more clearly illustrate the need to supplement or clarify contractual terms and would avoid compliant taxpayers being subject to additional and unnecessary scrutiny.
17. The example given in Paragraph 4, which aims to illustrate the need to supplement contractual terms, describes a common scenario in which a distributor not only distributes products, but also advertises and markets those products. The example notes that the contract is silent on remuneration specifically for marketing activities and that further detailed analysis is required. Selecting such a common transaction for use as an example raises the question of granularity: remuneration for the marketing activities is very likely already built into the reward for distribution, as in many franchisor/franchisee relationships and thus the independent entities

or transactions identified in the comparability analysis are often likely to already exhibit such attributes. A further granular analysis would potentially be double-counting the reward. How far is an MNE required to go in analysing relatively straightforward transactions, of which it may have thousands?

18. An alternative example for Paragraph 4 could be: Company P is the parent company of an MNE group situated in country P. Company S, situated in Country S, is a wholly owned subsidiary of Company P and acts as an agent for Company P's branded products. Company's P branded products are new to the Country S market. The contract between Company P and Company S is an agency contract, i.e. Company S sells P products on behalf and in the name of Company P. The contract is silent about any marketing and advertising activities in Country S that the parties should perform. In practice, Company S had to launch an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S. Based on these specific factual circumstances, and on a review of the functional analysis performed by the group, it may be concluded that the contract does not reflect the full extent of the commercial or the financial relationships between the parties, and that the analysis should not be limited by the terms of the contract. The additional step to take on would be to analyse whether or not the functional analysis needs to be revised, and the transaction repriced (better delineation of the transaction), or if the transaction does not make sense commercially, and if the agency relationship has to be recharacterised into a distribution agreement. It is important that the first step is undertaken (delineation) before the potential recharacterisation analysis takes place.
19. We agree with most of the content of Paragraph 5, but believe that the second and third sentences may bring some confusion to the reasoning. We also suggest adding the word "substantially" in the 4th sentence, which would read as follows: "*it is therefore particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties substantially confirm to the terms of any written contracts , ...*".
20. Paragraph 6 includes an example illustrating the need to supplant the terms of a contract with the actual conduct of the parties. The example concerns a licence arrangement in which the licensee is deemed not, in fact, to be a licensee, but rather a provider of services. This is based on the premise that the licensee is not capable of providing services to third parties without additional support, and is not developing its own capability. In reality, it is common for licence arrangements to include technical support or helpdesk services, and many licensees do not develop their own capabilities. The licence is a right to use, copy or distribute intellectual property, not the right to be involved in maintenance or development. Retaining this example risks bringing into the scope of inquiry a significant number of genuine licence arrangements, and may trigger some significant recharacterisations of standard contracts by tax administrations. We believe the example in Paragraph 6 is relevant for delineation and pricing, rather than the recharacterisation of a contract into another category of contract.
21. Whilst we generally agree with Paragraph 7, it may require some clarification with regard to the reference to the booking of some elements into the accounting systems. It should be noted that synergies, for example, do not translate into an accounting entry. This should not be the starting point for believing that the company has not recognized a transfer of value pertaining to a transaction. Synergies are a good example of why group companies exist and

cannot be perfectly compared to SMEs, or non-integrated businesses. For example, a manufacturer within a group can benefit from synergies - e.g. it may benefit from additional volumes when it is in an undercapacity situation to better absorb its fixed costs. Such synergies are often not reflected in the contracts, they do not directly appear in the accounting systems, and very often are not an element of a functional analysis. If businesses need to take into account elements deriving from being part of a group in delineating a transaction, it will entail a significant additional compliance burden, which, more importantly, would be very difficult to incorporate into a Transfer Pricing policy and be appropriately priced.

22. The example in Paragraph 8 aims to illustrate a situation where the taxpayer has not identified a transaction. In the context of this example we do not believe a transaction has occurred for Transfer Pricing purposes. Subsidiaries receive services from a third party for which they appear not to be charged, either via reimbursement to or a service charge from the entity paying for the services. The example could be expanded to acknowledge the fact that there may be no direct charge for the services, but the service could be taken into account in the pricing of another transaction between the parties. Given budgetary constraints and performance measures, it is rare for services to be provided for free within the context of an MNE.
23. We are concerned about the potential scope of work proposed by Paragraph 12, which notes that when evaluating potential transactions, independent enterprises compare the transaction in question to *'the other options realistically available to them'* and will only enter the transaction if there is no better opportunity that meets their commercial objectives. This concept is carried further in Paragraph 89, which states that an entity would only enter into a transaction if there was *'a reasonable expectation of enhancing or protecting its commercial or financial position on a risk adjusted basis'*. Whilst this is true in theory, in practice, it is rare that the alternative options are presented so clearly at the time: decisions are made under pressure of time and with incomplete or sometimes inaccurate information. It is not possible to contemporaneously document all options available at a given point in time. Therefore, to try and do this in hindsight, even days or weeks after the transaction, let alone in the context of a tax audit which might be years later, is simply not possible. The options that were realistically available at the time and the options that appear to be available with the benefit of hindsight are very different. There is a risk here that the tax authority deems a result that could not have been envisaged at the time of a transaction due to the different availability of information.
24. A further concern around documenting options to satisfy Paragraphs 12 and 89 is the compliance burden this would create. In addition to the options considered, Paragraph 89 refers to decisions not to undertake a particular transaction. If the documentation requirements are to cover: the transaction undertaken, the alternative options considered and the option not to undertake the transaction, then the burden of compliance increases significantly. This would further be multiplied by the actual number of transactions followed up, plus any that were considered but not implemented. The task of identifying such a broad scope of transactions, let alone documenting them, would require significant additional resource. It is not clear what benefit would be achieved in return for such a significant cost. Some guidance around materiality would be welcome in order to ensure the additional compliance obligation is proportionate and not unduly burdensome.

