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Final report on BEPS Actions 8-10: Guidance for applying the arm's length principle (including risk and recharacterization)

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On October 5, 2015, ahead of the G20 Finance Ministers' meeting in Lima on October 8, the Organisation for Economic Co-operation and Development (OECD) Secretariat **published** thirteen papers and an Explanatory Statement outlining consensus Actions under the base erosion and profit shifting (BEPS) project. The output is intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the OECD Model Treaty and transfer pricing guidelines. They are broadly classified as "minimum standard", "best practices" or "recommendations" for governments to adopt. The OECD will be continuing its work on some specific follow-up areas in future years.

As part of the 2015 output, revisions to Chapter I of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Guidelines) were contained in the 186-page final report *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10* (Actions 8-10 Report). This includes updated and expanded guidance to take account of the need to delineate and price the actual transaction undertaken, consider the appropriate allocation of risk, address circumstances where there is the provision of capital without functionality, and define exceptional circumstances where recharacterization may apply. It also includes the earlier guidance on location savings, assembled workforce and group synergies.

Determining intra-group transactions, including in relation to risks

Delineation of the actual transaction undertaken between associated parties is a key addition to the Guidelines contained in the Actions 8-10 Report. For this to be achieved, it will be important to identify the commercial or financial relations between associated parties and the economically relevant characteristics attaching to those relations. The guidance also emphasises that contractual arrangements form the starting point of the transfer pricing analysis. However, it is the conduct of the parties that will be determinative in interpreting the contracts for pricing purposes. This is consistent with the G20/OECD's work in relation to the transfer pricing of intangibles.

Risk for transfer pricing purposes is defined as the "effect of uncertainty on the objectives of the business". Identifying risks is a critical part of a transfer pricing

analysis, along with identifying functions performed and assets used. The Guidelines in the Actions 8-10 Report set out an analytical framework to apply to risk:

1. Identify economically significant risks with specificity;
2. Identify contractual assumption of the specific risk;
3. Perform functional analysis identifying risks and other facts, including conduct of the parties, control functions and risk mitigation functions, and financial capacity to bear risks;
4. Determine:
   (i) whether the contractual assumption of risk is consistent with the conduct; and
   (ii) whether the party assuming the risk is exercising control over the risk and has the financial capacity to assume the risk;
5. If the party assuming the risk does not control the risk or does not have the financial capacity to assume the risk, allocate the risk to the group company having the most control and having the financial capacity to assume the risk; and
6. Take account of all facts, including the analysis of risk in the determination of pricing.

While the contractual assumption of risk is the starting point, the agreement must have been made in advance of the risk outcomes being known (i.e., *ex ante*). A party is required to have both capability (competence) and functional performance (decision-making) in order to exercise control over a risk. Control includes the taking on, laying off or otherwise responding to a risk. Risk mitigation and preparatory work relating to the decision-making may be outsourced. Where such outsourcing takes place, the company controlling the risk should set objectives for the outsourced activity, assess whether the objectives are met, and hire (and terminate the arrangements with) the service provider. Merely formalizing decisions that were made in other locations in, for example, board meetings where documents relating to the decision are signed, does not qualify as exercising a decision-making function sufficient to demonstrate control over risk. Furthermore, setting the policy environment relevant to a particular risk also does not sufficiently demonstrate control over a risk.

Financial capacity to assume a risk is included as a criterion that ranks equally with control when analyzing the assumption of risk. The test of “financial capacity to bear risk” looks at access to funding (assuming the company is independent) to take on or lay off risk, to pay for risk mitigation functions and to bear the consequences of risk if the risk materializes.

Where a party does not assume a risk, or contribute to the control of the risk, it will not be entitled to any unanticipated profits or be required to bear unanticipated losses arising from that risk.

Funding activities without associated functionality (cash boxes)

The guidance addresses the situation where a capital-rich member of the group provides funding but performs little or no activities (cash boxes). If a cash box is not exercising control over the financial risk that is associated with its funding (for example, because it simply provides money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then the risk is allocated to the group entity that is performing the control functions and that has the financial capacity to assume the risk. The funding entity will be entitled to no more

than a risk-free return (or less if the transaction is not commercially rational and non-recognition applies - see below). Other BEPS measures may affect cash boxes, such as interest deductions, controlled foreign company rules and the minimum standard on treaty abuse, as well as domestic anti-abuse rules.

