Deloitte.

The new transfer pricing landscape
A practical guide to the BEPS changes

Global Transfer Pricing
November 2015
<table>
<thead>
<tr>
<th>Contents</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Accurate delineation of the transaction and risk</td>
<td>2</td>
</tr>
<tr>
<td>Location-specific advantages</td>
<td>7</td>
</tr>
<tr>
<td>Passive association</td>
<td>11</td>
</tr>
<tr>
<td>Intangibles</td>
<td>17</td>
</tr>
<tr>
<td>Hard-to-value intangibles</td>
<td>22</td>
</tr>
<tr>
<td>Low value-adding intragroup services</td>
<td>25</td>
</tr>
<tr>
<td>Cost contribution arrangements</td>
<td>28</td>
</tr>
<tr>
<td>Transfer pricing documentation and country-by-country reporting</td>
<td>32</td>
</tr>
<tr>
<td>Dispute resolution mechanisms</td>
<td>37</td>
</tr>
</tbody>
</table>
Introduction

The Organization for Economic Cooperation and Development (OECD) on October 5, 2015, released the final reports under the Base Erosion and Profit Shifting (BEPS) project it started two years ago to address perceived gaps in the international tax and transfer pricing rules. The final reports were submitted to the G-20 finance ministers at their meeting in Lima, Peru, on October 8. The ministers endorsed the package of recommendations, which will be presented to and are expected to be endorsed by the G20 heads of state during their summit on November 15-16 in Antalya, Turkey.

The 186-page final transfer pricing report, which covers Actions 8-10, and the 70-page documentation and country-by-country reporting report provide guidance on a multitude of transfer pricing topics, including risk, intangibles, the role of contracts, and funding, and the new country-by-country reporting requirements. The final reports (“new guidance”) represent proposals to amend the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The OECD has not announced when it expects to formally adopt the recommended changes, but it is expected to occur soon.

The new guidance has been hailed as a game changer intended to alter the transfer pricing outcomes in many situations and to require multinational enterprises to undertake additional analysis and documentation. But how will the new guidance impact your company? In this book, the transfer pricing professionals of Deloitte have attempted to provide practical considerations in answer to that question. The nine articles in this collection each address a specific transfer pricing issue, providing an overview of the changes wrought by the new guidance and practical recommendations for taxpayers who will find themselves navigating the new transfer pricing environment. The articles are presented in the same order as the topics they address appear in the final reports.

The new global transfer pricing landscape is fraught with uncertainty and complexity. To engage in further discussion about your particular concerns, please contact the authors of these articles or your local Deloitte transfer pricing professional.

Todd Wolosoff
Global Transfer Pricing Leader

Shaun Austin
EMEA Transfer Pricing Leader

Arindam Mitra
Asia Pacific Transfer Pricing Leader

John M. Wells
US Transfer Pricing Leader
The changes to Chapter I of the Transfer Pricing Guidelines provide a revised interpretation of the arm’s length principle predicated on an expanded view and analysis of the economic substance of a controlled transaction. The expanded analysis required to determine whether a controlled transaction has economic substance involves a significantly more granular functional and risk analysis, referred to as “accurately delineating the actual transaction.”

Under the new guidance, a contractual allocation of risk (and associated expected return) will be respected if and only if each party contractually allocated a risk is considered, through the accurate delineation analysis, to control their allocated risk and to have the financial capacity to bear the risk. The analysis of risks and of the functional control of risks thus becomes a pivotal element of the expanded functional analysis required under the new guidance. From a practical standpoint, taxpayers will have to separately identify the various risks involved in their controlled transactions and analyze and document, for each of them, the party actually making the decisions to take on, lay off, and mitigate the risks.

Financing risks are specifically called out in the new guidance as being separate and distinct from operational risks. The mere fact that a legal entity exercises control of a funding risk does not entitle that entity to the returns associated with operational risks, unless it Exercises control of those operational risks as well.

**Accurate delineation of transactions**

The changes to Chapter I establish the concept of “accurate delineation of a transaction,” which extrapolates the importance of determining the actual transaction introduced in the changes to Chapter VI on intangibles. At first glance, the concept is simple: the accurate delineation of a transaction is about assessing how the actual behavior of the parties to a transaction stacks up against what is provided in the written contract. Through the process of accurate delineation, the transfer pricing exercise focuses on pricing the “the real deal,” as opposed to pricing a written contract that may not reflect the true contributions of the parties to value creation.

One particularly important element of the new guidance is the specific requirement that funding risk be distinguished from operational risk. In that context, control of funding risk is about the competent ability to assess an investment opportunity as a provider of financial capital, and about the authority to make such investment decision and direct mitigation of funding risk strategies. Funding risk receives no more than a risk-adjusted financial return, not the residual income from taking operational risk. In contrast, control of operational risk is about the competent ability to assess the implications of various operational decisions on the results of the business, and about the authority to make operational decisions and direct mitigation of operational risk strategies. Operational risks receive residual income. The result under the new guidance is the opposite of the results in many situations in which the operations were tested under the transactional net margin method/comparable profits method and the residual return was allocated to the entity providing funding.

A chief financial officer sitting on the board of a controlled foreign corporation (CFC) may, depending on the facts, be competent at assessing the funding opportunity of a development project, but would generally not be competent at assessing whether a specific third-party laboratory should be retained to perform a spectral analysis of various pieces of experimental data generated by a particular development workstream at a particular junction of the development project. The exercise of control of funding risk results in no more than a risk-adjusted financial return. If the legal entity providing the financial capital is not considered to be managing and controlling the funding risks, the returns associated with funding will be limited to a risk-free rate of return.

A deeper examination of the concept of accurate delineation reveals the challenges taxpayers will face when applying it to a complex fragmented MNE when control of activities in connection with some of the key risks that drive the return do not clearly reside within a single legal entity. For example, if sourcing is a key value driver in an MNE, and the control of sourcing functions are performed by two senior executives residing in different legal entities, the returns to the control function will be allocated to the entity with “the most control.” How this is to be assessed in the
context of a complex multidimensional enterprise will likely be open to considerable debate, and may have to wait for the issuance of the G20/OECD’s guidance on profit splits, which has been deferred until 2016/2017.

Because of the level of granularity required by the new guidance in identifying all the specific risks affecting the MNE, in many situations multiple legal entities will share a portion of the consolidated returns commensurate with the level of risks they each assume. Taxpayers will have to manage the valuation challenges resulting from that approach.

To summarize, the new guidance prohibits the provider of financial capital to be the claimant to the residual income unless it also manages and controls the operational risks. When the provider of financial capital and the entity managing and controlling the operational and financial risks are one and the same, no adjustment is necessary. However, when that is not the case, the new guidance requires identifying who in fact (i) has access to or provides financial capital, (ii) performs operations, and (iii) manages and controls the risks of those activities. When more than one entity controls the risks that drive the returns, each may be entitled to a share of the income, depending on their respective contributions to value creation.

The process provided in the new guidance to accurately delineate the transaction is a five-step process outlined below. For each transaction, the process involves reviews of:

- The contractual terms of the transactions
- The functions, assets, and risks of each participant, including an assessment of how these relate to the wider generation of value within the MNE
- The characteristics of the property transferred or services provided
- The economic circumstances of the parties and of the market in which the parties operate
- The business strategies pursued by the parties.

The information generated by this delineation is expected to be documented, for each covered transaction, in the local file. The extent of the information and analysis required by the new guidance is so much greater and involved than before, it may result in an increase in the costs of compliance for many taxpayers.

For highly fragmented MNEs considering how to react to this new environment, the specific location of central service providers in the global MNE footprint may need to be reconsidered in light of how tax administrations in that jurisdiction adopt and implement the new guidance. For example, a consolidation of functions within fewer legal entities may be one way MNEs respond to the new environment.

The role of risk

The main goal of the new guidance is to introduce a process that provides tax administrations with a powerful two-pronged tool to disregard the contractually agreed risk-return allocation between the parties, even if their actual behavior is consistent with the letter of the contract (such as, for example, where the contract does not reflect an arm’s length allocation of risk). Consider the second factor that must be identified in the process of accurate delineation of a transaction presented in the previous section. The new guidance provides a six-step process to effectuate the analysis of risk under that factor. That six-step process articulates the two-pronged control and financial capacity test under step 2.3 below. The six-step risk process is:

- Step 1: Identify economically significant risks with specificity;
- Step 2: Determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction;
- Step 3: Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform control and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk;
- Step 4: Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analyzing (i) whether the associated enterprises follow the contractual terms; and (ii) whether the party assuming risk, as analyzed under (i) exercises control over the risk and has the financial capacity to assume the risk;
- Step 5: When the party assuming risk under steps 1-4(ii) does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk; and
- Step 6: The actual transaction, as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.

Because risk is such a central element around which contractual deference revolves, the new guidance provides taxpayers and tax administrations with a definition of risk for transfer pricing purposes; risk is defined as the effect of uncertainty on the objectives of the business.

To prevent a tax administration from rewriting a contract and reallocating risk, a taxpayer will have to demonstrate that two features are present for each specific risk when an entity claims an associated return (both upside and downside):

- The entity has the financial capacity to assume each specific risk: defined as access to funding to take on the risk or to lay off the risk, to pay for the risk-mitigating functions, and to bear the consequences of the risk if the risk materializes.
The entity controls each specific risk: defined as having the capability to perform, and actually performing decision-making to (i) take on or lay off the risk; and (ii) respond to the risk, including risk mitigation. The risk mitigation function can be outsourced, but when this occurs, control requires the capability to determine the objectives of the outsourced activities, and the capability to hire, assess, adjust, and terminate the provider of the outsourced activities. In essence, control of risk requires both the capability and the performance of that capability.

Because this two-pronged test was specifically designed to target low-functionality entities capitalized with intragroup funding, in the context of an entity committed to funding an intangible development project through a research and development (R&D) services arrangement, the guidance requires identifying and analyzing separately the risk of funding the development activity from all other operational risks, including the R&D services arrangement. For each of those risks, an analysis of financial capacity and of control of the risk is required. If the funding entity is considered to have the financial capacity to fund the development activity and is deemed to exercise control of that funding risk, it will still not be entitled to more than a risk-adjusted return unless it is also deemed to have the financial capacity to fund and control operational risks.

For funding entities that fail either of the two requirements, each risk it is contractually allocated will be reallocated by the tax administration to the party deemed to have the financial capacity and to have control of the risk. The funding entity will receive no more than a risk-free rate of return on its funding.

The assessment of financial capacity to bear risk should be made by reference to the funding entity’s ability to access the capital market and obtain third-party funding as a stand-alone entity, if needed to cover the required expenses, should the risk materialize. Just looking at the balance sheet of the funding entity is therefore necessary but not sufficient.

To satisfy the control requirement, decision-makers must be competent in the area of risk for which the decision is being made, and perform the decision-making functions in the location of the entity claiming entitlement to the profit. A mere formalizing of decisions made outside that location, including but not limited to keeping minutes of a board meeting or to signing documents executing the decisions, is specifically called out as insufficient to demonstrate decision-making. Similarly, setting the policy environment relevant for the risk is insufficient to establish decision-making.

The G20/OECD and other countries involved in the BEPS project went through an internal debate on the legitimacy of the risk/expected return trade-off, which has been upheld in the guidance. However, the guidance does not contain a clear definition of the risk-adjusted return. Is it a debt return? Is it a weighted average cost of capital return? The absence of further guidance as to how to determine the risk-adjusted return may increase the likelihood of protracted controversy.

Example
The new guidance contains a few examples to help taxpayers understand the important considerations in assessing their structures’ compliance with the new guidance. In Example 1, Company A decides to pursue a development activity and engages Company B to perform the actual development functions on its behalf. The arrangement between the two companies depicts a typical contract R&D arrangement many multinational companies have and are familiar with.

The discussion of the example focuses on the applications of steps 1-3 listed above. Under step one—identifying the risk—development is identified as an economically significant risk in the transaction. Under step two—contractual allocation of risk—it is determined that the contract allocates the development risk to Company A.

Step three—identifying the entity controlling the risks and who has the financial capacity—is the critical step that determines whether or not the contractual risk-return allocation is respected. In this particular example,

“Company A controls its development risk through exercising its capability and authority in making a number of relevant decisions about whether and how to take on the development risk. These include the decision to perform part of the development work itself, the decision to seek specialist input, the decision to hire the particular researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to Company B. Company A has mitigated its risk by taking measures to outsource development activities to Company B which assumes the day-to-day responsibility for carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides whether continuing investments in the project are warranted in the light of that assessment.”