25. Paragraph 16 of the Discussion Draft states that *'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 that the parties make to that value creation.'* We are very concerned about how this guidance could be interpreted, and that it could impose a disproportionate burden on taxpayers to not only document facts and circumstances, but to also interpret the many hundreds or thousands of ways that those facts and circumstances may directly or indirectly impact the creation of value elsewhere in the value chain. We believe this would be an impossible task for almost all taxpayers. The lack of relevant examples in the Discussion Draft makes it difficult to interpret the expectation behind this proposal.
26. The example given in Paragraph 18 is not clear to us. It seems to imply, due to diversification within a group, that a market price cannot be applicable for related party transactions (although presumably it would be the price charged by a third party). Such an approach appears to suggest that a market price ought always to be adjusted downward to apply to related party transactions to take into account the impact of the group. As we have suggested elsewhere in this paper, we believe such an approach would be contrary to the objective of the arm's length principle, and almost impossible to apply in a practical and predictable way. We would be grateful for further clarity around this example.
27. Paragraphs 21 and 85 – 87 refer to MNEs' ability to fragment their activities across multiple entities *'secure in the knowledge that the fragmented activities are under common control'*. At the ultimate parent level, an MNE acts in the common interest of the group: its aim is to make a return for its shareholders. However, at a regional, divisional or legal entity level there are often competing interests and obligations within a group. Furthermore, under the corporate law of most jurisdictions, a Board of Directors has a duty to act in the best interests of their individual entity, not the group. Therefore, whilst the Directors may act in the group interest, they cannot legally approve an operation or action that is against the interest of the particular entity. In regulated sectors, such as Financial Services, local country regulators take a standalone view of business and require entities to transact with associated entities at arm's length and not to focus on group interests.

Identifying risks in commercial or financial relations

28. BIAC welcomes the objective of increasing the clarity of practical guidance around risk, and the extended consideration of risk in Section D2, as this work has the potential to reduce the number and length of tax disputes. However, as the Discussion Draft notes in Paragraph 38, risks can give rise to difficulties in a Transfer Pricing analysis. Whilst some risks are clearly known and can be quantified on a probability basis, other risks may be known, but unquantifiable, and certain risks may be neither identifiable nor measurable until after they have materialised. It is equally often very hard to determine reliably, exactly how unrelated parties approach and accept risk. Although we welcome the ambition of outlining a risk framework in Paragraphs 40 and 42 as a tool to assist tax administrations in understanding and identifying risk, we are concerned that the standards set out in this section may, in practice, be very difficult to comply with as the analysis operates at a micro-level, and requires a granular and onerous level of compliance. This granular approach, rather than reducing the potential for disputes, is likely to increase the risk of controversy and double taxation as tax

administrations are encouraged to inquire into a level of detail which is very hard or impossible to comply with in practice.

29. In general, we agree with the theoretical assumption in Paragraph 38 that it generally makes sense for third parties to be allocated a greater share of risks over which they have relatively more control. In practice, however, risk allocation among third parties is far more complex, and can be driven by a large number of factors which do not align with this general principle. The perceived profit potential in a transaction, the perceived benefit for one of the parties, or the valuation of a certain risk, frequently does result in risk assumption which deviates from this general principle. As an example, at arm's length, the assumption of credit risk may be accepted by an exporting market company even though the detailed day to day control of that risk lies closer to the importing dealer company on the basis that the market company considers the risk to be very low, and the dealer company is not willing to take on the sales activity carrying that risk. Therefore, the guidelines should be clarified to say that the theoretical principle suggested in this paragraph (and elsewhere) can only be a starting point in the analysis.
30. We believe the example in paragraph 41 may trigger some misunderstanding and misinterpretation in certain jurisdictions, and would suggest the following amendments in order to make the point.

“The significance of the risk depends on the context: a different flavour of baked beans may not be the company’s sole product, the costs of developing, introducing, and marketing the product may have been marginal, the success or failure of the product may not create significant reputational risks so long as business management protocols are followed, and decision-making may have been effected by delegation to local or regional management who can provide knowledge of local tastes. However, in certain circumstances, such a new product, because of certain characteristics (less salt/less fat) can give the company a competitive advantage or /and feed most of the growth for future years. Risks may therefore vary depending on the factual circumstances surrounding the launch of the product. A basic technology may or may not have the same feature than a ground breaking technology.”

31. We are concerned by the examples suggested in Paragraphs 44 and 45 regarding the allocation of risk. Although the reason for selecting a certain transactional currency between independent parties is typically to establish the agreed allocation of F/X-risks, this often does not apply between related parties. Within a group, the application of transactional currency may be driven by several other factors, such as lack of system support, global hedging optimization, human errors in the transactional implementation etc. Furthermore, also between independent parties, local F/X-regulations may make it impossible to select the trading currency in a way which aligns the “conduct” with the desired risk allocation as established in the contractual terms. Therefore, the conclusion that a deviation between the contractual agreement and the functional currency should be viewed as an example where the contractual terms should be ignored based on the conduct of the parties is not correct.
32. The same holds true for the example in Paragraph 45 regarding inventory write downs. Within a group, the fact that a certain legal entity under relevant accounting rules has made a risk

related write down has very little or nothing to do with how – in this case an inventory risk – would be allocated between independent persons. Accounting standards typically do not consider allocation of control of risks, nor any of the other standards otherwise suggested as important for the allocation of risks for Transfer Pricing purposes. This reference should therefore be deleted. If not, there is a considerable risk that local tax authorities will question any sound arm’s length risk allocation properly documented in contracts and Transfer Pricing documentation based on the argument that it does not follow the conduct as indicated by the accounting entries.