Recognition of the accurately delineated transaction

The guidance notes that "every effort" should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction. Only in exceptional circumstances should tax authorities disregard the actual transaction ("non-recognition", previously termed "recharacterization") and/or substitute another transaction. Just because a transaction may not be seen between third parties does not mean that it should not be recognized.

The rules for non-recognition of an actual transaction (including new examples) are based on the concept of commercial rationality and assessment of the perspectives of and options realistically available to each party at the time of entering into the transaction. A transaction may be disregarded if it differs from those which would have been adopted by companies behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both parties. If the actual transaction is disregarded and a new one substituted for transfer pricing purposes, the new transaction should comport as closely as possible to the actual one while achieving a commercially rational result.

Location savings and other local market features

The guidance recognizes that features of the geographic market in which business operate can affect comparability and arm's length prices. Cost savings attributable to operating in a particular market (i.e., location savings) and other local market advantages or disadvantages should be taken into account in relation to comparability analyses. These include:

- location savings and other local market features – including when such savings exist and the amount and allocation of those savings;
- assembled workforce – where a business assembles a uniquely qualified or experienced group of employees which results in benefits; and
- group synergies – the benefits from group synergies (such as volume purchasing discounts) are to be allocated to the entities that contributed to those benefits.

OECD/G20 next steps

It is expected that the G20 leaders will give final approval to the papers in November 2015. While a new consolidated set of the Guidelines will take time to be formally published following approvals and ongoing work, the OECD's intent as per the Explanatory Statement that accompanied the final reports released October 5, 2015 is that the revisions to Guidelines are immediately applicable, even if other BEPS-related changes will require implementation via tax treaties or changes to domestic taxation laws.

As part of the 2015 output, the OECD Secretariat issued a short summary of the status of the ongoing work on the use of profit splits, in advance of additional guidance to be included in the Guidelines. A discussion draft on profit splits is expected to be released for public comments in advance of a public consultation to be held in May 2016. The guidance is expected to be finalized by June 30, 2017.

Deloitte's comments

The work on risk and non-recognition has focused on clarifying and refining proposals that received broad agreement in consultations (such as delineating the actual transaction undertaken), removing some impractical and challenging concepts (such as "moral hazard" and "special measures") and identifying areas where further guidance and examples would be useful. A number of additional clarifications have been made, such as clarifying how the "commercial rationality" test for recognition of transactions undertaken will work in practice and making clear that the financial capacity to bear risk is as important as exercising control over risk in a transfer pricing context.

The challenge for businesses will be in ensuring that risks are identified and analyzed in accordance with the framework set out, which is likely to be a considerable compliance exercise. The guidance is not industry-specific, and applies equally to insurance, banking and other financial services sectors. A footnote recognizes that the regulatory approach to risks for financial services businesses should be taken into account and reference made to the existing guidance for financial services businesses in the OECD's *Report on the Attribution of Profits to Permanent Establishments*.

The OECD has sought to address the issue of cash boxes in a number of ways designed to change behaviour. This includes commentary that funding provided by functionally-light entities that do not have the capability and functional performance to control risk should receive only a risk-free return for the capital provided.

It seems unlikely that there will be a new consolidated set of the Guidelines before 2017. Adoption of new guidance into domestic transfer pricing rules is likely to be piecemeal, depending on how each country's rules interact with OECD guidance. In Canada, the new consolidated guidelines are expected to be adopted swiftly when available. In many areas, the new guidance is seen as a "better explanation" of the operation of the basic arm's length principle and, as such, may not require law or treaty changes to become effective. There is evidence of the new guidance already being applied by tax authorities to open transfer pricing cases; this can be problematic, given the different guidance that existed at the time of the transactions and pricing analysis. Best practice for businesses is to take account of the revised guidance as soon as possible.

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