Company A has the financial capacity to assume the risk. Company B has no capability to evaluate the development risk and does not make decisions about Company A’s activities. Company B’s risk is mainly to ensure it performs the research activities competently and that it exercises its capability and authority in control that risk by making decisions about the processes, expertise, and assets it needs. The risk Company B assumes is distinct from the development risk assumed by Company A under the contract, which is controlled by Company A based on the evidence of the functional analysis.

This example illustrates some of the specific factors that a company would need to take into consideration in determining control. These factors will need to be discussed in the local file. Consider this statement:

“Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides…”
This statement is the result of evidence demonstrating that Company B regularly reports to Company A, and that more than a paper trail exists showing that the information contained in the paper trail is actually processed by Company A. Similarly, the statement that Company A assesses the progress of the development is the result of evidence demonstrating that Company A, after processing the information provided by Company B, provides actionable feedback to Company B. Notice that the activities of Company A suggested above need to be carried out in location, not merely formalized in location.

Practical implications
The new guidance is written broadly and applies to all related-party transactions. Thus, taxpayers should recognize that the new guidance is transactional, and not based on an analysis of the overall functionalities of any given legal entities. Specifically, a company may be deemed to exercise control of a risk in a transaction with an affiliate, but not in the same or similar transaction with another affiliate. Determining the allocation of returns within an MNE thus requires an application of the six-step risk process to determine the entity entitled to risk-related returns on a transaction-by-transaction basis. The accurate delineation of the material transactions, including the allocation of risk, is required to be documented in the local files.

Although some of the focus of the new Chapter I guidance relates to intangibles, it applies to more than just intellectual property transactions. Any transaction that involves an expectation of non-routine returns requires one or more claimants to the residual income that is above and beyond the sum of the routine returns. The new guidance provides the analytical framework taxpayers and tax administrations would use to determine which affiliates, at arm’s length, would be entitled to what portion of that residual.

In existing arrangements governed by the 2010 Transfer Pricing Guidelines, an analysis may result in a reallocation of the party bearing risk and resulting returns. Given the complexity of the new guidance, and the extent of the information required to perform the analyses, sufficient lead time should be allowed for a thorough analysis of the facts and the adoption of required adjustments, including the updating of contracts. For companies with highly complex arrangements this process could be time consuming.

Conclusion
The new rules on delineation of the transaction and the allocation of risk provide important new guidance on the application of the arm’s length standard that will have a far-reaching impact on many MNEs. MNEs with capital-rich, low-functioning entities may find the returns to those entities substantially reduced. However, the new guidance is not limited to those situations. MNEs engaged in activities that command more than a routine return in the market place that relied on TNMM/CPM to allocate non-routine returns may find that the new guidance allocates non-routine returns to different entities.
Philippe Penelle is a principal with the Washington National Tax office of Deloitte Tax LLP, specializing in designing, valuing, and defending transactions that involve the transfer of intellectual property rights.

Aengus Barry is a director in Deloitte UK’s London office. He has 13 years of experience and specializes in risk pricing and energy pricing.

Alan Shapiro is a senior advisor to Deloitte Tohmatsu Tax Co. He works with the organization’s largest multinational companies to develop and implement transfer pricing strategies. For over 25 years he has specialized in the full range of transfer pricing issues.

Fiona Craig is a partner in the Sydney office of Deloitte Australia and the leader of Deloitte’s Australian Transfer Pricing practice.
Location-specific advantages or LSAs are those location-specific market features and/or factors of production that enable a firm to achieve an improved financial outcome from the provision of the same product or service relative to alternative locations. The concept may include access to skilled labor, incentives, market premium, access to growing markets, superior infrastructure, and cost savings. The new guidelines focus on two types of LSAs:

- **Location savings**: These arise from cost savings due to differences in the cost of operations (arising from lower labor costs, real estate costs, etc.) between high-cost and low-cost jurisdictions.

- **Other local market features**: These are attributes of local markets (such as purchasing power and product preferences of households in the market, growth rate of the economy adding to increased demand for the products, and degree of competition in the market) that may allow a company to obtain a price premium for its products and/or gain access and proximity to growing local and regional markets, allowing it to gain a competitive advantage through scale economies in sale or production.

These factors account for the fact that the demand and production parameters in some countries can be significantly different than those in other countries. These differences may allow a multinational enterprise (MNE) to take advantage of better cost/demand conditions to remain competitive or edge out potential competitors.

The guidelines do not provide a formal definition of LSAs. However, they provide guidance on the concept of location savings and refer to other local market features that are synonymous with the concept of LSAs. The guidelines indicate that the location savings principles apply generally to all situations in which location savings are present, not just to business restructurings, as in the prior guidance. In addition to location savings, the guidelines expanded the discussion to other local market features, such as market advantages and disadvantages that may affect the prices and margins realized in the local market. The examples in the guidance include the purchasing power and product preferences of households, market expansion or contraction, and the degree of competition.

This article addresses some key issues in the guidance related to LSAs and compares it to the positions adopted by China and India.

### Transfer pricing issues related to LSAs

#### Are LSAs intangibles?

The OECD initially acknowledged and addressed the issue of location savings in Chapter IX of the Transfer Pricing Guidelines, which discusses transfer pricing issues associated with business restructurings:

> The allocation of significant location savings [should] normally depend on the functions, assets and risks of each party and on their respective bargaining powers. ([Chapter IX, Business Restructurings, paragraph 9.149](#))

In the new guidance in Chapter I, the OECD refers to the discussion in Chapter IX as the principles generally applicable to all situations related to location savings. It is clear from the various discussions on LSAs, as well as the definition of intangibles for transfer pricing, that the guidance does not consider LSAs to be intangibles, because LSAs are market features the MNEs would neither be capable of owning nor controlling, but merely be able to use. The guidelines properly distinguish between features of the local market, which are not intangibles, and any contractual rights, government licenses, or know-how necessary to exploit that market, which may be intangibles. It is only in such instances that LSAs can be exploited through a process of obtaining a complementary and scarce “right” that may give rise to additional value associated with LSAs.

The mere presence of a form of LSA in a market may not be economically valuable to the MNE, because such features may be commonly available to all other market participants who can benefit from them without incurring any additional costs, thereby driving the economic value of such LSAs to zero.
Income attributable to LSAs

The starting point of any transfer pricing analysis involving LSAs should be their identification. It is important to note that the mere perception that LSAs exist within an MNE can often be unfounded, particularly because MNEs’ decision to locate their manufacturing or service operations in a given location can be driven by competitive pressure from the markets that require them to lower costs simply to remain in business. Clearly, in such instances, all or a portion of any location savings are passed on to the end customers of these companies. This is consistent with the guidelines, which recommend that any allocation of location savings associated with LSAs can be determined only after ascertaining “the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers.”

The guidelines state that the measurement of location savings should take into account both benefits and costs associated with local market features, and that only the “net” savings are relevant for purposes of transfer pricing analyses. In the context of location savings, benefits from a location may be offset by economic costs that result in dis-savings. These dis-savings may take the form of higher transportation costs, higher warranty costs, higher cost of capital, economic costs of managing an operation in a remote location, and higher indirect costs of doing business. It is possible that part of the cost savings may be offset at times by dis-savings on account of poor infrastructure in relation to the quality and reliability of the power supply, higher costs for transportation, quality control, etc. Accordingly, only the net location savings (savings minus dis-savings) may give rise to an extra profit to an MNE due to the relocation of its business from a high-cost to a low-cost jurisdiction.

The guidelines further state that “suitable comparability adjustments be made to account for LSAs” giving rise to location savings within the MNEs, when reliable adjustments to improve comparability can be identified.

The key question that arises in this context is whether suitable local comparables can be identified that can reliably allocate the location savings to the two (or more) entities of the MNE group. Technically, from a transfer pricing perspective, LSAs, if any, would depend on the functions, assets, and risks of each party and on their respective bargaining powers. In a perfectly competitive market, given competition and pricing pressures, the concerned party will pass any additional benefits on to the customers to remain competitive. Accordingly, it would not be able to earn more than what third-party comparables—in the same geography, performing similar functions, and assuming similar risk—would earn. Therefore, any LSAs that the specific geography has to offer (if any) are equally available to all local comparables. At arm’s length, an entity cannot expect to be compensated more than what other comparables in the market would earn. Thus, the above clearly provides a logical view that the return to LSAs, if any, is already embedded in the profit margins of comparable companies.

While this view is generally accepted, such a premise would apply only if there are reliable comparables, and market forces exist to demonstrate price equilibrium in a given setting. If the market is not perfectly competitive or market imperfections give rise to monopolistic power, comparability itself breaks down and it can be concluded that comparable margins may not be a sufficient comparison.

When location savings exist and suitable comparables cannot be found, the question emerges as to how to split the savings, but the guidance does not provide any answers.

Assuming that LSAs give rise to net positive location savings, the guidelines recommend that a thorough functional analysis describe the facts and circumstances surrounding an LSA, clearly identifying:

- Whether LSAs exist;
- Amount of any net LSAs;
- Extent to which LSAs are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and
- When LSAs are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

Economic tools such as the use of a Shapley Value-based approach also provide an indication of how location savings may be split in the absence of suitable comparables. The Shapley Value concept describes an approach to the fair allocation of gains obtained among several members based on an analytical construct. The setup is as follows: a group of companies cooperates and obtains a certain overall gain from that cooperation.
Because some members may contribute more to the group than others, the question arises how to fairly distribute the gains among the members. Or phrased differently: how important is each member to the overall operation, and what payoff can they reasonably expect? Under this approach, the share of joint output of a group attributable to any single member depends on that member’s contribution to the group that preceded it (that is, not the value the new member thinks it should get based on its efforts).

**View from China and India**

While the concepts of LSAs and particularly location savings are slowly gaining ground in developing countries around the world, it is primarily in India and China where these concepts have been adopted by the tax authorities, both in law and in audits.

**China**

In 2012, China’s State Administration of Taxation (SAT) announced its position on transfer pricing practices in China with the release of a chapter on “China Country Practices” in the UN Transfer Pricing Manual. Location savings, according to this chapter, are “the net cost savings derived by a multinational company when it sets up its operations in a low cost jurisdiction.” Market premium “relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.”

In the China chapter of the UN Manual, the SAT provides a specific example regarding the automotive industry, listing LSAs such as the “market-for-technology” industry policy, the local customer’s preference and demand, the duty saving, the local supply capacity constraints, and the low-cost suppliers.

The SAT on September 17, 2015, released a discussion draft of the revised Special Tax Adjustment Implementation Rules. The discussion draft proposed for the first time to include the concept of LSAs in Chinese transfer pricing rules. The draft also requires Chinese taxpayers to consider local economic factors in determining transfer pricing methods and comparability when selecting comparable companies, as well as to take LSAs into account in determining the presence of intangibles and their value. The SAT is expected to release the final rules by the end of 2015.

The SAT generally has taken the view that suitable comparables do not exist in the Chinese market. The tax authorities agree that valuing and allocating LSAs is a challenge in the absence of suitable comparable companies. Therefore, they tend to take a practical approach in terms of understanding the taxpayer’s value chain, and analyzing the contribution factors of the China entity, including LSAs, to determine whether the local entity is properly compensated.

In many cases, to address the measurement of economic contribution resulting from LSAs, the SAT applies mathematic methods to quantify the LSAs. For example, • For a contract R&D study (as presented in the China Country Practices chapter of the UN Manual), the SAT compares the Chinese taxpayer’s cost base with the parent company’s cost base in the developed country. The SAT then adjusts the full cost mark-up by reference to the cost base difference to calculate the additional profit attributable to China for location savings.

• In another case, the SAT compares the Chinese taxpayer’s selling expense per unit of revenue with that of the overseas parent company, which shows that to fulfill the same unit of revenue the Chinese taxpayer incurs a lower level of selling expense. The expense level gap is viewed as the evidence of LSA in China market, which should be compensated through a residual profit split together with other factors like manufacturing and marketing intangibles.

The SAT has also applied other mathematical methods in other cases.

**India**

Indian regulations do not provide any specific guidance on location savings and or LSAs/local market characteristics. However, in the absence of specific regulations, the Indian tax authorities have relied on international guidance in applying the concept of location savings.