33. This detailed level is illustrated in Paragraphs 46 and 47 which note that assumption of risk is not always limited to the party in which the outcome of the risk materialises. In addition Paragraph 49 notes that risk outcomes can affect many group companies. Similarly, Paragraph 56 notes that multiple functions (and entities) contribute to risk management. Whilst each of these statements is true, the implication is that multiple entities could assume risk or be involved in risk management in respect of one single transaction. In practice, it is not feasible to analyse every transaction and allocate reward for risk down to this level of detail.
34. Paragraph 49 questions the assertion that a party performing commercial activities could be insulated from all commercial risk. This appears to be targeted at certain types of distributors who are rewarded on a risk-free basis. The acceptance, to date, of this type of reward for limited risk entities by the majority of tax administrations around the world indicates this is a concept that is widely recognised and approved (provided that it is aligned with the substance required to assume these risks as outlined in Chapter IX of the Guidelines). It should be considered that one of the key reasons for implementing centralised risk models is the difficulty in identifying and valuing risks in global value chains, and the acceptance of these models has significantly reduced the compliance burden for taxpayers and freed up resources for tax administrations to examine higher risk transactions. Including this wording within the Guidelines could change the existing practice, and lead to extended investigations that take up resource with little additional resulting revenues, especially when considering the reciprocal impact of direct and compensating adjustments. Although blanket statements about risk allocation may warrant closer scrutiny, we think that the Guidelines should clearly indicate that that such risk allocations shall be acceptable as long as they are appropriately aligned with the control and capabilities to assume the risks.
35. We are concerned about some of the drafting around risk management in section D.2.5, and in particular Paragraph 55. As we see it, the question of risk management is instrumental to the analysis of risk allocation for Transfer Pricing purposes. Paragraph 55 suggests that risk management requires the capability to make decisions to take on or decline, respond to and mitigate risks *“together with the actual performance of that decision making function”*. Within a group, risk related decisions are taken every day at every level of the organization, from strategic decisions (about investments, budgets, corporate control functions, escalation models, customer funding strategies etc.) at central level, to local day-to-day decisions about individual customers, product quality improvements, warranty handling, workplace safety etc.) - typically based on the central strategic decisions as set in guidelines and instructions. Apart from the onerous and often impossible task of identifying and valuing risk at the level of detail suggested in this section, without further guidance on what *“actual performance of risk making decisions”* means in this respect, we see a considerable risk of increased disputes among tax authorities about the proper allocation of risks for Transfer Pricing purposes (in

particular in cases where substantial risks have materialized). In addition, we see considerable risk that fully commercial and legitimate Transfer Pricing models with centralization of risk and IP, which have been built up and accepted by a large majority of tax authorities around the world, will be very difficult to sustain, and may be caught up inadvertently by the wide drafting of the revised Guidelines. On this basis, we believe that the Guidelines should further clarify what types of decision making functions are required to be able to manage, control and thereby assume risks from a Transfer Pricing perspective. Indeed, we fully recognize the need to prevent unacceptable allocations of risk (and IP) to entities or jurisdictions without proper capacity, authority or substance to assume those risks. However, without further clarity in this respect, we believe that the suggested new guidelines would significantly drive compliance, uncertainty and disputes.

36. As noted in Paragraph 36 above, it would be helpful if Paragraph 55 could distinguish more clearly what is meant by risk management and control of risk, and why these two concepts, which in practice seem very similar, should be treated differently. If risk management is to be regarded as a function that can be carried out at all levels, and therefore perhaps worthy – in the appropriate circumstances - of a more routine reward, and control is to be regarded as a ‘higher’ function that is more strategic in nature, it would be very helpful for Paragraph 55 to say so more clearly. This would facilitate the framework for analysing assumption of risk and allocation of reward.
37. We would also appreciate clarification in Paragraph 56 regarding the level to which the Transfer Pricing analysis should go. As written, it appears that each transaction must be analysed to line management level in every entity, which is not feasible. As the Discussion Draft notes, risk management is carried out at several levels within an organisation. We agree with this statement, but would point out that not all levels of risk management make the same contribution towards controlling risk and different organisations may have very different risk management structures. We feel the analysis in Section D2 does not sufficiently distinguish between these different levels of contribution to either management or control of risk, and that this will lead each tax administration to apply its own interpretation as to how control of risk and allocation of reward should be attributed. Clearer guidance is therefore required to avoid multiple interpretations of the same fact pattern.
38. Whilst we agree that risk management is a fundamental element of a functional analysis, it should be noted that the usual way to undertake a risk analysis in a Transfer Pricing study is through a global analysis of the main risks pertaining to the business, rather than a risk analysis transaction by transaction. We would be grateful for confirmation that this is not the approach proposed by the Discussion Draft. If we are required to include a detailed analysis of all the risks pertaining to each intercompany transaction, the Transfer Pricing Documentation would certainly be unmanageable. We believe that Paragraph 56 may lead to such a conclusion. It is possible that paragraph 56 (*“line management in business segments, operational entities, (...) may (...) put in place appropriate controls and processes to address risk and influence the risk outcome arising from day to day operations”*) could be interpreted by the tax authorities as requesting a management risk analysis based on the Group’s Chart of Authorities, which would clearly not be appropriate, nor manageable.
39. Paragraph 58 might be understood as requiring an adjustment to Transfer Pricing from a risk perspective when budgets are used versus actuals. We would welcome some clarification in

this respect. If the Transfer Pricing policy is predicated on the use of budget costs, for example, there is no need for an adjustment in view of actuals, even if they differ significantly from the budgeted amounts, as variances between budget and actuals will be dealt with elsewhere in the Transfer Pricing policy, unless that policy explicitly provides for actual adjustments. We would request that this clarification is included within Paragraph 58, otherwise, it appears to suggest that all budget to actual variances could be open to question.

40. Paragraph 78 also carries implications for budgeted or ex-ante outcomes versus the actual or ex-post result. Consideration is not given to the circumstances in which it might be appropriate to set ex-ante prices and leave them unchanged, irrespective of the outcome. In certain sectors (e.g. insurance) the estimation of the possible outcome is a key part of the pricing mechanism, and it is not appropriate for prices to be adjusted ex-post. It would be helpful if Paragraph 78 could include a statement confirming that in the right circumstances, ex-ante pricing is acceptable. As the wording stands, it seems to imply that an adjustment to ex-ante prices can be considered in all cases.
41. As stated for Paragraph 41, there must be some room for interpretation in the example of Paragraph 60, which does not always reflect “real life” business situations. The example assumes that product recall risk is always on the manufacturer’s side as the risk is managed and controlled by the manufacturer, and that accordingly, the manufacturer should attract the outcome of upside and downside risk instead of the distributor, as opposed to what is stated in the contract. This is an example where recharacterisation, in view of the actual conduct of the parties, may be very confusing. While the analysis might be true if the product recall clearly comes from a mistake at manufacturing level, there are many more examples where the source of the issue is not identified and a third party distributor would not, in such a case, be able to allocate the costs and financial consequences of the recall to the manufacturer. If we take for example the well-known case of the Perrier product recall in the US, where it is still uncertain that the safety allegations on the presence of benzene in some bottles were true, it would not be abnormal for a future Perrier distributor to ask for a higher margin in the contract as a high reputational and market risk may lie with the distribution of the product.
42. Paragraph 63, which suggests that risks must be analysed with specificity (in conjunction with the following paragraphs) raises a general concern about the practicality of what is being proposed. We believe that the level of detail in which risks are supposed to be identified, analysed and valued under the proposals are not achievable. Although a full functional and comparability analysis to assess the contributions by all of the associated parties to which risk relates (as required in Paragraph 65) may be valuable in theory, the tools to perform such an in-depth analysis are typically not available. Comparable data is generally not available at this level of detail, and hence, the required level of risk analysis will often not be possible in practice. We believe that even compliance focused taxpayers will most likely fail, even with their best efforts, to live up to the new standards.
43. Paragraph 64 considers the position of independent cash investors in a business and states that they will not invest unless they are given some form of security. It is common for investors to invest in high-risk enterprises without any form of security, in the expectation of high rewards (but also recognising the potential for substantial downside). The investor may seek to diversify their risk by making additional investments in other areas, but they do not directly or indirectly control or manage the business risks within the investment itself. Their

