BIAC THE VOICE OF BUSINESS AT THE OECD

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Submitted by email: TransferPricing@oecd.org

August 16, 2016

Ref: BEPS CONFORMING CHANGES TO CHAPTER IX OF THE OECD TRANSFER PRICING GUIDELINES

Dear Jefferson,

Thank you for the opportunity to comment on the *BEPS Conforming Changes to Chapter IX of the OECD Transfer Pricing Guidelines* ("the discussion draft") issued on 4 July 2016. Many of the amendments noted, accord with the OECD's focus on risk management as a determinant of value creation, and we appreciate that efforts have been made to condense the chapter, and to ensure that this revision is consistent with other BEPS changes.

On an administrative note, it would be extremely helpful for all commentators if revisions to guidance, such as those proposed in the discussion draft, could be released in a "tracked changes" version in addition to a plain text version. This would improve the efficiency of the review process, and would allow commentators to more effectively target their comments on the areas where there have been significant changes. This is particularly important given that several BEPS-related discussion drafts have been issued at the same time.

Whilst we understand that this discussion draft is not considered by the OECD to warrant broad consultation, we are concerned that it may be inappropriate to address "perceived" inconsistencies without a further opportunity to comment. Furthermore, we did feel that some of the changes on "real" inconsistencies went beyond what was required in order to bring Chapter IX in line with the BEPS recommendations. We have, therefore, outlined comments on several changes below, and would welcome a public consultation to discuss these issues further.

Again, we thank you for the opportunity to comment on this draft.

Sincerely,

Will Morris

Will Morris, Chair
BIAC Tax Committee

Summary comments

1. We agree with the OECD that changes to Chapter IX of the Transfer Pricing Guidelines ("TPG") should only reflect the broader revisions to the TPG proposed as part of the BEPS project. We have not commented on changes from the old Chapter IX which are simply conforming, or which replace older formulations with revised but similar concepts. Within this response, we have first set out some general comments on the discussion draft, before exploring some specific changes in more detail.

2. BIAC welcomes the streamlining of Chapter IX, and agrees that the guidance should indeed reflect the principles established in the earlier chapters of the TPG, rather than reiterating them in significant detail.

Primacy of the arm's length principle

3. During the initial development of this guidance and throughout the BEPS project, the OECD and governments have made clear that the arm's length principle, properly applied, should be reinforced and reaffirmed rather than replaced.

4. With that in mind, it is important to maintain a focus on what the arm's length principle is attempting to achieve: namely, a reflection of the realities of third party arrangements in transactions between controlled parties. We are disappointed that some elements of the discussion draft seem to impose approaches that do not fully conform with this principle. For example, the discussion draft emphasises consideration of the impact of a restructuring on pre-tax profits as an indicator of whether an arm's length payment is needed (9.37), or whether the business purpose of the restructuring should be investigated in more detail (9.38).

5. We do not advocate that the guidance single out any aspect as more important than another, but instead, it would be more helpful to identify the broad range of factors that should to be considered as part of a restructuring to determine whether or not a payment is necessary in accordance with the arm's length principle. We believe, therefore, that emphasising the pre-tax impact in this way is likely to create expectations of payments without those expectations being grounded in business practice (or solid economic principles).

6. In arm's length business restructurings, each party may use a wide range of factors to determine their approach to a business restructuring. This would, for example, include the restrictions imposed by contractual terms and conditions, relative negotiating strength, the impact on pre and post-tax profit, market share, long term growth prospects amongst many other factors. Calling out one factor risks overlooking many of the arm's length considerations that two third parties might take into account, therefore potentially imposing non-arm's length requirements on controlled transactions. The commercial rationality of the transactions ought to be based on how two third parties would have approached a comparable restructuring under comparable circumstances. We do not believe that the TPG should explicitly mandate one indicator over all others, but we reiterate that third parties would not look to anticipated pre-tax profits as a determinative factor.