In recent audits, Indian tax authorities have made several transfer pricing adjustments wherein they have held that because of MNE’s easy access to factors of production such as low-cost skilled manpower, raw materials, and infrastructure, they enjoy substantial cost savings in India. The Indian tax authorities’ view is that the economic benefit arising from the shifting of operations from a high-cost jurisdiction to a low-cost jurisdiction such as India should accrue to the country where such operations are actually carried out. The Indian tax authorities do not accept taxpayers’ assertions that location savings, if any, are embedded in the local comparables’ margins. Accordingly, the Indian tax authorities take the position that comparability is not sufficient. Therefore, benchmarking using local comparables does not take into account the benefit of location savings, which in some cases has been computed by taking into account the cost difference between costs in the low-cost country and in the high-cost country. Thus, the arm’s length compensation for cost and location savings should be such that both parties would benefit from participating in the transaction. Moreover, it should also reflect an appropriate split of the cost savings between the parties, which in some cases has been split one-half to each party.

The Indian tax administration’s view is contrary to the guidelines and to several court decisions in India that ruled that no separate compensation for location savings/LSAs is required if there are local comparables. In a landmark ruling by the Mumbai Income Tax Appellate Tribunal in the case of *Watson Pharma Pvt. Ltd.*, the court examined the factors in this case—a perfectly competitive business environment, the parties’ bargaining power, the options realistically available to both parties, and the absence of above-normal profit in the value chain—and held that when the operating margin earned by a taxpayer is based on local market comparables operating in similar economic circumstances as the taxpayer,
no further return on account of location savings is required. The ruling is similar to that in the case of GAP International Sourcing (India) Pvt. Ltd. The decision in Watson is also in line with the views expressed in the Rangachary Committee report on safe harbor rules. In another court decision, the Li Fung case, the Delhi High Court denied an adjustment on the ground that the Indian tax administration failed to demonstrate the extent to which the related party benefitted from locational advantages before arbitrarily rejecting the taxpayer’s economic analysis.

Similar views have been adopted in other recent judicial pronouncements. These rulings clearly reflect the maturing attitude of the Indian courts’ transfer pricing position on this matter, in line with international standards.

Conclusion

The concepts of LSAs/local market characteristics and location savings are becoming increasingly important in developing countries. The BEPS guidelines for the first time have created an agreed upon framework to analyze the existence and allocation of LSA. According to the guidelines, LSAs are not intangibles but primarily a comparability adjustment issue. The key question going forward is whether the comparables in the local market are suitable for the proper allocation of location savings. The tax authorities in some countries, in particular those in China and India, have taken the position that suitable comparables do not exist. The BEPS guidelines do not provide guidance in that situation, which leaves MNEs and tax authorities to determine an acceptable approach to allocating location savings.

About the authors

Anis Chakravarty
Mumbai
anchakravarty@deloitte.com

Anis Chakravarty is a partner and lead economist with Deloitte’s transfer pricing practice in India. He brings significant experience in advising companies in the European Union, India, and the United States on a number of issues related to economics, finance, and transfer pricing.

Shanto Ghosh
Boston
shghosh@deloitte.com

Dr. Shanto Ghosh is a principal in Deloitte Tax LLP’s transfer pricing practice based in Boston. He has over 16 years of transfer pricing experience and leads Deloitte’s transfer pricing team in the Greater Boston area.

Eunice Kuo
Shanghai
eunicekuo@deloitte.com.cn

Eunice Kuo is a tax partner with Deloitte China, and the national leader for transfer pricing services in charge of transfer pricing, business model optimization, and tax structuring services.
Passive association

It sometimes takes only subtle changes in tax law or guidance to cause significant practical consequences for taxpayers. The OECD’s view on how the arm’s length principle applies to estimating the creditworthiness of affiliates, to be set out in just a few additional paragraphs in Chapter I of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, has not necessarily been a headline issue for the OECD BEPS project. However, given the vast flows of debt funding within multinational groups, along with the common use of parental guarantees to allow subsidiaries to access local debt markets, any changes may have significant potential ramifications. It may also create many practical interpretation challenges for multinational enterprises (MNEs). This uncertainty may raise the likelihood of more tax disputes between taxpayers and revenue authorities and also between revenue authorities.

This article provides some context to the issue of “passive association” and implicit credit support that may be provided within multinational groups. It includes an explanation of the OECD’s new position on this issue, why it matters, and the practical consequences for multinationals, specifically within the context of debt arrangements.

One clear implication of the changes made by the OECD is that it will be necessary for multinationals to take a position on this issue, both at a global policy level and in setting and defending interest rates and guarantee fees on a transactional basis. In addition, many taxpayers will need to prepare themselves to be challenged by tax authorities citing the new guidance as a basis for interpreting the arm’s length principle.

What is passive association?

Passive association can be defined as an incidental benefit attributable solely to an entity’s association and linkages with other entities that are part of an MNE. It is distinguished from active promotion of the MNE’s attributes that positively enhances the profit-making potential of particular members of the group (such as provision of a legally enforceable guarantee or security).

Implicit support refers to the implied aspect of parental support that may arise in circumstances in which parental support would be expected to be provided by the parent even in the absence of any legal obligation (for example, a guarantee) arising from the entity’s affiliation with the parent or group. Credit rating agencies acknowledge that, in some circumstances, a parent entity may provide credit support to a subsidiary even in the absence of a legal obligation to do so.

Passive association and implicit support may be viewed as any benefit derived by an entity solely from its affiliation with the parent or broader group.

Although this concept has potentially wider implications, this article is limited to consideration of passive association/implicit support in the context of financial transactions. As noted below, the OECD’s views (and the changes that will be incorporated into Chapter I, Section D, of the OECD’s *Transfer Pricing Guidelines*) appear focused on financial transactions. However, the relaxation of a strict functionally separate entity view as an interpretation of the arm’s length principle in favor of how a market participant would look at an entity that is part of an MNE, taking into account its position within the wider MNE organization, for many may represent a departure in interpreting the arm’s length standard. Such thinking may have consequences in considering the arm’s length nature of non-financial transactions.

Why is passive association important?

In the financial markets, a borrower’s credit quality generally has a significant impact on the interest rate applied to a loan or the price of a credit guarantee. To the extent that it is appropriate to apply passive association principles to a given transaction, adjusting the credit quality of an obligor to account for the potential contingent credit support of another member of the multinational group may have a significant impact on the rate applied to a financial transaction.

The chart below shows why the issue of creditworthiness is of critical importance in pricing funding transactions. The credit spread between what a borrower with a strong credit quality (say, A rated) and a low/medium-rated borrower (say, BB rated) would pay can be significant. Thus, the potential
impact of passive association, which a tax authority may use to adjust the credit rating of an unsupported subsidiary toward that of the parental credit rating, can be substantial (potentially up to 500 basis points (bps) at 2008 peak credit spread levels). For a $1 billion transaction, this means a reduction in interest payments of up to $50 million per annum. Over a five-year funding period, for example, the issue could have a gross impact of up to $250 million. In the context of pricing intragroup guarantees, the issue is even more stark, as it may determine whether any fee is payable, and, if so, the pricing of the guarantee.

Chart 1 — Illustration of pricing impact of creditworthiness

It is therefore not surprising that tax authorities—initially those from capital-importing countries such as Australia and Canada—have been taking an increasing interest in this issue. For example, the Federal Court of Canada has addressed this issue, and a number of governments and tax authorities around the world have introduced laws and issued guidance on the subject.

Most recently, the Australian Federal Court in October 2015 issued its decision in Chevron Australia Holdings Pty Ltd v Commissioner of Taxation ([2015] FCA 1092). The case involved an intragroup financing arrangement, and the issue of implicit support, discussed further below, was considered.

Changes to the OECD guidelines

Application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction between associated enterprises with the conditions in transactions between independent enterprises. The arm’s length principle traditionally has followed the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. To apply the arm’s length principle in a financial transactions context, one hypothesized a relationship in which the borrower and the lender were independent entities. Applying this principle, the credit quality of a subsidiary of an MNE would be based on its stand-alone functional and financial profile, without any consideration of the credit quality of the broader group. As a general matter, branches were equalized in credit standing with their head office.

The final report on BEPS Actions 8-10 (“Aligning Transfer Pricing Outcomes with Value Creation”), released by the OECD on October 5, 2015, set out the amendments that will be incorporated into Chapter I of the Transfer Pricing Guidelines in relation to “group synergies” (paragraphs 1.157 to 1.173). These sections discuss the issue of passive association/implicit support and expand upon Section 7.13 in the 2010 Transfer Pricing Guidelines. The new sections provide two examples regarding MNE group synergies in the context of financial transactions. In addition, the OECD notes that it may limit a multinational’s interest deductions based on group-wide tests or other “targeted measures.”

Example 1 (paragraphs 1.164 to 1.166) recognizes the impact of group synergies on the credit rating of a subsidiary that is a member of the MNE group.

On a stand-alone basis, however, the strength of S’s balance sheet would support a credit rating of only Baa. Nevertheless, because of S’s membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating.
The OECD notes that no payment or comparability adjustment is required for the group synergy benefit because the benefit arises from S’s group membership and not from any deliberate concerted action of members of the MNE. This is consistent with the notion of passive association considered in the context of intragroup services, as distinguished from active promotion. It should be noted that this approach is from a “borrower’s perspective”; there may be costs to a parent in providing contingent credit support to a subsidiary.

A similar principle is applied in Example 2, which distinguishes incidental benefit from active promotion. The facts in Example 2 (illustrated below) are the same as in Example 1, but in a situation whereby the parent company provides a guarantee (legal obligation). The new guidelines state that S should be required to pay a guarantee fee to P based on the enhancement of S’s credit standing from A to AAA, not on the enhancement of S’s credit rating from Baa to AAA.

The enhancement of S’s credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S’s credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by Parent, and should therefore give rise to compensation. [Paragraph 1.167]
The OECD’s new guidance will be influential in requiring tax authorities and taxpayers to consider the issue of passive association or implicit support in any analysis requiring pricing of financial transactions.

A first step in estimating the credit quality of an obligation is to estimate an issuer rating and then adjust that rating (by notching the entity/issuer rating up or down) based on instrument-specific factors. Credit rating agencies in general subscribe to a stand-alone approach as a starting point in determining/estimating the credit rating of a corporate entity regardless of its status as a parent, holding company, or subsidiary within an MNE group. From there, ratings agencies consider the impact of different forms of “support” or “relationships” between various entities, both related and unrelated, on the corporate entity’s stand-alone credit rating. Ratings agencies have disseminated their ratings outside of a tax transfer pricing context.

Credit rating agencies often base their credit opinions of subsidiaries of multinationals on the premise that creditors can reasonably rely on the parent or other interested party to provide contingent credit support in times of financial distress, based on that entity’s fiduciary duty to the subsidiary, and on the notion that a subsidiary would typically be rescued by its parent, which would service any subsidiary debt in the event of default. Unlike explicit support, whereby the parent is legally bound to support a subsidiary, implicit support is not legally binding and relies on the expectation that in the event of a subsidiary’s default or near default the parent would support the subsidiary financially to avoid such default. Thus, depending on the relationship or relative importance of the subsidiary to the parent and/or group as a whole, the parent may choose to provide implicit support (if it has the capacity to do so) or allow the subsidiary to go bankrupt. As a practical matter, the ability of a multinational to provide such contingent credit support varies considerably (with financially weak parents less able to provide support). In addition, the amount of credit uplift that a lender might provide varies across the credit cycle, and may also vary by the seniority of a given obligation.

Each of the major ratings agencies (Standard & Poor’s, Moody’s Investors Services, and Fitch Ratings) provides a general framework as it relates to subsidiary/parent links and implicit support.

Other market participant considerations
Credit ratings are only part of the pricing process, and are not the only determinants of the margins at which lenders are prepared to extend credit. Thus, a complete analysis must take into account the practices of the participants in the market.

The role of credit ratings agencies is to analyze and signal to investors the quality and risk associated with various debt instruments. However, actual pricing decisions are made by lenders and borrowers. Investors (such as bond investors) often take differing views on credit risk than the ratings agencies, and will make price/investment decisions based on their own criteria, including the specific circumstances of the transaction. This is evidenced by the observable spreads of credit margins in the market at any given credit rating and time.

In the context of the other market participants, it is important to note that investors will not necessarily agree, nor will the pricing of an instrument always be consistent with, the rating disseminated by a rating agency based on implicit support.

Banks and other lending institutions will have their own approaches to assessing credit risk and in making lending and pricing decisions in accordance to their own risk appetite. A critical component of that is the capital requirements for loans, which in many jurisdictions are regulated locally having regard to the output of the Bank of International Settlements Basel Committee on Banking Supervision.