sole function is to provide capital and, if the business is successful, they will receive a significant reward in return for the provision of capital alone. Whilst the Discussion Draft provides comprehensive reviews of people, functionality and risk, it is silent on the contribution to economic value made by capital. We have provided additional information on the impact for regulated sectors in a subsequent section (see paragraphs 97 to 118). We would be grateful for additional guidance concerning the role of capital.

44. Capital is a requirement for all businesses. This is particularly so in the regulated financial services sector. Regulators require financial services firms to hold significant amounts of capital in a prescribed form; without such capital firms cannot do business. These regulatory capital requirements come from the need to protect customers, for example so that banks can repay client funds and insurance firms are able to pay out claims to policyholders. If a regulated entity does not hold sufficient capital, its licence to do business will be withdrawn. As well as regulatory obligations, rating agencies impose their own, additional, capital requirements in order for an entity to attain or maintain a specific credit rating. The particular level of credit rating is key as, the higher the credit rating, the more it opens access to a wider range of possible markets and customers. Capital, therefore, plays a vital role in the financial services sector and its contribution should be recognised.
45. A further example of the importance of capital can be seen in the mining sector, where billions of dollars are invested into exploration activities. These activities are spread across a diverse range of commodities, geographically challenging and diverse operating environments. Therefore the risk associated with exploration capital is significant. In the mining sector, the probability of discovering a World Class greenfield deposit² is in the order of 0.07%³ (1 in c.1,500)³.

The evolution of a project from initial testing to commissioning can take 10 to 20 years, involving a series of stages to reach investment approval and implementation: area selection, target identification, testing, resource delineation, resource evaluation, and detailed evaluation. The number of opportunities that progress successfully from one stage to the next is low: of the many ideas and targets pursued, only a small number will make it through to a discovery. Whilst the risk associated with exploration is significant, the potential rewards are high, although the timing can be in excess of 40 years. This ensures that MNEs operating in the mining sector continue to put significant capital at risk in their exploration activities.

Typically, the parent company of a MNE operating in the mining sector is the provider of capital to either a central exploration company or individual exploration entities in a particular country. Management of risks, functions and assets (such as exploration licensees) is typically the responsibility of the exploration entity, which takes on an entrepreneurial exploration role. The parent company's responsibilities and involvement do not generally extend beyond the investment committee's allocation of the exploration budget, leaving the exploration function to decide autonomously how it should spend the budget, perform the exploration functions and manage/control the risks, in order to deliver value to itself and the wider group.

² A mineral deposit at a site with no existing mining operations that has the potential to develop into a tier 1 (i.e. high-quality) mining asset.

³ Discovery in Mineral Exploration by Stephen B. Bartrop & Pietro Guj, Western Australia School of Mines – June 2009

46. We feel that Paragraph 66 is written from the point of view of profit-making enterprises, when it states that financial capacity is a relevant, but not a determinative factor in considering the allocation of risk return. It does not appear that consideration has been given to losses. In the event of losses, pre-existing financial capacity is key to an enterprise's ability to survive. If that capacity is not already in place when the loss crystallises, it may not be possible to acquire it on a timely basis, potentially resulting in insolvency or administration. The events of 2008 demonstrate that an entity bearing losses cannot always rely on other group enterprises to provide additional capacity. For an entity that bears risks, a lack of such financial capacity could lead to a statutory audit qualification as a going concern, and would certainly cause significant difficulties for the Board of Directors of the entity. We would therefore suggest that the question of financial capacity is reconsidered and more emphasis is placed on its contribution.
47. We welcome the acknowledgement in Paragraph 67 that there are risks that can be transferred for an arm's length fee. We are, however, concerned that the use of the word "some" in the Paragraph suggests that this is more the exception than the norm. In line with this, we question the implication later in this paragraph that a full transfer of core risks is unlikely to happen at arm's length. The paragraph seems to assume that some risks, such as strategic, marketplace, infrastructure and operational risks, are more fixed than other risks and that they subsequently cannot be transferred at arm's length between dependent (or independent parties). Although some risks clearly are fixed in the sense that they, for example, relate to a particular market, the paragraph fails to identify that the allocation of risk is not a question of transferring the risk as such. Instead, it is a question of transferring the liability of a risk. Certainly, in third party situations, you can observe that the liability for certain market related risks are transferred to parties not operating physically in that market. Likewise, the *liability* to assume infrastructure risk may very well be allocated among third parties even though the risk itself geographically may be hard to relocate. On this basis, we believe that this paragraph should be reviewed. In the context of the insurance industry, risk is a core component of the business. Risk transfers by means of reinsurance (both third party and intra-group) happen on a continuous basis.
48. As an example for proposed inclusion: in the financial services sector risk is routinely traded. The party assuming the risk is not in a position to control or manage the risks underlying that risk transfer. Put another way, risk can be packaged up and traded, bifurcating the underlying risk with the control or management of that risk. As an example, credit default swaps (CDS) are market instruments exhibiting these characteristics and in a default scenario, the purchaser of the CDS assumes the financial cost of the full risk without controlling or managing any aspect of the risk itself. As a result, since such market traded instruments exist in commercial markets, MNEs should not be restricted from providing comparable instruments internally within the group. The main point is that there is a market for risk management, and there is a market for risk-taking. Other examples include FX deals, interest rate derivatives, insurance and reinsurance products.
49. We appreciate the guidance in Paragraph 78 concerning the circumstances in which profits should be adjusted as a result of differences in ex-ante and ex-post pricing. It would be helpful if some more clarification could be given as ex-post pricing is not appropriate in many situations. For example, the insurance industry is based on risk and probability, it would not be appropriate to retrospectively adjust Transfer Pricing outcomes for insurance.