7. We are also concerned that the guidance could be interpreted as requiring *"arm's length compensation"* for all participants to all business restructurings. In this regard, we note that Para 9.37 reads *"it is expected that an appropriate transfer price [...] would generally be available to provide arm's length compensation for each accurately delineated transaction."* Although BIAC acknowledges than an arm's length price could be zero, and the use of terms like *"general"* do not mandate a payment, the tone of the paragraph seems to suggest that governments believe that arm's length compensation payments ought to be expected in most cases involving restructuring. This could create an expectation from tax authorities that any minor change to the operation of any MNE ought to result in payment ("*that is, compensation for the post-restructuring arrangement plus any compensation payments for the restructuring itself*"). In this regard, BIAC would welcome more objective language to clarify that whether an arm's length payment is (or is not) required, ought to be based on an objective assessment of the facts at hand. We do not believe that conclusions should be presupposed in the general terms. There are many examples of business restructurings between third parties where no compensation is due over and above what has already been contractually agreed (e.g. where a distributor contract is cancelled with minimal notice, in accordance with the terms and conditions agreed by the parties, the only compensation due for the restructuring of the contract would be the notice period itself).

Economic potential (rather than profit potential)

8. Transfer pricing outcomes must apply equally to profits and losses. Although this is noted in some instances within the draft, it is not clear throughout. At numerous places the term "profit potential" is used - "economic potential" would be more accurate to reflect that either profits or losses could be generated as the result of a restructuring.

Compliance requirements

9. BIAC has a general concern about the level of documentation that will be required to comply with the draft guidance. We have highlighted some examples where the guidance will place an increased, and undue, compliance requirement on business in our comments on specific changes.

10. Many taxpayers are concerned about their ability to comply with the increasingly complicated TPG. The transfer pricing changes proposed under Actions 8-10, in addition to the documentation requirements under Action 13, will impose a substantially increased compliance burden on all MNEs. That compliance burden doesn't just relate to the volume of documentation required, but also to the complexity and detail of the analysis needed to feel confident that the terms and conditions of a related party transaction, as well as the conduct of the parties, can be robustly defended. Given that the arm's length principle will, by its nature, continue to be subjective, increasing the complexity of its application significantly drives up the compliance burden, without necessarily mitigating the risk of dispute. The additional level of detail taxpayers must provide may not reduce ambiguity for tax authorities about the appropriateness of the transfer price; rather the result may be a wider range of potential outcomes.

11. Indeed, the level of detail that seems to be required from the discussion draft in relation to all business restructurings would appear to give tax authorities an overly wide range of

opportunities to challenge whether a taxpayer is 'compliant' – even when the taxpayer has made a best-efforts attempt – increasing the costs of both taxpayer and tax administration. Taxpayers' resources are constrained (in terms of staff and budget to pay advisors) and complying with the strictest interpretation of the requirements set out in the revised TPG and this discussion draft will be challenging for many.

12. In relation to business restructurings, we believe it would be helpful for the TPG to acknowledge that some transactions will require very little or no analysis for tax authorities to feel comfortable than an arm's length outcome has been achieved (e.g. where a related party distribution contract has been terminated early, where it has already been documented that the terms and conditions of the transaction are consistent with the arm's length principle).

13. There is a real risk that the extensive documentation requirements, coupled with threats of punitive penalties for non-compliance under domestic legislation, will decrease the attractiveness of cross-border trade and investment in some circumstances.

14. It is also worth noting that implementing blanket compliance obligations, which are very challenging for taxpayers to meet and give tax authorities the grounds to open audits, does not necessarily contribute to a positive tax compliance culture. The OECD's Centre for Tax Policy and Analysis has produced some excellent work on co-operative compliance models; such strategies require taxpayers to be transparent and responsive, and tax authorities to show a commercial understanding of the needs of business[1]. Introducing compliance requirements that will be exceptionally difficult and/or exceptionally burdensome to meet completely undermines these approaches. Therefore, additional language within this guidance on the specific scope of what is required would be very welcome.

Business decisions

15. One final point BIAC would like to highlight is the shift in the OECD's focus with regards to the reach of Chapter IX (and the TPG more broadly). We note in paragraph 9.34 the removal of the sentence *"MNE groups cannot be forced to have or maintain any particular level of business presence in a country"*. It cannot be reiterated strongly enough that any business is free to act in whatever commercial manner it sees fit within the constraints of the laws in the jurisdictions in which it operates. The omitted sentence is also in line with bilateral investment treaties.

16. The objective of the transfer pricing guidance is to ensure related party interactions are taxed in a way which is consistent with how unrelated party transactions are taxed. This guidance should not be used to exert requirements on business beyond this objective. It is not clear from the discussion draft why it was felt that this particular sentence should be deleted. We request that it be retained in the new TPG.