In essence, under both the Basel Standardized and Internal Ratings approaches, for credit support to be recognized for capital adequacy purposes, it should be legally enforceable. Implicit credit support does not carry the same weight from a regulatory perspective. The effect of this is that banks generally need to hold more capital against loans that do not have a legally enforceable parental guarantee, which in turn means the pricing of the loan (i.e., the credit margin) should be higher than at the parental credit rating.

This market participant view means that the issue of determining how the market would view the creditworthiness of the subsidiary requires a careful evaluation of the facts of the case, and recognition that reliance on ratings agency approaches may not be the only appropriate method to consider.

Implications
Review global policies and risk assessment
When the new guidance on group synergies and passive association is adopted in the new OECD Transfer Pricing Guidelines, it will be important for all multinationals with intragroup debt arrangements or financial guarantees to review their global policies to set and test the transfer prices (interest rates and guarantee fees) to ensure consistency with the OECD Transfer Pricing Guidelines. This does not necessarily mean adjustment from stand-alone credit ratings; rather, MNEs will have to take a position on the relevance of the issue of passive association for the group, and documentation supporting that position will have to be prepared accordingly.

In determining the practicalities of what type of analysis is required to determine the scale of any adjustment to stand-alone credit ratings, if appropriate, companies should evaluate the tax risk inherent in their intragroup financial transactions.
Sensitivity to passive association will typically be a function of:

- Regulations/laws, in both the lender’s and the borrower’s jurisdictions
- The taxpayer’s global approach to pricing intragroup funding
- Materiality of the transaction
- Rating gap between the parent and subsidiary (stand-alone rating)
- Nature of transaction (for example, short-term/medium-term/long-term deposit)
- Known tax authority views

In the post-BEPS world of increased transparency and greater tax authority focus on both sides of a transaction, the leading approach is to develop an approach that will stand up to scrutiny in both jurisdictions. While the OECD has taken a broad stance on the issue of passive association, the potential for divergent tax authority views is still material. When there are clear mismatches between the laws or approaches taken by two jurisdictions, it will be important to consider these issues carefully to enable an educated decision regarding the approach to manage the transaction’s tax risk.

In practical terms, the work required to determine an arm’s length interest rate should be commensurate with the level of risk.

**A practical approach to the ratings process for an intragroup loan**

In general, the process for determining the appropriate entity rating for a subsidiary borrower/obligor in the context of an intercompany financial transaction when implicit support must be considered (that is, when the OECD Transfer Pricing Guidelines form the basis for the approach) involves the following information and steps:

- Determine the borrower subsidiary’s stand-alone rating.
- Determine the parent’s rating, or rely on the parent’s public rating if available; otherwise the parent will also need to be rated.
- Determine the rating gap -- the difference between the parent’s rating and the borrower subsidiary’s rating.
- Perform analysis regarding whether the credit market (lenders, credit rating agencies) would take into account the implicit support of a parent (or associate entity) in pricing the financial transaction.
- If the answer to the above step is ‘yes,’ perform analysis having regard to available guidance to quantify the extent to which the rating gap should be reduced, and the stand-alone rating of the borrower subsidiary enhanced.

**Conclusion**

The issue of passive association, while not a new one, is increasingly important when analyzing the arm’s length nature of financial transactions. Intragroup financial transactions, including loans, guarantees, and derivatives are a significant issue for MNEs. Tax authority sophistication and focus on financing has increased significantly globally. The OECD BEPS agenda will help drive the tax authority focus, and the proposed changes to Chapter I of the OECD Transfer Pricing Guidelines signal that the OECD position has moved toward recognition of passive association when the market would do so.

Credit rating is one of the most important determinants of the rate applied to loans and guarantees. Adjusting for passive association can significantly change the transfer price, and hence the taxation outcomes in both jurisdictions of the parties to the transactions.

It will be important for taxpayers to review their global transfer pricing policies to consider whether passive association could have an impact on the interest rates set for intragroup debt. A key element of the policy should be to consider whether the arrangements have a high or low degree of potential sensitivity to passive association.

When the potential sensitivity is low, a high-level analysis, which may for example group or “bucket” loans based on similar characteristics, may be a practical approach. When the potential sensitivity is high, a detailed analysis will likely be required to determine whether the stand-alone credit rating of a borrowing affiliate should be adjusted to take account of passive association, and if so, by how much. Determination of any adjustment could follow the ratings agency approaches; however, in some cases it may also be appropriate to consider whether other lending market participants, such as banks, might follow a different approach.
About the authors

Geoff Gill is a partner and economist with Deloitte’s Global Transfer Pricing group in Sydney. He has over 16 years of experience in transfer pricing based in both London and Sydney. Geoff leads Deloitte Australia’s transfer pricing practice for the financial services industry.

Bill Yohana is a director in Deloitte Tax LLP’s transfer pricing practice in New York City. Over the past 18 years, Bill has focused on financial transactions transfer pricing.

Kevin Gale is a senior manager with Deloitte Canada and the Canadian practice’s lead practitioner for financial transactions.

Bill Yohana
New York
byohana@deloitte.com

Kevin Gale
Winnipeg
kgale@deloitte.ca

Geoff Gill
Sydney
gegill@deloitte.com.au

Contents

16
The revisions to Chapter VI of the Transfer Pricing Guidelines contain some of the most significant changes adopted by the OECD/G20 under its BEPS mandate to ensure that transfer pricing outcomes are consistent with value creation. The revisions contain new guidance on risk consistent with changes to Chapter I—the returns to capital—and place significant emphasis on the returns to the important functions related to the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles. The new guidance will likely drive significant changes to current practices. The release does not contain any new guidance on the transactional profit split method, which has been deferred until 2016 or 2017.

**Definition of intangibles**

In most respects, the new guidance is unchanged from the previous draft. It adopts a broad definition of intangibles to preclude arguments that valuable items fall outside the scope. This expansive approach is similar to that of recent domestic rule-making in many countries.

The new guidance defines an intangible as something (1) that is not a physical asset nor a financial asset; (2) that is capable of being owned or controlled for use in commercial activities; and (3) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. In commercial terms, this would include (but not be limited to) “intellectual property.”

In identifying intangibles for transfer pricing purposes, the new guidance focuses on what would be agreed upon between unrelated parties in a comparable transaction. The broad definition is not dependent on accounting or legal definitions or characterizations, and is not dependent on or intended to be used for any other tax purposes. The new guidance notes that a transfer pricing analysis should carefully consider whether an intangible exists and whether an intangible has been used or transferred. For example, not all research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible.

The availability and extent of legal, contractual, or other forms of protection is not required, although it will usually affect value. Likewise, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes, a point included in the new guidance following the debate on the nature of “goodwill.” The new guidance discusses several items that are characterized as intangibles for transfer pricing purposes, and some that are not:

<table>
<thead>
<tr>
<th>Intangibles for tax purposes</th>
<th>Not intangibles for tax purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Patents</td>
<td>• Group synergies</td>
</tr>
<tr>
<td>• Know-how and trade secrets</td>
<td>• Market specific characteristics (e.g., local consumer purchasing power and location savings)</td>
</tr>
<tr>
<td>• Trademarks, trade names, and brands</td>
<td>• Assembled workforce</td>
</tr>
<tr>
<td>• Rights under contracts and government licenses, including contractual commitment to make a workforce available</td>
<td>• Goodwill and ongoing concern value</td>
</tr>
<tr>
<td>• Licenses and similar limited rights in intangibles</td>
<td></td>
</tr>
</tbody>
</table>

The new guidance provides that, in conducting a transfer pricing analysis, it is important to identify the relevant intangibles with specificity, and that vaguely specified or undifferentiated intangibles are insufficient for that purpose. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets, and with business operations to create value.
Rights to returns for the development and exploitation of intangibles

Section B of the new guidance addresses the difficult question of how to allocate the overall profit created by an intangible among the functions involved, assets used, and risks associated with the DEMPE functions related to the intangible. Section B incorporates the new guidance on contractual terms, risk, and control of risk in the revisions to Chapter I. The strong point in this section is its directive to apply the arm’s length principle in accordance with Chapters I-III of the Transfer Pricing Guidelines. As such, the analysis in section B is based on expected returns, not actual returns. A separate discussion in Chapter VI on hard-to-value intangibles examines when it is appropriate to look at actual returns.

The new guidance in Section B recognizes that payment for use of an intangible should be made to the party having the legal rights to such intangible. However, when another party has participated in the DEMPE activities, provides funding, or assumes various risks, a separate transaction dealing with that activity must also be considered. There is therefore no intention under the new guidance to divert the income stream arising from use of the intangible away from the legal owner, but instead to recognize that the legal owner has a transfer pricing obligation to pay for those activities that it does not perform. The new guidance is clear that the legal owner of the intellectual property might not earn any profit from simply owning the intangible, after compensating other members of the group for their respective contributions.

The new guidance states that contracts may be used to describe the roles, responsibilities, and rights of associated enterprises, and may serve as a reference point for identifying and analyzing controlled transactions. Thus, associated enterprises are encouraged to express their intent in contracts. However, the new guidance is clear that if the actual assumption or control of risk and performance of the DEMPE functions differs from those stipulated in the contractual agreement, then the transfer pricing analysis must be based on the actual activity.

The guidelines contain a clear statement that the legal owner need not be the one to carry out all the DEMPE functions itself, but recognize that independent parties do sometimes engage others to perform such functions. Accordingly, under the arm’s length principle, it is acceptable for related parties to act in a similar manner. According to the new guidance, for an outsourced activity to be priced as an “outsourced service,” someone other than the service provider should exercise control over its performance. In this situation, an entity would be deemed to exercise control if it has the ability to understand the function being performed, to determine if the function is being performed adequately, and to be the final decision-maker regarding important aspects of the function. The new guidance is clear that when the legal owner does not adequately control the outsourced activities, the party that in practice controls the outsourced activity, whether the party performing the outsourced activity or another, should be appropriately compensated.

The new guidance states that, in determining the prices to be paid for functions performed, some “important functions” will have, in appropriate circumstances, “special significance” because they usually make a significant contribution to intangible value. The list provided is not all-inclusive but is intended to be merely illustrative. In some situations, any of the listed items might not have special significance; in others, something not listed might. The list includes:

• Design and control of research and marketing programs
• Direction of and establishing priorities for creative undertakings, including determining the course of “blue-sky” research
• Control over strategic decisions regarding intangible development programs
• Management and control of budgets
• Important decisions regarding defense and protection of intangibles
• Ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible

In practice, as between unrelated parties, any of these activities might be performed by another party whose specialized knowledge makes it sensible, from a business point of view, to rely on the other parties’ judgement. Transfer pricing practitioners need to investigate and identify the activities of “significant importance” and show the arm’s length nature of the actual arrangements. The new guidance cautions that the reliability of one-sided transfer pricing methods will be substantially reduced if parties performing a significant portion of the important functions are treated as tested parties. Failure to perform or control the significant functions is likely to leave the legal owner with only a small return on the other functions it performs. If these significant functions would not have been outsourced by unrelated parties the transfer pricing consequence might be that comparables cannot be found, which leads either to the application of profit split methods or, in appropriate cases, to the recharacterization of the transaction.

One new aspect of the new guidance is the way in which it now recognizes and rewards a party that funds the performance of the DEMPE functions. The new guidance distinguishes between financial risk associated with funding a project and operational risk associated with operational activities with which the funding is used, such as development risk when the funding is used to develop a new intangible. The new guidance states that when the party that provides funding exercises control over financial risk without assuming and controlling operational risk, the funder would generally expect only a risk-adjusted return, such as the cost of capital or a realistic alternative investment. The new guidance states that to exercise control over financial risk, the party providing the funding must make the decisions with respect to the risk-bearing opportunity and respond to risks associated with the opportunity, such as determining how the development project will impact the expectation of returns and the requirements for additional funding. In addition the
funder must perform day-to-day risk-mitigation activities regarding the management of financial risk or, if those activities are outsourced, exercise appropriate control over the outsourced activities. A funder that does not exercise control over the financial risk will be entitled only to a risk-free return.

The new guidance lists a number of risks that may be important to transactions involving intangibles:

• Risk related to the development of intangibles, including the risk that the development may not be successful
• Risk that competitors’ technical advances or other factors may make the product obsolete
• Infringement risk
• Product liability risk
• Exploitation risk associated with the returns to be generated by the intangible

The party actually controlling and assuming the relevant risks consistent with the requirements of Chapter I will be entitled, by way of a secondary transaction rewarding such activity, to gains and losses associated with those risks. Conversely, a party that is not controlling and assuming the relevant risks nor performing the important functions will not be entitled to any of the gains, nor be responsible for the losses that might be associated with any difference between anticipated and actual returns. For situations in which a party is allocated a specific risk under a contract, which it has the financial capacity to assume, the Chapter I guidance allows that such party will be allocated the risk even though other parties may also exercise control over the specific risk.