Interpretation and Non-recognition

50. Certainty is a key concern for MNEs in their relationships with tax administrations and their reporting of financial results to the market and investors. Where international transactions are concerned, consistency of application of tax rules by different jurisdictions is critical: it is in no one's interests to have multiple cross-jurisdictional disputes. Therefore, any decision not to recognise a transaction should be taken with the utmost care and an understanding of the consequences, both for the counterparty tax administration and the taxpayer. Bearing this in mind, we feel that whilst it is helpful that the criteria for non-recognition set out in Section D4 and Section D3 stress every effort should be made to recognise the actual transaction, the proposed Guidelines do not contain sufficient safeguards to prevent compliant taxpayers being erroneously swept into non-recognition. It would be helpful if the comments in Paragraph 82 could be strengthened with an acknowledgement that non-recognition should be used only as a last resort, and that there is no policy intention to increase cases of re-characterisation. We would also welcome threshold guidance on what constitutes non-recognition as opposed to a re-pricing of the transactions as structured.
51. Pricing adjustments should be considered and used wherever possible before non recognition is contemplated. When a pricing adjustment or non recognition lead to the same outcome, the pricing adjustment approach should be used in preference, as this will increase the likelihood of corresponding tax authorities reaching agreement on the issue, and reduce the incidence of double taxation. This approach would also mitigate the potential implications of secondary and follow on adjustments described below at Paragraph 69. On the point of corresponding tax authority acceptance, before non recognition is imposed, we would recommend that the imposing tax authority should have a preliminary MAP/Treaty discussion with the corresponding tax authority to ensure that any double taxation issue that might arise can be resolved under the MAP process.
52. We are concerned about the inference tax administrations may draw from the wording of Paragraphs 85 – 87. The majority of MNEs are compliant taxpayers who wish to build good working relationships with tax authorities and have certainty in their tax affairs. These paragraphs appear to start from the premise that all MNEs establish complex and fragmented structures in order to manipulate their Transfer Pricing outcomes. Whilst this may be true in individual minority cases, in the last ten years, many MNE groups have taken significant steps towards simplification and reduction in the number of legal entities. We would suggest a change in emphasis to recognise that most MNEs do not engage in fragmentation merely to obtain a particular Transfer Pricing outcome, but that other commercial factors also dictate the organisation and structure of MNE groups.
53. Whilst we accept that the practice noted in Paragraph 88 of finding a price, rather than further investigating the commercial rationality of a transaction, may theoretically have its limitations, the fact remains that it is a pragmatic solution to a difficult and highly theoretical issue. In terms of time and resource allocation, it may be preferable from a cost-benefit point of view to retain the possibility of reaching agreement on this basis, rather than closing it down as an option.
54. As the consequences associated with the existence of "*fundamental economic attributes*" are very significant, further guidance on how the OECD expects MNEs to "*exhibit*" such attributes in Paragraph 89 would be welcome.

55. Paragraph 89 notes that fundamental economic attributes “*would offer both of the parties the opportunity to enhance or protect their commercial and financial positions.*” This is a very broad statement and may be open to differing interpretations as to what constitutes ‘enhancing’ or ‘protecting’ a commercial or financial position. It would therefore be very helpful to expand this section to give some examples of how it should be read so there is consistency in interpretation between different tax authorities and MNEs.
56. The inclusion of examples may assist MNEs in formulating and implementing Transfer Pricing policies, and help tax administrations in auditing those policies. Although carefully drafted, we believe that the example outlined in paragraphs 90 and 91 does not establish clearly enough why the facts and circumstances presented should be considered “fundamentally uneconomic”, illustrating the difficulty in providing proper and reliable guidance. The example overlooks the implications of the fact that S1 is receiving 400mUSD as an up-front payment for the intellectual property. Depending on the financial and cash-flow position of S1, it may very well be at arm’s length willing to make the trade-off outlined in the example in order to avoid a financial crisis or even bankruptcy. This clearly illustrates the risks with oversimplified examples which do not appropriately consider all aspects of today’s complex business environment.
57. It is surprising that the examples in Paragraph 90 and 91 relate to recharacterisation, as these could be viewed as typical examples of a business restructuring transaction. In business restructuring, the transaction is not ignored, it is either repriced or subject to non Transfer Pricing regulations, such as exit costs. We believe that the conclusion set out in Paragraph 92 is inconsistent with Chapter IX of the Guidelines on Business Restructuring, which also includes an analysis of risk. For reasons of clarity and to avoid duplication, we would propose that the sections of Chapter IX relating to risk and the new proposals for risk in Chapter I are reviewed jointly to ensure they are consistent.
58. Paragraphs 89 and 92 appear to introduce a new element to the Guidelines, which is to compare the pre- and post-tax results of the Group. This seems to be a move away from the arm’s length principle, which focuses on how a third party would price a transaction and has not – to date – taken account of post-tax results (even if such information regarding third parties were available). We do not see the post-tax result of the group as a relevant factor in determining the price of the transaction, but rather, as an element to price or influence future transactions between the parties. The Guidelines should, as far as possible, establish a framework that represents a practical interpretation of how parties would act at arm’s length.

Moral Hazard

59. Without detailed and considered analysis, there is a risk that the insertion of highly theoretical economic concepts such as moral hazard into the Guidelines could have unknown and unintended consequences.
60. With regard to Question 1, whilst we accept the concept of moral hazard and recognise that it can play a role in certain business transactions, it is not always the case that third parties will only accept risk if they can incorporate safeguards or incentives into contractual arrangements. By attempting to incorporate moral hazard into the Guidelines and implying that related party transactions do not exhibit moral hazard in the same way as unrelated parties, the Discussion Draft risks rendering the arm’s length principle not applicable to a wide

range of transactions. Our understanding is that a move away from the arm's length principle is contrary to the aims of the BEPS project, which recognises that the arm's length principle remains the best available and most widely accepted basis for Transfer Pricing methodologies.