[1] *Study into the Role of Tax Intermediaries*, OECD, 2008, *Co-operative Compliance: A Framework*, OECD, 2013, Building Tax Culture, Compliance and Citizenship, OECD, 2015, and *Co-operative Tax Compliance: Building Better Tax Control Frameworks,* OECD, 2016

Comments on specific amendments to the guidance

Paragraph 9.2

17. Paragraph 9.2 sets out a number of scenarios that may constitute a business restructuring. The paragraph has been amended to include the following new language on functions as an example: *"The concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally; examples may include procurement, sales support, supply chain logistics."*

18. Although BIAC agrees that a change in functions may be a restructuring subject to the Chapter IX guidelines, in other cases a centralisation of certain functions should not be assumed to have the potential to materially impact profit/economic potential. More pragmatic guidance should be provided to clarify that such restructurings will not always have an impact on the transfer pricing outcome. As an example, where a related party entity provides routine back-office administrative services, it may well be consistent with the arm's length principle that the service contract can be terminated at relatively short notice without any additional compensation. This would reflect the fact that the services are routine and widely available, that competition in the marketplace is high, and that the service recipient would have the lion's share of the bargaining power. In such situations (i.e. where the service contract is terminated to transition to a different, perhaps more centralised service model), it would not be appropriate for extensive documentation to be prepared to justify that no additional payment is required.

19. Further, some of the profits from services discussed in the newly added text refer to the same profits that are dealt with under Chapter VII on low-value intra-group services. The guidance should make clear that profit potential of some functions will be minimal and provide additional detail on how to treat those profits classified as low-value adding services under chapter VII.

Changes pertaining to the recognition of the actual transactions undertaken

Paragraph 9.16

20. This paragraph includes language which implicitly presupposes that there must always be some form of transfer pricing compensation for a restructuring. We propose the following amendments to this paragraph –

> *"In order to determine **whether** ~~the arm's length~~ compensation **should be** payable upon a restructuring to any restructured entity within an MNE group, **as well as the arm's length value of this compensation and** the member of the group that should bear **any** such compensation, it is important to accurately delineate the transactions occurring between the restructured entity and one or more other members of the group. For these purposes, the detailed guidance in Section D of Chapter I of these Guidelines is applicable."*

Paragraph 9.18

21. It is asserted in this paragraph that an "accurate delineation" of a business restructuring transaction requires a full functional analysis both before and after the transaction takes place.

22. Given the breadth of what can be considered to be a "business restructuring" we fear that this will be a very heavy – and disproportionate – requirement to place on businesses. Many taxpayers will simply lack the resources to comply with such an extensive obligation. This is especially pertinent given the increased complexity associated with applying the other chapters of the TPG which have been updated throughout the BEPS project.

23. BIAC believes it is important to note that some transactions that could be considered to be a "restructuring" would not warrant such an extensive review, and requiring such work from taxpayers in all cases would create a disproportionate compliance burden.

24. To provide an example, an MNE may have distribution agreements with a number of related party and third party entities. Those agreements may have been established on comparable terms and conditions, which would allow the engaging party to cancel the distribution contracts with 3 months' notice with no additional compensation for the restructuring. If the MNE group has already documented and supported the arm's length nature of the distribution services, it should not be necessary to undertake an excessive review of the 'restructuring' to determine that the result is consistent with the arm's length principle.

25. The same concerns would also hold true with respect to contract manufacturing arrangements and long term supply arrangements involving both related party and third party entities, which have also been established on comparable terms and conditions. Generally these agreements would include details with respect to notification periods regarding contract termination as well as related penalties or termination costs. Other examples would include long term construction or installation contracts which involve change orders. Again, if the MNE group has already documented the arm's length comparables which support the arm's length nature of these types of arrangements, any changes which occur through a restructuring should not require extensive or excessive reviews to demonstrate that the result is consistent with the arm's length principle.

Paragraph 9.22

26. The term "profit potential" is used throughout the draft. This paragraph uses the term "profit potential" to describe an indicator of economic risk. Rather than profit potential, we would prefer the use of the term "economic potential" or some other more neutral formulation to ensure that it adequately captures that risk entails the potential for both profits and losses and that this guidance should be applied consistently when businesses are in loss-making situations. Again, we believe that the TPG should take an objective view of related party transactions, and not establish an implicit expectation that there is always "profit potential" or a requirement for a further payment to be made to a restructured party.