Valuation of intangibles
The new guidance makes it increasingly likely that, when taxpayers select a transfer pricing method to value intangibles, the “most appropriate method” will be the transactional profit split, and the use of discounted cash flow techniques by requiring consideration of both parties’ realistic alternatives. The new guidance specifies the difficulties, in many circumstances, of finding suitable comparables for the use of the comparable uncontrolled price (CUP) method.

Realistically available options
The new guidance strongly emphasizes that the comparability analysis regarding intangibles transactions must consider the options realistically available to each of the parties to the transaction, and that a one-sided comparability analysis is insufficient. The new guidance further provides that the specific business circumstances of one of the parties should not be used to support an outcome contrary to the realistically available options of the other party. The new guidance includes an example that states that a transferor of intangibles would not accept a price that is less advantageous than its other realistically available options merely because it lacks the resources to effectively exploit the transferred rights. A second example states that a transferee should not be expected to accept a price that would make it impossible to anticipate earning a profit using the acquired rights in the intangible in its business.

The new guidance takes the position that an intercompany price for a transaction in intangibles can be identified that is consistent with the realistically available options of each of the parties, and is consistent with the assumption that taxpayers seek to optimize their allocation of resources. The new guidance cautions that in situations when there is no overlap in the prices acceptable to both parties, given their realistically available options, it may be necessary to consider whether the actual transaction should be disregarded based on the new guidance in Chapter I.

Comparability analysis
The supplemental new guidance states that it is essential to evaluate the unique features of the intangibles in conducting a comparability analysis. This is particularly important when the CUP method is applied, but it is also relevant in applying other methods that rely on comparables. Important factors in determining comparability include the actual and potential profitability of potential comparables in comparison to the transferred intangible, and whether the transferred intangible can be used as a platform to shorten the development time of future generations of the product. The new guidance questions whether comparable information drawn from public or private databases is sufficiently detailed to satisfy the new guidance’s comparability standards.

The new guidance provides that if amounts attributable to comparability adjustments represent a large percentage of the total value, the computation of the adjustment may not be reliable, and the intangibles being compared may in fact not be sufficiently comparable to support a valid transfer pricing analysis. The new guidance effectively sets a high comparability bar in applying the CUP method to value intangibles transfers, and the OECD explicitly notes that the identification of reliable comparables involving intangibles may be difficult or impossible in many cases.

Transfer pricing methods
The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how the transferred intangibles interact with other functions, assets, and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies, among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

The new guidance states that, depending on the specific facts, any of the five OECD transfer pricing methods may constitute the most appropriate transfer pricing method for the transfer of intangibles. Nevertheless, the new guidance goes on to caution that one-sided methods, including the resale price method and the transactional net margin method (TNMM), are generally not reliable methods for intangibles transactions, in part because they can assume
that all of the residual profit is allocated to the owner of the intangible. The new guidance further notes that transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development are generally discouraged, because there rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Consequently, the new guidance concludes that the transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method, and that valuation techniques can be useful tools.

As described above, the new guidance sets a high bar on comparability, which in practice will likely make the CUP method difficult to apply (except in cases when there is a recent acquisition from an unrelated party, a suitable internal CUP, or when there are multiple intangible options that achieve the same result).

The new guidance suggests that a profit split may be a reliable method for valuing developed intangibles in the absence of CUPs. However, as mentioned, the guidance on the application of the profit split method has been deferred until 2016 or 2017.

The new guidance further provides that it may be possible to use valuation techniques, including income-based methods such as the discounted cash flow method, to estimate the arm’s length price of intangibles. New guidance on the application of the discounted cash flow method is provided. In applying a valuation technique, it is essential to consider the assumptions that underlie the analysis. In particular, the new guidance notes that the following issues should be considered:

- Accuracy of financial projections
- Assumptions regarding growth rates
- Discount rates
- Useful life of intangibles and terminal values
- Assumptions regarding taxes
- Forms of payment

As a practical matter, it may be necessary to document contemporaneously the important risks and functions and identify the parties assuming and controlling those risks and functions. The new guidance requires that the analysis be done up front at the time development activity begins or a structure is put in place. In many instances, it may be very difficult to assess what may have been the upfront expectations of the parties, and identify the exact parties that were controlling and assuming risks, several years later when a tax authority inquiry begins. This may create a challenging administrative burden for companies who, in many cases, may not possess information necessary to track significant intangible-creating activity in real time.

The final report provides little guidance on how to allocate intangible returns among the multiple parties that together may be contributing to the creation of a valuable intangible. Implications

In many cases, the new guidance will require companies to identify and obtain a much deeper understanding of how value is created with respect to the development and exploitation of a company’s significant marketing and technology intangibles. In the future, companies will need to pay particular attention to identifying specific risk associated with intangible transactions, as well as identifying who within the organization exercises control over those risks. It may no longer be possible for one party to simply contract with a related party to undertake the development of the IP and have all of the residual return inure to the payor without that party demonstrating substantive functions capable of exercising oversight and control of the development process. This may mean being able to demonstrate the performance of such functions and capabilities in either its own qualified personnel or in others that they control. For companies with complex structures where important functions are distributed among many group companies, these rules could prove particularly onerous and difficult to comply with. In other cases, movement of qualified personnel may be required and additional qualified personnel may need to be assigned to specific control functions.

The new guidelines and examples assume that a single set of defined transactions and a single set of intangibles are the main drivers of the intangible returns. In many cases, companies have multiple intangibles, some of which derive their value from synergies with other types of intangibles. Determining intended returns from development activity for some but not all of the intangibles in these cases is likely to be a challenge.

As a practical matter, it may be necessary to document contemporaneously the important risks and functions and identify the parties assuming and controlling those risks and functions. The new guidance requires that the analysis be done up front at the time development activity begins or a structure is put in place. In many instances, it may be very difficult to assess what may have been the upfront expectations of the parties, and identify the exact parties that were controlling and assuming risks, several years later when a tax authority inquiry begins. This may create a challenging administrative burden for companies who, in many cases, may not possess information necessary to track significant intangible-creating activity in real time.

The final report provides little guidance on how to allocate intangible returns among the multiple parties that together may be contributing to the creation of a valuable intangible. The examples in the new guidance are simplistic. For instance, the examples assume that one party takes on and controls the significant risks and activities, and the other party is simply left with either a service or financing return. Perhaps the guidance on transactional profit splits will provide some additional guidance. However, even then, it is possible that companies will face significant challenges and potential controversy determining which entity contributes the most to value creation.
Conclusion
The changes to Chapter VI of the Transfer Pricing Guidelines on intangibles, along with the changes to Chapter I, go a long way to articulating the OECD/G20’s stated goal of trying to align transfer pricing outcomes with value creation. It is likely that that the OECD/G20 will have achieved its goal of preventing a cash-rich minimally functioning entity (a cash box) from earning the residual returns associated with development, enhancement, maintenance, protection, and exploitation of intangibles.

The new guidance will likely require companies to devote significantly more resources to documenting their intellectual property transfer pricing. However, even with due diligence, it is likely that the new guidance will increase the incidence of protracted controversies concerning the proper allocation of intangible returns. Many companies may find that they will need to invoke potentially time-consuming mutual assistance procedures to eliminate double taxation to resolve their intangible-related disputes.

About the authors

John Henshall
London
jhenshall@deloitte.co.uk

John Henshall is a partner in the UK Transfer Pricing group and global co-lead of the Business Model Optimization (BMO) services. He specializes in the transfer pricing of business reorganizations and intellectual property.

Alan Shapiro
Tokyo
alan.shapiro@tohmatsu.co.jp

Alan Shapiro is a senior advisor to Deloitte Tohmatsu Tax Co. He works with the organization’s largest multinational companies to develop and implement transfer pricing strategies. For over 25 years he has specialized in the full range of transfer pricing issues.

Keith Reams
San Francisco
kreams@deloitte.com

Keith Reams is a principal in the San Francisco office of Deloitte Tax LLP, and the US and global leader for clients and markets for Deloitte’s global transfer pricing practice.
Hard-to-value intangibles

Richard Schmidtke
Munich

Sajeev Sidher
San Jose.

The hard-to-value intangibles (HTVI) recommendations included in the final report on BEPS Actions 8-10 are intended to address perceived information asymmetries between tax administrations and taxpayers whereby tax administrations may lack access to information, be too reliant on “specialized knowledge, expertise, and insight” provided by the taxpayer, or be incapable of determining whether the differences between projected results used to set the transfer pricing (ex-ante) and the actual results (ex-post) were due to unforeseen developments or faulty transfer pricing.

The OECD initially considered the use of special measures that may have operated outside the arm’s length principle, including the recharacterization of intangible transactions and the application of other anti-abuse provisions. However, the OECD Secretariat instead adopted an approach consistent with the US commensurate with income (CWI) rules, which are deemed to be consistent with the arm’s length principle. These rules are intended to encourage multinational enterprises (MNEs) to include price adjustment or other contingent pricing mechanisms in their license agreements when the value of the intangible being transferred is highly uncertain.

HTVI guidance
HTVI are defined as intangibles or rights in intangibles for which, at the time of the transaction, no reliable comparables existed, and projections of future cash flows expected to be derived from the transferred intangible or assumptions used in valuing the intangibles were highly uncertain. HTVI possess one or more of the following characteristics:

• The intangible is only partially developed at the time of the transfer.
• It is not expected to be exploited commercially until several years following the transaction.
• It is integral to the development of other hard-to-value intangibles.
• It is expected to be exploited in a novel manner, making reliable projections from past developments unavailable.
• It is transferred to an associated enterprise for a lump sum payment.
• It is used in connection with, or developed under, a cost contribution arrangement or similar arrangements.

Given these broad features, many intangibles will be included under the proposed HTVI analysis.

The new guidance uses actual financial outcomes to evaluate intangible transfers or license arrangements related to HTVI under certain conditions. It is presumed, barring unforeseen events, that the transfer pricing is not arm’s length if there are material differences between the forecasts used to price the transaction and the actual results. However, taxpayers may rebut this presumption based on one of the following exemptions:

1. The taxpayer documented how the original projections were determined, including how reasonably foreseeable events and risks were considered and the probabilities assigned to those events. In addition, the taxpayer must provide reliable evidence that any significant difference between the financial projections and the actual outcome is due to unforeseeable events, or that the probability of the occurrence of foreseeable outcomes at the time of the transactions was not significantly overestimated or underestimated. An unforeseeable event is a low-probability event that could not be foreseen, such as a natural disaster.

2. The transfer of the HTVI was covered by a bilateral or multilateral advance pricing arrangement.

3. Any significant differences between the financial projections and the actual outcomes do not cause the projected compensation for the HTVI to deviate by more than 20 percent.

4. The HTVI has generated unrelated party revenues for the transferee for a five-year commercialization period, and any difference between the financial projections and the actual outcomes was less than or equal to 20 percent of the forecasts for that period.

The OECD Secretariat has stated that further implementation guidance will be provided in 2016. Specifically, taxpayers will have to wait for details on how tax authorities will re-price transactions if the safe harbors or exceptions are not met.

1. Under the arm’s length principle, tax administrators evaluate the terms of intercompany transactions based on the terms that two unrelated parties would have concluded.
Current practice
As noted above, the US tax authorities have adopted in statute and regulations provisions similar to the HTVI recommendations. Section 482 of the Internal Revenue Code requires that income paid for the transfer of an intangible be commensurate with the income generated by the intangible. The CWI regulations include an objective 20 percent safe harbor (although the precise calculation is slightly different) to test the reliability of the projections used to set the price at the time of the transaction.

The regulations also provide for exceptions for unforeseeable events when the safe harbor is exceeded. When an adjustment is necessary, a periodic adjustment may be made to an already closed taxable period during a subsequent tax period. Accordingly, the entire transaction could be revalued in subsequent tax years regardless of the statute of limitations. The US cost sharing regulations use a different mechanism to come to a similar result. Thus, for US taxpayers, the adoption of the HTVI recommendations would have little additional impact.

With the exception of Germany, European tax and transfer pricing laws have not included price adjustment clauses or followed CWI standards. However, even though price adjustment clauses have not been stipulated in local law, practical experience in European countries shows that European tax authorities tend to challenge the pricing of intercompany transactions if there is a large deviation between the forecasted data and the actual outcome, based on the fact that under arm’s length market conditions, independent parties would include a provision allowing review of pricing based on actual outcomes. Tax authorities often argue that price adjustment clauses are an inherent part of the arm’s length standard.