61. In stating that individual entities will only act in the best interests of the group, the Discussion Draft takes a simplistic view of how associated entities act. Although this may be correct in some cases, MNEs differ in their organisation and at a micro level, especially in a more autonomous MNE, associated entities may behave very much like independent parties when personal performance, bonus or adherence to projected budgets is at stake. This is even more prevalent in MNEs that conduct their operations extensively through JVs with third parties or through companies with large minority or public shareholder interests.
62. The business of insurance is a case in point: in an insurance transaction a third party (the insurer) takes on risk over which it has neither control nor the contractual ability to impact the risk - particularly in the case of earthquake or other natural catastrophe insurance - in return for the payment of a premium. So effectively, the moral hazard is traded for risk-return: the insurer takes on risk over which it has no control and therefore takes on moral hazard, but at a high price to the party laying off the risk. Simply put, the moral hazard risk is reflected in the market premium charged.
63. There are numerous other examples in the market of transactions entered into by third parties where risk is neither controlled nor managed, while the party who assumes the contractual risk still enjoys the risk-reward trade-off that follows. Examples include:
 - a. Home mortgage securitizations
 - b. Where governments implicitly or explicitly guarantee banking organizations that engage in transactions involving risk
 - c. Compensation structures that protect risk-taking employees from the consequences of their risks
64. Although moral hazard exists in certain third party transactions, it does not exist in all. It is therefore very difficult under the arm's length principle to know when moral hazard should be imputed in a group context.

Risk – Return

65. With regard to Question 4, we believe that transactions between associated enterprises that solely transfer risk should be recognised. An example of such a transaction would be intra-group reinsurance. Reinsurance exists both as a third party and a related party transaction. The terms of both transactions are identical – the transfer of risk from one party to another – and the pricing is performed under identical methodologies. Other similar transactions include all hedging activities (to re-locate/centralise/manage FX, interest rate or credit risk etc.) and related party guarantees. We are concerned that, as drafted, the proposed Guidelines may allow tax administrations to disregard related party transactions where a risky stream of income is traded for an equivalent, less risky income stream, even though – as noted above – such transactions frequently occur between third parties. Under the arm's length principle such related party transactions should continue to be recognised.

66. Another example where the transfer of risk(s) may well be reasonable may be upon the acquisition of an external business. Depending on how the business is set up prior to acquisition (for example, its control structure, authority levels, risk management structures, financial steering principles etc.), compared to the arrangements subsequent to the acquisition, it may be unreasonable to allocate the same risk profile to the business before and after the transaction. If, for example, a stand-alone entity is acquired by a large MNE, the acquired business will typically become subject to a large range of central governance rules, financial steering principles and management policies. In such a case, due to the integration of the new business into the MNE, a functional analysis may very well show that the full risk profile of the business pre-acquisition may not reflect the commercially rational position after the acquisition. In such a case, even though there are no other formal transactions, it may very well be reasonable, in alignment with the arm's length, for risk(s) to be transferred.
67. The concept of risk return trade off raises some interesting questions. For example, the statement "the discount rate applied to the anticipated nominal income provides a link in deciding whether the seller is better off in the selling or retaining the asset" is not explained in detail, and would benefit from further clarification. The assumption would be that if an entity reduces its risk and accepts a lower return, by doing so, it should reduce its WACC and discount rate. Therefore, when the reduced return is considered using the lower discount rate, the entity is in a similar or better NPV position. The WACC question also goes to the split of debt and equity and what is the optimum level of each?
68. In relation to Question 5, the example at Paragraphs 90-91 has a number of issues. Whilst it is clear which transactions this is seeking to catch, the example is somewhat complex and is unlikely to be seen in practice. It does not address how the initial \$400m is to be treated if the transaction is not to be recognised. The lump sum payment may have resulted in tax for company S1, which would need to be reversed. In addition, if the \$400m is not returned to S2 for a number of years (which is probable, if indeed it is returned at all), a tax adjustment is needed for S1 to reflect the tax that it will have earned income on the \$400m (potentially through other investments) or reduced its deductible costs, e.g. by reducing its debt balance and thus its interest payments. We would therefore welcome further guidance on how not only the primary consequences are dealt with (e.g. how is the royalty payment dealt with if not recognised), but also how the secondary and other consequences are dealt with (e.g. the lump sum payment and the lost opportunity cost of the investment or the reduced debt). These secondary and other consequences of non-recognition indicate the additional complexity of applying non recognition versus an adjustment to pricing and highlight the likelihood of double taxation.
69. For Question 8, the insurance sector is discussed separately in a subsequent section (see paragraphs 97 to 118).

Special Measures

70. The existence of special measures, in addition to non-recognition, creates further uncertainty for taxpayers. We believe that the analysis of commercial and financial relations set out in Sections D1 and D2 followed, where necessary, by the application of non-recognition in Sections D3 and D4 should be sufficient to ensure that Transfer Pricing outcomes are in line with value creation and therefore, special measures are not required.

71. We do not believe that any special measures should be adopted without further development of the proposals across the BEPS Action Plan. It should first be understood how those wider proposals tackle Governments' specific BEPS concerns before new special measures are introduced. Using this approach, it would be possible to identify specific residual issues so that future rules could be well defined and targeted.
72. With regard to the information asymmetry mentioned in Paragraph 3, we believe that BEPS Action 13 on Transfer Pricing Documentation and Country-by-Country Reporting, together with the information sharing it promotes, significantly reduces the risk of information asymmetry. The documentation required by Action 13 gives tax administrations the necessary tools to conduct risk assessments and commence audits and again obviates the need for special measures.
73. Section D1 focuses very much on functionality and actual capabilities/conduct. The existence of minimal functional entities referred to in Paragraph 3 could therefore be analysed under Section D. It is difficult to see why additional measures are required to deal with such entities.
74. If special measures are to exist, then there must be a clear and consistently applied set of criteria for their application and an unambiguous gateway for entry into them and sequencing rules to determine when they should apply in the place of the broader Guidelines. In the absence of clear criteria, each tax administration will interpret the provisions individually, which will result in inconsistent application, a significant increase in disputes and potential double taxation.
75. We are concerned that Paragraph 6 appears to disregard the arm's length principle for the sake of achieving a specific result. We consider that any move away from the arm's length principle is detrimental to the existing international agreement around the use of Transfer Pricing methodologies. If we begin to define circumstances in which the principle does not apply, then the underlying principle itself may come to be questioned.
76. With regard to Framework Question 7, we believe special measures should be considered only after the application of normal Transfer Pricing rules. As noted above, we believe all situations can be dealt with under the existing Guidelines. It is hard to envisage a circumstance in which those Guidelines could be ignored and special measures applied immediately. One of the criteria for applying special measures must be that all efforts under the existing Guidelines have been exhausted by taxpayers and tax administrations. A second criterion to be satisfied would be that the matter has been referred to Competent Authorities, but they have been unable to resolve the issue through a Mutual Agreement Procedure.
77. With regard to Framework Question 8, significant consideration must be given to preventing the possibility of double taxation due to disputes arising from the application of special measures, and a mechanism must be identified to deal with this. Given the complexity of the situations likely to be covered by special measures we believe that the existing mutual agreement procedures would be severely stretched in trying to cope with the additional work. We therefore suggest that if special measures are to be implemented, one of the requirements should be that any resulting cross-border disputes are granted priority by tax administrations.