Paragraph 9.30

27. Paragraph 9.30 explores the "options realistically available" hypothesis, and states that "*In such cases, an independent party may not have agreed to the conditions of the restructuring, and adjustments to the conditions made or imposed may be necessary*." The guidance should expand on what taxpayers and tax authorities ought to do in such circumstances, i.e. where a restructuring has happened that one of the parties might not have agreed to it if it were between unrelated parties. An example would be very useful to illustrate this point, as it is not exactly clear what situations this sentence is looking to address. In this paragraph, it would be useful to reiterate again the importance of undertaking the analysis on an *ex ante* basis.

Paragraph 9.31

28. Paragraph 9.31 notes that taxpayers are not required to document all possible hypothetical options realistically available. At the same time, it indicates that if there is a realistic option that is clearly more attractive to an individual entity, it should be considered in the analysis of the restructuring. In order to determine whether there are any options clearly more attractive to each entity involved in a restructuring, taxpayers seem to be required to have done the analysis for all possible hypothetical options realistically available, so we believe this is an inappropriate recommendation. If this is the intention of the OECD, we would highlight that the broad range of hypothetical situations is likely to result in disagreements between tax authorities. An example might provide useful context for taxpayers to better understand what is meant by "clearly more attractive" – although, again, this will likely be subjective.

Paragraph 9.34 (previously 9.163)

29. The following sentences have been deleted from paragraph 9.34: "*MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests in this regard*."

30. This text should be retained in the new guidance as it does not relate to the broader changes to the TPG delivered through the BEPS project. As noted above, it is not clear why these sentences have been deleted. The TPG should not be used to impose non-arm's length requirements on business. BIAC notes that there is a trend where some countries are acting on a unilateral basis to effectively mandate how multinational companies should operate as a commercial matter within their borders. This is being achieved through the use of domestic law and regulation, based on the specific economic objectives of the country. Although BIAC does not support the adoption of such restrictions as a general principle, whether or not to apply such laws is a decision for the country itself. BIAC does not believe that the TPG should implicitly or explicitly endorse restricting the re-organisation of a business, and should continue to state that a business is free to organise itself in the most appropriate way to deliver its commercial objectives within the confines of the law.

Paragraph 9.37 (previously 9.178 and 9.179)

31. These changes relate to the relevance of a tax purpose in a business restructuring. Both the discussion draft and current version of Chapter IX make it clear that domestic anti-abuse rules are not within the scope of the TPG. So, domestic rules that require a non-tax business purpose for a restructuring are not implicated by the guidance.

32. This paragraph also includes language which implicitly presupposes that there must always be some form of transfer pricing compensation for the restructuring. As noted above, this approach is not in line with the arm's length principle and, if retained, would put an undue compliance burden on business, and could lead to tax authorities regularly asserting that compensation is due post-restructuring, leaving a taxpayer exposed to the risk of double taxation if a corresponding adjustment cannot be obtained.

33. The significant changes to the paragraph are in the following sentence: *"Where a restructuring* ***makes commercial sense*** ~~*is commercially rational*~~ *for the* ~~*MNE*~~ *group as a whole on* ***a pre-tax basis****, it is expected that an appropriate transfer price (that is, compensation for the post-restructuring arrangement plus any compensation payments for the restructuring itself) would generally be available to* ~~*make it*~~ *provide arm's length* ***compensation for each accurately delineated transaction comprising the business restructuring*** *for each individual group member participating in it." (Deletions* ~~*struck through,*~~ *additions* ***bold****.)*

34. We disagree that the arm's length price should be determined solely on a pre-tax basis, and, as noted above, that there should be any expectation that an arm's length payment should "generally" be available. A true arm's length price is one which would be realistic in a transaction between unrelated parties. In such transactions we would expect each party to consider a wide number of factors in determining their position (including pre and post-tax income, amongst many other factors[2]).

Paragraph 9.38 (previously 9.181 and 9.182)

35. The first sentence of current paragraph 9.182, which reads as follows, has been deleted: *"Provided functions, assets and risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings."*

36. The retained language in the paragraph still makes clear that *"In making commercial decisions, tax considerations may be a factor"* and therefore we can see that the deleted sentence could be considered duplicative to an extent. However, we believe that the original wording was clearer and it is therefore our preference for it to be retained.