Implications
In countries that did not have formal rules or did not have a clearly defined safe harbor, the new rules may bring a measure of relief. Taxpayers now have more clearly defined rules concerning when tax authorities can make adjustments when outcomes differ from expectations.

To avoid ex-post adjustments, taxpayers should consider preparing detailed contemporaneous documentation to support the transfer price of their intangible transactions. Specifically, taxpayers will need to identify all likely risks related to the transferred intangibles and assign reasonable probabilities to the identified risks and events. The contemporaneous documentation would have to present sufficient current reliable evidence that any material differences between the projections and the actual profits were due to unforeseeable developments or the realization of properly identified and priced risks. The breadth and depth of the final documentation requirements are undefined and thus, it is not clear how demanding the final recommendations will be until the final implementation package is released in 2016. However, given the potential scrutiny to which intangible transactions are subject, taxpayers are encouraged to thoroughly document transactions.

Given the proposed treatment of HTVI, it may also be prudent to implement mechanisms that independent parties have historically used to account for uncertainty in valuing intangibles, such as contractual provisions to account for the effects of reasonably foreseeable developments. In situations with high uncertainty, taxpayers may want to limit the time frame of the agreement or include clearly defined price adjustment clauses that determine a new price. For example, including a clause that will adjust the price if the HTVI triggers are satisfied may be an option to consider. Care will need to be taken that the price adjustment clauses are appropriately balanced so that additional compensation is not required. When transferring intangibles that are not yet ready to be commercialized, taxpayers may also include contingent milestone payments.

The German transfer pricing regulations mandate the use of price adjustment clauses for intangibles if no third-party comparables can be identified. If the parties do not include an arm’s length price adjustment clause in their intercompany contract and cannot rebut the presumption that at the time of the transaction uncertainty existed regarding the underlying expectations by showing that third parties would not have included a price adjustment clause, a default price adjustment clause as defined in the German regulations would be applicable. A transfer pricing adjustment is then made if, within a 10-year period, a substantial deviation from the predicted profits or cash flows occurs. The German tax authorities are currently discussing internally whether the price adjustment provisions in the German regulations have to be amended to be in line with the OECD recommendations.
About the authors

Richard Schmidtke
Munich
rschmidtke@deloitte.de

Richard Schmidtke is a partner in the Munich office of Deloitte Germany. He leads the local transfer pricing team and specializes in IP planning and controversy.

Sajeev Sidher
San Jose
ssidher@deloitte.com

Sajeev Sidher is a director in the San Jose office of Deloitte Tax LLP, and the US Transfer Pricing Technology industry leader.
Low value-adding intragroup services

For efficiency reasons, the headquarters of multinational enterprises (MNE) often provide affiliates with a variety of intercompany support activities. Typically, these services fall into broad categories of support, including human resources, finance, information technology, legal services, and marketing. With the rise in volume of cross-border transactions and intensifying competition among various MNE groups, companies often centralize the entire range of intragroup services in a single location to bring efficiency and avoid duplication of services. This trend has led to the creation of intragroup shared service centers.

Typically, intercompany support services provided by both headquarters and intragroup shared service centers are remunerated based on cost or the cost plus method, as the costs incurred for rendering such intragroup services are allocated among group companies usually based on allocation keys. Tax authorities around the world have expressed skepticism at these allocated costs, citing the potential that MNE groups are eroding the tax base through excessive management fees and head office cost allocations. Under the existing guidelines, tax authorities may request that MNEs justify the benefit to each member group entity in a detailed manner that may not be practical on a large scale, and without a solution, taxpayers may face disallowed deductions, competent authority claims, or double taxation.

The OECD’s final report on Actions 8-10 of the BEPS project, Aligning Transfer Pricing Outcomes with Value Creation, includes a section on “Low Value-Adding Intra-Group Services -- Revisions to Chapter VII of the Transfer Pricing Guidelines.” This guidance introduces an elective, simplified approach to determining whether the service charge is due (the benefit test) and calculating the arm’s length charge in the case of low-value-adding services.

Unlike the existing guidelines, the new guidelines state that if taxpayers elect the simplified approach to document low-value-adding intragroup services, they only need to demonstrate that a benefit was received by the group members within the specific categories of services, rather than specifying the specific benefits received by group members. Once implemented by individual tax administrations, the simplified approach may reduce the burden taxpayers face in preparing the documentation of low-value-adding intragroup services.

The final report indicates that the countries participating in the BEPS project have agreed to a two-step approach to implementation. As a first step, a large number of countries plan to include the simplified elective mechanism in their domestic regulations before 2018. As a second step, the countries that have indicated that intragroup management services and head office charges constitute a major concern will be allowed to combine the introduction of the guidance with the introduction of a threshold that, if exceeded, would permit tax administrators to require a full transfer pricing analysis, including a benefit test. Follow-up work on the design of the threshold and other implementation issues is expected to be completed before the end of 2016.

Simplified approach

Services can qualify for application of the simplified approach if the services:

• Are of a supportive nature
• Are not part of the core business of the MNE group (that is, they do not create profit-earning activities or contribute to the MNE group’s economically significant activities)
• Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and
• Do not involve the assumption or control of substantial or significant risk by the service provider, and do not give rise to the creation of significant risk for the service provider.

The new guidance provides examples of activities that would not qualify for the simplified approach, such as research and development, manufacturing, sales, marketing
and distribution, financial transactions, and exploration or extraction. Services provided by corporate senior management are also excluded. This means that companies cannot simply apply the simplified approach to their entire headquarters cost base, but rather must determine the group of costs that qualify for this approach.

The new guidance provides a list of services that may qualify for the simplified approach, which is similar to the services that qualify for the services cost method under the U.S. transfer pricing regulations and includes, for example, accounting and auditing, human resources activities, regulatory issues, communications (internal and external), information technology, legal services, tax support, and administrative and clerical support.

For those services that qualify for application of the simplified approach, the arm’s length charge would be calculated following these steps:

• Step 1: Identify, on an annual basis, the pooled costs by category associated with the low value-adding services, excluding any costs that benefit only the service provider; pass-through costs in the cost pool should be identified.
• Step 2: Eliminate costs associated with services provided to only one group entity.
• Step 3: Allocate costs among group members using simplified allocations keys appropriate for the services, such as revenue, assets, headcount, and information technology users (the allocation key selected should reasonably reflect the relative benefits expected to be received by each recipient of the service of particular type).
• Step 4: Apply a markup of 5 percent of the allocated costs; the mark-up does not need to be justified by a benchmarking study.
• Step 5: Calculate the net charge due by a given group member.
• Step 6: Prepare simplified documentation to support the charge.

Once implemented by individual tax administrations, the simplified approach is likely to reduce the burden taxpayers face in preparing the documentation of low-value-adding intragroup services.

The final report indicates that, due to the nature of low-value-adding intragroup services, the task of documenting the charges based on the general guidance for services may be difficult or require an effort disproportionate to the value of the charges. The new guidance indicates that, for those reasons, tax administrations generally should refrain from reviewing or challenging the benefits (in cases when the simplified approach has been applied) provided the documentation requirements specified in the guidance are met. Taxpayers are expected to maintain the following documentation:

• A description of the categories of qualifying services provided:
  – The description would include the reasons justifying that each category of services qualifies for application of the simplified approach;
  – The rationale for the provision of services within the context of the MNE’s business;
  – A description of the expected benefits of each category of services;
  – A description and support for the selected allocation keys; and
  – Confirmation of the mark-up applied.
• Written contracts or agreements for the provision of services;
• Calculations showing the determination of the cost pool, including a detailed listing of all categories of services and amounts of relevant costs; and
• Calculations showing the application of the specified allocation keys.

The new guidance indicates that provided the information listed above is made available to the tax administrators, a single annual invoice describing a category of services should suffice to support the charge, and no further evidence (such as correspondence, reports, etc.) should be required.

Shared services centers

The new guidance does not distinguish between low-value-adding services provided by shared service centers or by headquarters companies. For that reason, the recommendations presented in the report should be applicable equally to intragroup services provided by shared services centers.

Cost contribution arrangements

Example 2 of the guidance on cost contribution arrangements (CCAs) contains another approach to sharing low-value-adding services. If the requirements of a CCA are met, the parties may be able to share management fees and headquarters charges, but not separate shared services center costs, at cost with no mark-up. The example indicates that services with an arm’s length mark-up of 3 percent or 5 percent would qualify in this case as low-value-adding services. One potential drawback of a CCA is that participants would not qualify for the reduced benefit test and would still be required to show that the services benefited each of the participants.

Implications

The simplified approach may reduce the time and effort MNEs spend supporting the benefit provided by low-value-adding services, justifying allocation keys, and supporting the mark-ups applied. Whether the simplified approach is an option for MNEs depends on how and the extent to which tax authorities around the world implement the guidance.
For developed countries that are often locations for service providers, broad adoption of the simplified method is more likely. The simplified method generally would ease the burden on headquarters to retain records documenting in detail beneficial services to each recipient entity and potentially reduce controversy. For U.S. MNEs, the general approach is in keeping with the overall outline of the services cost method under the U.S. transfer pricing regulations, and the U.S. regulations do not require a mark-up. It is unclear whether the United States will now change its rules to require a mark-up.

The impact on developing nations, which are often service recipients and service providers in shared services arrangements, is less clear. Many developing countries have indicated that the services represented by management fees and headquarters charges are less relevant in their markets, and that the cost of the services exceeds the cost of local service providers. These countries have requested that the guidance be limited to situations in which the costs do not exceed certain thresholds. Whether the guidance will provide simplification in these cases will depend on the threshold and its implementation, which will be decided in 2016. In addition, many developing countries are the location for shared services centers that take advantage of lower labor and other costs. In some situations, developing countries have taken the position that these location-specific advantages should be considered in the mark-up on costs. It is unclear whether those countries will be willing to accept the 5 percent mark-up envisioned by the guidance as compensation.

Conclusion

The guidance on low-value-added services has the potential to simplify the policy and documentation requirements for intercompany charges for management fees and headquarters allocations and reduce controversy. However, in order for MNEs to apply the simplified guidance, the rules will have to be adopted and applied by the countries in which they provide intra-group services. Questions remain as to how easy it will be for countries to opt out of the rules because threshold levels of charges have been met, or whether countries will fail to adopt the rules because they believe the cost plus margin provided in the rules is inadequate.

About the authors

Shannon Blankenship
Denver
sblankenship@deloitte.com

Shannon Blankenship is a principal in the Denver office of Deloitte Tax LLP, leading the MidAmerica transfer pricing practice. She helps companies wade through complexities to find practical solutions to their transfer pricing issues and opportunities.

Rafal Sadowski
Warsaw
rsadowski@deloitteCE.com

Rafal Sadowski is a partner in Deloitte Poland’s Transfer Pricing team, with extensive experience in business restructurings, transfer pricing policies, risk management, and transfer pricing litigation projects.

Mudigonda Vishweshwar
Bangalore
mvishweshwar@deloitte.com

Mudigonda Vishweshwar is a partner in the Bangalore office of Deloitte India. He leads Deloitte’s transfer pricing practice in India.

Contents
Cost contribution arrangements

Cost contribution arrangements (CCAs) are contractual arrangements entered into to allow parties to share the contributions and risks involved in either (1) the development, production, or acquisition of intangible or tangible assets, or (2) the execution of services, with an expectation that the parties will enjoy the anticipated benefits to be derived from their contributions equitably.

The Organization for Economic Cooperation and Development’s (OECD’s) new transfer pricing guidelines released October 5, 2015, contain guidelines that may require participants that provide CCA funding to significantly increase substance around such arrangements and, in many cases, to change the method of valuing CCA contributions. Companies may find that the new guidelines mandate an increased administrative commitment to and extensive monitoring of CCAs.

The CCA final guidelines diverge somewhat from the draft guidelines issued earlier this year. Controversial aspects of the guidelines, such as the ability to use cost for the determination of contributions, the control and substance requirements, and the financing return requirements have been slightly modified but in large part remain consistent with those presented in the draft guidelines. The following sets out an overview of the new CCA guidelines, summarizes relevant points of departure from the draft guidelines, and identifies practical considerations for multinational enterprises considering entering into a CCA.