78. With regard to Framework Question 9, we believe that the Financial Services sector should be excluded from the measures focused on capital. Please see Paragraph 97 to 118 for a further discussion of capital in the Financial Services sector.

Hard-to-value intangibles (Option 1)

79. We do not see the benefit of complicating the discussions on hard to value intangibles beyond what will be included in the Guidelines for Intangibles. It is not clear to us whether this section proposes a new valuation methodology in case of an intangible that produces a more significant return than initially expected (which can also happen in third party situations), or if the Discussion Draft is trying to shift the burden of proof to the taxpayer in cases where projections do not crystallise, which would be a significant change to current regulations in OECD countries, or if this should be seen as a 'penalty' in case the tax authorities see the Transfer Pricing documentation as unsatisfactory. We would welcome clarification on this section and its main objective.
80. Intangibles may be transferred between third parties for lump sum amounts. This may happen through the straightforward purchase of the intangible, or by the takeover of a company (coupled with a transfer of the intangible to a different location at the same or similar price). In both instances, there may be no future adjustment with both parties living with the consequences. Therefore, it appears strange that the starting point is the transfer for a fixed price.
81. When considering a retrospective price adjustment, consideration should be given to the development or value added by the new owner in the intervening period since the original sale of the intangible. A distinction should be made between the return due to the original owner and that due to the current owner.
82. If this approach is considered necessary, **very clear and objective criteria need to be** developed to determine how and when the rule should apply.

Inappropriate returns for providing capital (Options 2 and 3)

83. In considering inappropriate returns for capital, the special measure does not appear to take account of potential losses. We also believe that any BEPS related work that considers capital structures of MNEs should be closely coordinated with the work under Action 4 – which may satisfactorily address government concerns.
84. We believe that this measure should not apply to MNEs in Financial Services sector groups as capital is a key component of their business. Efficient management of capital is a key competitive advantage in this sector and therefore, entities are highly unlikely to be over-capitalised. A group or fixed ratio would not be appropriate. It should be noted that capital adequacy requirements would also not be appropriate, as they are a regulatory minimum and are often not sufficient for a FS entity to actually undertake business. In order to do business, a FS entity requires additional capital to satisfy the ratings agencies and any further margin imposed by its regulator.
85. The independent investor approach appears to be rather subjective and leaves much opportunity for differing views between tax authorities and taxpayers or even between

different tax authorities. The extent to which this option would help taxpayers or tax authorities come to an agreed position is unclear, and may even be detrimental to achieving it.

86. The starting point for the thick capitalisation option appears to be an arbitrary capital ratio that may be based on a group ratio. Different MNEs in differing industries have vastly different capital ratios. Furthermore MNEs that have multiple businesses could have a blended capital ratio that bears no relationship to any of the individual standalone businesses.
87. Neither option takes account of potential Joint Venture agreements, or production sharing agreements where debt financing is not permitted. Consideration also needs to be given to territories that have adopted Sharia law, where interest is not recognised. It is not clear from the thick capitalisation option how a group attribution would overlay on the legal form in such cases and how this might, in the case of a Joint Venture, lead to a disproportionate allocation of funding.
88. The thick capitalisation option makes the assumption that all tax authorities involved would interpret and apply the proposed rule in the same way and that a corresponding adjustment would be available on both sides. If this is not the case – and it is likely that an issue of this type would be disputed – then there is significant potential for double taxation.
89. We would note that BEPS Action 4 on Interest Deductions is also concerned with the capital structure of MNEs, although Action 4 is focused on debt rather than equity. We believe it is not appropriate to treat these two capital elements in isolation and that work on Options 2 and 3 should be co-ordinated with Action 4. Jointly these considerations may have a significant impact on capital structures and without such co-ordination there may be unintended macro-economic consequences.

Minimal functional entity (MFE) (Option 4)

90. The Discussion Draft states that *“it may prove simpler and more effective, therefore, in dealing with such cases [i.e. for minimal functional entities lacking fundamental economic attributes] to adopt a targeted special measure.”* Although we support clear and practical rules, it should not be the case that ‘simplicity’ over ‘complexity’ should be the deciding factor over when a special measure should apply. It is our concern that governments may see such special measures as generally providing a more ‘simple and effective’ approach, and that this could undermine the more detailed and principled framework in the remainder of the Guidelines that is generally applied by taxpayers to reach a reliable conclusion.
91. 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 Action 4 – Interest Deductions Discussion Draft, particularly the group wide ratio, would essentially require 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. This Discussion Draft 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 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 this Discussion Draft 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.

92. We disagree with the thresholds of functionality contained in this section. We do not believe that “qualitative attributes” can play a role in assessing whether or not an arrangement is lacking fundamental attributes. Whilst we recognise that the presence of assets, people, capital and functions is relevant, we believe it may be the case that a group entity “*lacks functional capacity to create value through exploiting its assets and managing its risk and is mainly reliant on a framework of arrangements with other group companies to exploit its assets and manage its risks*”. For example, hedge funds often operate with relatively few, high value fund managers and partners investing substantial amounts of investors’ capital in financial markets with significant risk. The draft guidance on MFEs would seem to suggest that such entities may be problematic. This inability to run a business outside the group may even be the main characteristic of a group company (e.g. .a R&D Centre). We believe the wording should instead refer to the ability of the company to carry out its business.
93. The option does not give due consideration to operational efficiency. There is a risk with this proposal that an efficient, but lean, entity would be considered an MFE. We would question why this option seems to require a fully competitive market within a group context, when it could be a sign of efficiency that certain entities are lean.
94. We are concerned that the ‘*mandatory profit split... based on pre-determined factors*’ could in reality become formulary apportionment.