37. Further, the final (newly added) sentence of 9.38 discusses the example in 9.122-9.124, stating that: "*Moreover, as indicated in paragraph 1.122, the fact that a MNE group as a*

[2] Including (but not limited to): post-tax income, cash flow, geographical factors, market share, local expertise and cost, legal/regulatory requirements/obligations, reputation, exchange rate fluctuations, political stability, competition, available options, bargaining power, and impact on credit ratings.

whole is left worse off on a pre-tax basis may be a relevant pointer in determining the commercial rationality of the restructuring." While we appreciate that it only "may be" a relevant factor, this is not a useful addition to the guidance and is not helpful for taxpayers who require clear, practicable guidance. It also seems slightly incongruent with paragraph 9.26, which makes the point that there may be cases where a change to a business model designed to increase synergies will not lead to an outcome where the post-restructuring profits are higher than the pre-restructuring ones. There are many factors that can lead to this, ranging from poor forecasting to changes in economic conditions or unanticipated obsolescence.[3] Accordingly we believe that the pricing should be based on *ex ante* information only. We believe that the TPG should be more explicit on the various other factors that, taken together, would help to inform a taxpayer and tax authority as to whether there is likely to be transfer pricing risk.

Paragraph 9.46

38. We welcome the recognition that arm's length responses will depend on both the economic and commercial environment and the relative position of the parties transacting, and, in particular, we welcome the following language –

> *"in evaluating profit potential, it is necessary to evaluate whether historic profits ..[.].. are an indicator of future profit potential, or whether there have been changes in the business environment around the time of the restructuring that mean that past performance is not an indicator of profit potential. For example, competing products could have the effect of eroding profitability, and new technology or consumer preferences could render the products less attractive. The consideration of these factors from perspective of the distributor can be illustrated with the following example."*

Paragraph 9.65

39. The additions to this paragraph are rather confusing and, in particular, the reference to "legal ownership" of local marketing intangibles seems to be at odds to the broader changes to the TPG. Per the OECD's "something of value" approach to defining what is an intangible asset, it may well not be possible to transfer legal ownership of IP, as in fact, the "something of value" may not be capable of being legally owned or recognised for accounting purposes. This language confuses and further complicates the application of this part the guidance. BIAC recommends that this paragraph is reformulated to clarify that it applies where a local entity has developed local intangibles, but that the reference to legal ownership is clarified or removed to improve consistency.

[3] For example, synergies that were anticipated or cost savings that were expected to arise by some decision makers sometimes do not, when implemented, achieve their objectives. There may be overwhelming market pressure to reduce employees (internal "headcount") in a high-wage jurisdiction. The work will still have to be done, and may therefore be outsourced at greater cost (and/or less efficiency) than that incurred by the former employees.

Paragraph 9.84

40. We were pleased to see the new language in this paragraph, which illustrates again the limitations of the options realistically available comparatives –

> *"as in some situations, it may be the case that, in comparable circumstances, an independent party would not have had any option realistically available that would be clearly more attractive to it than to accept the conditions of the termination or substantial renegotiation of the contract. The guidance in Section D of Chapter I, as well as the Guidance in Section B of this Part, are applicable."*

Paragraphs 9.122- 9.124

41. These paragraphs outline an example where valuable intangibles are transferred to a shell company. In the current guidelines there is also an example (paragraph 9.193 Example C) where there is a transfer of an intangible for a tax purpose; in the example, this transfer is recognised, demonstrating the deleted sentence from paragraph 9.182[4]. BIAC believes that this example is useful and should be retained in the updated guidelines.

42. The deletion of this example creates uncertainty regarding the legitimacy of transactions which are rational on a post-tax rather than pre-tax basis and the example should, therefore, be retained for several reasons:

    a. Not recognising the transaction contradicts the principle that the result should not be different whether the transaction was originally structured in a particular way (which would clearly be respected) compared to if the parties restructure into it.

    b. The TPG should be applied to the restructuring, and then the post-restructuring transactions. If this is applied appropriately then there should be no basis for a country to continue to tax income arising from activities that are undertaken in a different country.

    c. We believe that if the tax benefits do not arise from a regime that is deemed a "harmful tax practice" (which has been addressed through BEPS Action 5 and the work of the Forum on Harmful Tax Practices), companies should be able to take advantage of them when dealing with third parties or related parties.

43. A changing of position of the legitimacy of transactions that make commercial sense on a post-tax basis would go beyond a conforming change to these guidelines and should not be included without due consideration, including an appropriate public consultation process.

[4] In the example the trademarks are transferred together with the head office personnel that can make the strategic decisions and control the risks, therefore the new company has the financial capacity to bear the risks. The main reason for the group to enter into the restructuring is to benefit from a favorable tax regime. The conclusion is that the substance and the form go together and independent parties in comparable circumstances acting in a commercially rational manner would have done the same.