Overview of guidelines

The new guidelines address both asset-development and service-provision CCAs. The primary difference between an asset-development CCA and a service-provision CCA is the timing of expected benefits and the level of risk undertaken in each. An asset-development CCA is generally expected to deliver ongoing, future benefits, whereas a service-provision CCA is expected to deliver current benefits. An asset-development CCA generally entails significantly more risks than a service-provision CCA. The majority of the discussion in Chapter VIII of the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations focuses on the more complex asset-development CCAs and provides limited commentary on service-provision CCAs.

The new guidelines aim to ensure (1) the consistency in transaction delineation and analytical evaluation when considering CCAs versus other transactions with similar attributes; (2) alignment of guidance on the valuation and pricing of intangibles whether or not they are associated with a CCA; and (3) consistency in the valuation of DEMPE (development, enhancement, maintenance, protection, and exploitation) functions, whether or not they are connected with a CCA. Consequently, the CCA chapter refers to other sections for specific guidance to ensure a common framework for analyzing economically relevant characteristics of an agreement (Section D, Chapter II), risks (Section D, Chapter II), intangibles transferred (Chapter VI), funding risk (Chapter VI), the identification of beneficial services (Chapter VII), and documentation requirements (Chapter V). The new guidelines in Chapter VIII caution that they are designed to provide supplementary guidance when a CCA, connecting multiple transactions and delivering shared benefits, is entered into.

Delineation of the CCA arrangement

CCAs continue to be evaluated based on the substance of the arrangement rather than the contractual form expressed. Thus, while the delineation of the transaction starts with the division of economically relevant risks, responsibilities, and beneficial interests expressed in the contractual arrangement, ultimately, only the actual risks, responsibilities, and expected beneficial interests of the CCA parties are relevant for valuing contributions. Accordingly, from a practical perspective, CCA parties should ensure that CCAs are maintained and updated as necessary to reflect an evolution of the arrangements based on changing business needs and opportunities.

Criteria for CCA classification

The fundamental CCA requirement that contributions reflect expected benefits, and that all CCA parties have a reasonable expectation of benefitting from the CCA objectives remain unchanged. However, under the new guidelines all participants must exercise control over the risks arising from the arrangement, must have the financial
capacity to assume such risks, and must, at the outset of the CCA, have a clearly defined interest in the CCA output. In the event a CCA does not meet these criteria, the arrangement may be re-characterized by the tax authorities as a funding transaction, or in more extreme cases, may be disregarded. As a practical matter, a CCA will be disregarded only if, when viewed in its totality, it lacks commercial rationality.

Control
The guidelines state that a CCA participant “must have (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity presented by participating in the CCA, and must actually perform that decision making function, and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, and must actually perform that decision-making function.” This can be interpreted to mean that each CCA party must have qualified technical personnel capable of analyzing the risk of the CCA opportunity and making an educated decision whether or not to partake in the opportunity. It is not necessary for a participant to perform day-to-day risk mitigation activities; however, the participant must at least be capable of contracting for qualified advice with regard to such decisions and determining the objectives of the risk mitigation activities to be performed by contracted third parties.

The requirement that all parties must exercise control over the development risks may pose a challenge. In many current CCA arrangements, one party is primarily responsible for development and control over the CCA’s technical direction and process. The party managing the R&D team typically will direct that team and make strategic decisions regarding the technical direction without input from or consultation with the other CCA parties. The new guidelines would require active development guidance from all CCA parties. This may not be immediately practical or feasible, especially if not all participants have senior technical resources.

Returns to funding
CCA parties should have the financial capacity to assume CCA risks. Thus, participant equity capital and debt and expected earnings (including the timing of the earnings) will need to be reconciled to the CCA financial commitment and risks. If a CCA participant’s role is primarily that of funding, often referred to as a cash-box participant, the new guidelines limit the return available, unless the funder also manages and controls the risks associated with development, maintenance, enhancement, protection and exploitation (DEMP&PE) of the CCA intangibles. If the CCA participant controls the funding risk (a “smart” cash box), the return is limited on an ex ante basis to a risk-adjusted return on the CCA invested capital. This return should reflect the opportunity cost of using the funds in connection with the CCA, and the expected return on the hypothetical alternative investment. Such a return may be the company or industry weighted average cost of capital. If the provider of funds does not manage and control the funding risks (a “dumb” cash box) the funder cannot be a risk-invested participant and will likely be limited to a risk-free return.

Expected returns
At the outset, expected returns from the CCA must be determined for each participant based on projections. The general and broad standard to be applied, based on the new guidelines, is that CCA participants should determine “whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight.” This is a challenging standard to comply with, given its qualitative and subjective nature. As a practical matter, a participant might consider formal business projections used for other business planning purposes or key macro and industry economic indicators, and how they correlate with the projections of the same period and with overall company results.

The expected returns identified at the outset of a CCA may differ significantly from those actually realized throughout the term of the CCA. The guidelines recognize that it may be difficult for tax authorities to verify the assumptions used to develop expected projections. These problems may be exacerbated when the CCA activity begins several years before the expected benefits actually materialize. Accordingly, the guidelines recommend that the CCA provide for periodic reassessments and possible prospective adjustments of proportionate shares of contributions to be made by each party in the CCA, to reflect changes in relevant circumstances triggering changes in relative shares of benefits. If the contributions to the CCA include “hard-to-value intangibles,” discussed in section 4.D of Chapter VI, then those rules would be applicable to CCA contributions.

Valuation of contributions to a CCA
The guidelines are clear that all contributions—whether consisting of preexisting tangible or intangible assets or of current development services in the framework of the CCA—must be valued at the time they are contributed using the specific guidelines and valuation techniques provided in Chapters I, II, III, and VI of the OECD’s Transfer Pricing Guidelines. In the case of an asset-development CCA, contributions may include services performed (such as R&D or marketing), tangible property, and intangible property. An important clarification included in the new guidelines is that the value of preexisting contributions will be based on the value those contributions are expected to produce in the context of the development activity. This implies that there may be an element of synergy value that needs to be captured when preexisting IP is contributed to a CCA. On the other hand, ongoing current contributions are to be based on the value of the function itself, not on the potential value of the current contribution in the context of the CCA and its developing intangibles.

Cost is generally not permitted as an approximation of value under the guidelines, unless cost is considered the arm’s length price for the services (or function), or unless the value of any mark-up that is forgone is calculated and included as a preexisting contribution of value specific to that service function. Thus, R&D services or CCA management services performed by one CCA party, as current contributions, should be recorded based on the value of the functions,
rather than at cost. For example, assume a CCA composed of two parties. Party A performs R&D development activities costing 100, with a value (considering them separately) of cost plus 20 percent. Party B performs IT development services costing 100, with a value (considering them separately) of cost plus 10 percent. If the CCA parties expect benefits of 2,000 each, then the CCA should reflect 50 percent of the contribution value being allocated to each party \([(120+110) \times 50\% = 115]\) and thus a compensating payment of 5 should be made by Party B to Party A. Prior CCA rules would have permitted computing the cost contribution of 100 made by each of the parties and therefore, no adjustment would be needed to achieve proportionality with expected benefits.

If the CCA parties choose to allocate costs for administrative convenience, then a preexisting contribution (equal to the net present value of the arm’s length mark-up associated with the services, that is, the “opportunity cost of the ex ante commitment to contribute resources to the CCA”) must be determined and accounted for in the CCA as a contribution. The guidelines, however, provide an exception in cases in which the difference between the value of the contributions and their costs is relatively insignificant. In those circumstances, cost can be used as a practical means to measure relative value of current contributions.

Consistent with prior guidelines, the new guidelines state that costs should include those incurred directly and solely in connection with the CCA activity, as well as those that support the CCA activities (indirect costs). Indirect costs may include the use of buildings, information technology systems, and administrative support costs. These support costs must be allocated to the CCA cost pool in a commercially justifiable way, taking into account treatment specified by recognized accounting principles. The allocation of indirect costs may create some challenges if the local accounting principles vary significantly between the countries of the CCA participants.

The key for existing CCAs will be whether countries will adopt a consistent set of grandfathering rules to limit the impact of the control requirement and the requirement that contributions be at value.

Budget versus actual costs
If cost is permitted and used in determining the value of a CCA current contribution, as discussed above, the parties generally would be expected to use budgeted costs as long as there is agreement between the parties as to what factors are to be taken into account in setting the budget and how unforeseen circumstances affecting the actual costs are to be addressed. The guidelines also state that, “where cost is found to be an appropriate basis for measuring current contributions, it is likely to be sufficient to use actual costs as the basis for so doing.”

Balancing payments
The guidelines state that a CCA is consistent with the arm’s length principle if the value of each participant’s proportionate share of the overall contributions is consistent with the share of expected benefits. If the overall contributions are materially inconsistent with the actual benefits or a reevaluation of expected benefits occurs, then prospective balancing payments are required to correct the level of contribution by each party. The CCA agreement should include a requirement to make prospective balancing payments in these circumstances.

The guidelines also provide that tax authorities may require balancing payments if they determine that the value of the participant’s proportionate contribution was incorrectly determined at the time it was made, or when CCA expected benefits have been incorrectly assessed. These balancing payments, whether initiated by the CCA parties or by the tax authorities, are treated as an addition to the contribution of the payor and as a reduction in the contribution of the recipient. The character and tax treatment of balancing payments will be determined in accordance with domestic tax law.

The guidelines raise questions as to how the rules will apply in practice. For example, the guidelines require that CCA contributions must be consistent with the share of benefits at the time they are made, and that changes in contributions based on differences between expected versus actual benefits must be made prospectively. Future contributions must therefore take into account all contributions over time. Thus, future contributions will not necessarily be consistent with the share of benefits at the time they are made.

Buy-in and buy-out payments
The guidelines remain unchanged regarding the tax treatment and valuation of buy-in and buy-out payments resulting from changes in the membership of a CCA. The amount of the buy-in payment will be based on the value of the interest in the intangible or tangible assets the new entrant obtains, taking into consideration the value of the assets that new entrant may bring to the CCA and its proportionate share of the overall expected benefits to be received under the CCA. In the event the new participant makes a contribution to the CCA, the value of the buy-in payment would be netted against the contribution. Similar rules apply to the buy-out of a participant.

Documentation requirements
The guidelines set out details of documentation to be prepared in connection with a CCA, referencing detailed documentation provisions in Chapter V. The documentation is largely consistent with the original guidelines, and overlaps considerably with the US cost sharing documentation requirements.

The guidelines also contain a list of recommendations for initial terms within the CCA and a list of information that will be useful to maintain over the term of the CCA.
The latter list includes changes to the arrangement, a comparison between projections used to determine expected benefits and actual benefits achieved, and annual expenditures incurred in connection with the CCA activities, including the form and value of, and method used to determine, each participant’s contribution to the CCA.

**Implications**
The new CCA guidelines largely follow previously issued CCA guidelines. However, the few changes to the rules are likely to cause significant challenges to CCA participants. In particular, the new substance and control requirements; the restrictions introduced for using cost as a basis for valuing preexisting and current contributions; the need to account for risk-weighted financing; the limited guidance regarding what constitutes a rigorous process for determination of the expected benefits; and the expectation that the CCA will contain periodic reassessment provisions with balancing adjustments to account for certain differences between expected and actual benefits, will all present significant practical challenges in developing new CCAs or maintaining existing ones.

**Conclusion**
The new guidance on CCAs adopts the principles of the changes to Chapter I on delineation of the transaction and risk, and the changes to Chapter VI on intangibles. Countries are currently considering these guidelines and how to adopt them. One significant question for companies now managing existing CCAs will be whether adopting countries will align their grandfathering rules, particularly around the sensitive area of cost-based contributions, and control requirements. If grandfathering rules are not adopted, or if the adopted grandfathering rules are inconsistent, MNEs with existing CCAs will need to review these guidelines carefully to determine the implications jurisdiction by jurisdiction for their CCA and determine specific structural changes that will need to be made.

---

**About the authors**

Jacqueline Doonan is a tax partner in the San Francisco office of Deloitte Tax LLP and is the national emerging-technology and innovation industry leader for Deloitte’s US transfer pricing practice.

Ramón López de Haro is a transfer pricing and cross-border tax partner with Deloitte Spain and a leader of the Business Model Optimization (BMO) practice in Deloitte Spain.
Transfer pricing documentation and country-by-country reporting

The revised Chapter V of the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations contains new standards for transfer pricing documentation. The guidelines recommend that individual jurisdictions adopt a three-tiered approach to transfer pricing documentation:

- A master file with global information about a multinational corporation group, including specific information on intangibles and financial activities, that is to be made available to all relevant country tax administrations;
- A local file with detailed information on all relevant material intercompany transactions of the particular group entity in each country; and
- A country-by-country (CbC) report of income, earnings, taxes paid, and certain measures of economic activity.