Ensuring appropriate taxation of excess returns (Option 5)

95. Whilst we believe that Options 1 to 4 can be dealt with using Sections D1 to D4 of the Guidelines, Option 5 falls outside Transfer Pricing. In principle we have no objection to the use of controlled foreign corporation (CFC) measures as a means to prevent BEPS, although we believe significant further work is required to develop the primary and secondary rules set out in Option 5, as these are very broadly drafted. In particular the allocation of taxing rights to various jurisdictions would need to be carefully considered.

Sector Specific Comments

Insurance Sector

96. In response to questions in the Discussion Draft we have commented in detail below on two areas:
 - The discussion of risk in the Discussion Draft is too general in nature to apply to the insurance sector, where risk and risk transfer are the core of the business
 - Operating in a regulated sector, insurance MNEs do not have the freedom to control their capital and legal structures
97. The business of insurance is the transfer of risk from the insured party to the insurer, in return for the payment of a premium. The insurer assesses the risk in the context of the likelihood of

the loss event and the pool of other risks held by the insurer. By pooling risks across various geographies and sectors the insurer can diversify risk and spread the risk of loss.

98. In order to bear the risk of loss – i.e. to ensure that claims can be paid out to policyholders – regulators require insurers to hold an appropriate amount of capital. The regulator acts to protect policyholders in their jurisdiction and ensure sufficient capital is available in that jurisdiction to cover any unexpected losses. In addition to this minimum regulatory capital requirement, ratings agencies also impose capital conditions in order for an entity to attain or maintain a specific credit rating. The level of credit rating is key as it opens access to particular customers and markets who will not deal with entities that have a credit rating lower than Y. Maintaining the required level of capital in a particular entity is, therefore, not a question of choice but is critical to the ability to do business. In addition to these two requirements it is common for regulators to impose a further ‘buffer’ or margin over and above the minimum capital requirement. Again the insurer has no choice in this matter as it needs an insurance licence to do business and if it does not meet the regulator’s requirements the licence will be withdrawn.
99. Similarly the insurer often has no choice over the legal structure it must adopt in a particular jurisdiction. Some regulators may allow a permanent establishment, others may require a subsidiary, but the permitted activities and capabilities of staff in those entities are closely governed by the regulator; for example the issuance of policies often cannot be done by a foreign entity.
100. Capital is needed to back risk, but it is a scarce resource and thus is expensive. In the insurance sector this is exacerbated by the requirements from regulators, ratings agencies and customers to hold ‘high quality’ capital – i.e. capital in the form of assets that are more secure and therefore more expensive to hold.
101. For insurance MNEs there is a balance that continually needs to be struck between the demands of regulators and ratings agencies to hold relatively large amounts of capital and the fact that holding capital is expensive. Holding high quality capital is costly, which means lower profits, which in turn diminishes the returns available to satisfy and retain investors. This constant juggling means there is every incentive for an insurance MNE to hold the minimum possible capital rather than over-capitalising. The ability to manage capital efficiently is a key source of competitive advantage in the sector.
102. The most common way of managing the balance between bearing risk and the need to hold capital to support that risk is through the use of reinsurance arrangements. Under a reinsurance arrangement a large single risk, or a group of risks is transferred from the insurer to another insurer (the reinsurer) in return for payment of a premium. The original insurer no longer bears the risk and therefore is not required to hold capital against it. The risk and the associated capital requirement have been transferred to the reinsurer.
103. Reinsurers exist both as third parties and in a group context. Like insurers they and the arrangements they enter into are regulated. Irrespective of whether a reinsurance arrangement is with a third party or a group entity, in order for the arrangement to be recognised and thus remove risk (and associated capital) from the originating insurer the arrangement must comply with regulatory and accounting requirements. It must genuinely transfer risk and must be with a sufficiently capitalised counterparty (again the regulator is

acting to protect policyholders in its jurisdiction, ensuring that the reinsurer is sufficiently capitalised to meet claims).

104. In accordance with Part IV of the Attribution of Profits to Permanent Establishments⁴ (“Part IV”), profits and losses in the insurance industry are attributed to the KERT function which, for both insurers and reinsurers, is those people who select and price risks. As noted above, in the insurance business the bearing of risk and the holding of capital go together and thus the location in which the KERT function takes place is also the location in which the capital is held. In order to avoid any confusion between Part IV and the proposed framework for allocating risks contained in the Discussion Draft we would suggest that Section D2 on risk clarifies the precedence of Part IV in respect of the insurance sector.
105. Reinsurance within a group – i.e. reinsuring with another group entity – offers additional benefits over and above third party reinsurance:
106. Pooling risks in a central group entity has the effect of diversifying those risks – i.e. spreading the risk of loss, which means the capital requirements are lower. The more centralisation of risk a group can achieve, the less capital it is required to hold and the lower its cost of capital in relation to the business it can undertake. With a lower cost of capital the group can offer lower prices to customers
107. It is more flexible to hold capital centrally. Rather capitalising each individual jurisdiction (which would be expensive), capital held centrally can be used via reinsurance to support business in multiple jurisdictions.
108. Capital held centrally can be deployed very quickly if necessary to support a particular jurisdiction
109. Centralising capital also improves liquidity management, as it can give more flexibility around the type of assets held and, in the event of a large loss, can give access to a larger pool of liquidity to settle claims
110. Centralising risks in one location enables the group to negotiate better rates of reinsurance with third parties, rather than each individual group entity entering into separate arrangements with third party reinsurers in respect of several smaller pools of risk
111. As noted above, the regulator’s primary concern is that policyholders are protected and therefore the regulator will review reinsurance contracts to ensure the terms and conditions, capital and credit-worthiness of the reinsurer meet regulatory requirements. This is irrespective of whether the reinsurance is third party or intra-group. Intra-group transfers of risk for reinsurance purposes are therefore real transfers of risk and are not distinguishable from third party reinsurance arrangements. In response to question 4 under Risk-return trade-off we believe that intra-group reinsurance is a transaction that should be recognised for Transfer Pricing purposes.
112. The points made above relating to reinsurance apply equally to insurance.

⁴ Part IV, 2010 OECD Report on the Attribution of Profits to Permanent Establishments