The new guidance will change the documentation process fundamentally and significantly increase MNEs’ transfer pricing compliance burden, because it requires most MNEs to gather and provide to the tax authorities substantially more information on their global operations than they have previously provided.

Three-tiered approach to documentation

Master file
The master file should provide an overview of an MNE’s global operations, its overall transfer pricing policies for the creation and ownership of intangibles and its financial activities, and its global allocation of income and economic activity to place the MNE’s transfer pricing practices in their global economic, legal, financial, and tax context.

In preparing the master file, MNEs should use sound judgment to determine the appropriate level of detail, taking into consideration that the guidelines indicate it is not necessary for the master file to include exhaustive details. Nonetheless, there is some concern that an individual tax authority’s view of prudent business judgment could be affected by the information on local transactions.

The required information can be grouped into five categories:

- The MNE’s organizational structure
- A description of the MNE’s business or businesses
- The MNE’s intangibles
- The MNE’s intercompany financial activities
- The MNE’s financial and tax positions

MNEs could present the information for the group as a whole, or by line of business, as long as centralized group functions and transactions between business lines are properly described. In addition, if the master file is prepared by line of business, all product groups will have to be submitted to all tax authorities, even if the local entity is part of only one line of business.

The new requirements are relatively prescriptive and will require MNEs to collect a considerable amount of information that has not been collected by either the headquarters or the group members in the past.

The new requirements include:

- A supply chain chart for the five largest products and service offerings, plus other products or services amounting to more than 5 percent of an MNE’s sales;
- A list and brief description of important service arrangements between members of the MNE group, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intragroup services.
• A description of the main geographic markets for the group’s products and services that are referred to in the bullet immediately above;
• A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, such as key functions performed, important risks assumed, and important assets used;
• A description of important business restructuring transactions, acquisitions, and divestitures occurring during the fiscal year;
• Important intangibles or groups of intangibles, and which entities own them;
• A general description of how the group is financed, including important financing arrangements with unrelated lenders;
• The MNE’s annual consolidated financial statement for the fiscal year in question, if otherwise prepared for financial reporting, regulatory, internal management, tax, or other purposes; and
• Advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

The new information required will likely necessitate new processes to obtain, collect, validate, analyze, and refresh data.

Master file information was not previously available to tax authorities, except possibly to the extent it had a direct impact on a local entity’s transactions. This increased level of global transparency may result in tax authorities focusing on broader aspects and structure. For example, the additional information could result in inquiries about the development of intangibles by one group member, funding or ownership of the intangibles by another group member, and exploitation by yet another group member. Similarly, the general description of the MNE’s transfer pricing policies related to financing arrangements between group members, as well as the description of important financing arrangements with unrelated lenders might highlight non-arm’s-length interest rates, overcapitalization of low-tax finance companies, and inadequate debt capacity. Therefore, it would be prudent to analyze the impact of the new requirements on current transfer pricing policies and processes.

Local file
The guidance requires that the local file contain much of the same information that was traditionally found in transfer pricing documentation related to the local entity, including its controlled transactions and financial data. Although the local file will be centered on a traditional functional and economic analysis, the guidelines are more prescriptive than the documentation rules in many countries, and require additional details not required or contained in many documentation reports. While the master file provides a high-level overview, the local file should provide more detailed information relating to specific material intercompany transactions.

One of MNEs’ major concerns regarding the local file may be the varying thresholds of what constitutes a material transaction that must be documented. Some countries require, under domestic rules, that virtually all transactions be documented, whereas other countries are more concerned with major transactions that have a significant impact on the local entity’s tax liability. The guidelines recommend that individual country transfer pricing documentation requirements include specific materiality thresholds. As a practical matter, the guidelines are unlikely to reduce the current proliferation of materiality standards and the burden on business that they impose.

A positive feature of the guidelines is that they state that searches for comparable companies need be completed only every three years if the company’s functional profile has not changed, although the data on the comparable companies must be updated annually. However, the guidelines still generally support the use of local comparable companies over regional comparable companies when local comparable companies are reasonably available. This requirement may increase the number of sets of comparable companies an MNE must obtain and update.

The guidelines indicate that the local file must contain a breakdown of the intragroup payments and receipts for each category of controlled transactions involving the local entity (that is, payments and receipts for products, services, royalties, and interest) by tax jurisdiction of the foreign payor or recipient. It is also a requirement that various types of agreements be reported, including all material intercompany agreements concluded by the local entity and copies of existing unilateral and bilateral or multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and that are related to controlled transactions described in the local file. The key issue for the future is whether local jurisdictions will impose additional requirements for the local file that will require additional costs to prepare locally tailored documentation reports.

A key concern for MNEs may be the lack of guidance in terms of post-transaction adjustments that are required to prepare a compliant local file. Most countries allow only upward adjustments. This means that if an entity needs to make an upward adjustment to be in compliance, but is prohibited from making a downward adjustment in the counterparty’s country, it would be subject to double taxation. This suggests a need for close monitoring of transfer prices to reduce the potential for post-transaction adjustments.

Cbc report
As set forth in the guidelines, the final piece of the three-tiered documentation package—the Cbc report—should contain aggregate information (without any intercompany adjustments or eliminations) for all entities and for each tax jurisdiction on the following eight items:
• Revenue by related and unrelated party and the sum, including royalties, service fees, interest income premiums, and any other amounts derived from transactions with related or unrelated persons, excluding dividends;
• Profits before income tax;
• Income tax paid, including withholding taxes;
• Income tax accrued, that is, the sum of the accrued current tax expense recorded on taxable profits of the year of reporting, excluding reserves or deferred taxes or provisions for uncertain tax liabilities;
• The number of employees on a full-time equivalent basis;
• Stated capital;
• Retained earnings; and
• Tangible assets other than cash and cash equivalents.

The CbC report should provide information on each group member (company, corporation, trust, or partnership) by tax jurisdiction, along with an indication of the jurisdiction of organization or incorporation, and relevant business activity codes for each entity, including dormant entities.

The CbC report requirement applies to MNEs with annual consolidated group revenue in the immediately preceding fiscal year of €750 million or more (or a near equivalent amount in domestic currency). The monetary threshold does not apply to the master file or local file. Individual countries may adopt different thresholds for those documents.

In preparing the CbC report, the reporting entity should use the same sources of data from year to year, if there is a change, the company should explain the reason for that change. Reporting entity is defined as an entity that is required to file a CbC report in its jurisdiction of tax residence on behalf of the MNE.

The reporting entity may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, regulatory financial statements, or internal management accounts. The reporting entity is required to provide a short description of the sources of data that it used in completing the CbC report. If statutory financial statements are used as the basis for reporting, all amounts should be translated to the stated functional currency of the reporting entity at the average exchange rate for the year. If information is used from consolidated financial statements, upon audit, the tax authority may ask for that information to be reconciled to the statutory or regulatory financial statements and then reconciled again to the tax return although the guidance specifically does not require that the information be reconciled. For this reason, some companies are considering using separate entity statutory financial statements or regulatory financial statements for purposes of preparing the CbC report.

In many cases, MNEs may not know where to obtain all the required CbC information, and a CbC data-blueprinting exercise may need to be undertaken to identify where the CbC information is found in the MNE’s systems, and how to retrieve it most efficiently. Larger MNEs should perform reporting systems readiness assessments and address potential gaps. Some of the items requested may not be centrally collected on an entity-by-entity or country-by-country basis. For many MNEs, the sheer volume of information that must be collected to complete the report will substantially increase their compliance burden.

Larger MNEs may want to consider technology solutions to collect, store, analyze, and prepare the CbC report. The time and effort necessary to manually locate, collect, validate, and assemble the required data in a spreadsheet or report is likely to be significant for large MNEs, especially because the process will have to be repeated annually. Technology solutions may enable MNEs to better manage their transfer pricing compliance by providing functionality that allows for regular monitoring of their transfer pricing results. Some software solutions may provide comparisons to budgets or expectations; others may provide sophisticated analytics, including drill down, root cause, and sensitivity-testing analyses, to help a company understand the causes of any unanticipated deviations, potential adjustments, and the impact of those adjustments on taxes paid in relevant countries, the overall effective tax rates, and other items such as VAT and customs duties.

Adoption of the CbC report as part of the OECD’s transfer pricing guidelines was one of the key goals of the BEPS project, because it may provide most local tax authorities, for the first time, an organized picture of where a company earns income and pays taxes. The report may highlight gaps and inconsistencies in a company’s transfer pricing policies or its implementation of those polices. In addition, the report may highlight potential inconsistencies in the place where revenue is recognized and the place where “value” is created. MNEs should be ready to provide counterarguments, especially in situations where seemingly similar functions and risks have resulted in different profits for their affiliates in different countries. Such analysis should focus on the location of the decision-makers and the location of unique, high-value assets, including technical and marketing intangibles. MNEs should consider addressing any potential gaps or inconsistencies before they file their first CbC report.

The CbC report is intended to be a risk assessment tool for the tax authorities, and “should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis.” The guidelines state that “It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.” The OECD has indicated that if such adjustments are made by the local tax administration, the jurisdiction’s competent authority will be required to promptly concede the adjustment in any relevant competent authority proceeding.

Notwithstanding the OECD’s admonishments, some countries and MNEs are concerned that the CbC report might lead more frequently to allocations of income on the basis of people and tangible assets, whether by way of greater use of the profit split method or by other means.

Other key elements

Language

Local law will determine the language in which documentation must be submitted. The guidance encourages countries to permit the filing of transfer pricing documentation in commonly used languages when the usefulness of the documents will not be compromised. If tax administrations believe that translation of documents is necessary, the guidance suggests that tax administrations make specific requests for translation and provide sufficient time to complete the task.
Timing

MNEs will be required to file their first CbC reports for their first fiscal year beginning on or after January 1, 2016, and to file it no later than 12 months after the end of that fiscal year. This means that for MNEs with fiscal years ending on December 31, the first CbC report would be required to be filed by December 31, 2017. For MNEs with other fiscal years, the first CbC report would be required to be filed in 2018, 12 months after the close of the first fiscal year beginning after January 1, 2016.

The guidance recommends that the master file and local file requirements be implemented through local-country legislation or administrative procedures, and that MNEs file the master file and local file directly with the tax administration in each relevant jurisdiction under the requirements of such administrations. The guidance indicates that both confidentiality and consistent use of the framework for the content to be included in the master file and local file should be taken into account when incorporating these requirements under local law and procedures.

Implementation legislation

The OECD has released model legislation that could be used by countries to mandate the filing of the CbC reports by the ultimate parent entity of an MNE and also the exchange of this information on an automatic basis with the relevant qualifying jurisdictions in which the MNE operates. Countries with existing transfer pricing documentation rules may choose to affirmatively adopt the OECD’s approach or augment their rules, and countries without existing transfer pricing documentation rules should be able to immediately adopt the OECD’s approach.1 The extent to which various countries will provide their own guidance on CbC reports is unclear.

The OECD’s model legislation also provides that members of an MNE must notify their country’s tax administration whether they are the reporting entity for the group no later than the last day of the MNE’s fiscal year. The model legislation requires tax authorities to share the CbC information with other relevant tax authorities within 18 months of the end of the financial reporting year for the first year, and within 15 months of the end of the financial reporting year for subsequent years.

Unfortunately, the guidance does not include any provisions regarding penalties to be imposed in the event a reporting entity fails to comply with the reporting requirements for the CbC report, under the assumption that jurisdictions would wish to extend their existing transfer pricing documentation penalty regime to CbC filing requirements. However, the guidance states that local documentation-related penalties should not be levied if the information is not in the possession of the local entity, but expressly sets out that the assertion that other group members are responsible for transfer pricing documentation is not sufficient reason to preclude the local subsidiary from being charged documentation-related penalties.

Implications

The new documentation guidance may accelerate the trend toward centralized management and documentation of an MNE’s transfer pricing policies and the monitoring of transfer price implementation, as MNEs may strive for more consistency in light of the new transparency of their financial results. This increase in global transparency is likely to mean that deviations from transfer pricing policy or the implementation of that policy will become more apparent to tax authorities around the world. For these reasons, MNEs that currently do not establish and monitor transfer pricing policies on a global basis may find a need to do so in the near future. For some MNEs, the new guidance could require an increase in authority and resources to establish and implement transfer pricing policies, and new systems and procedures to regularly and proactively monitor transfer pricing results on a global basis.

The CbC report and the master file are likely to be prepared by the headquarters company because as a practical matter, it is likely that only the MNE’s headquarters will be able to obtain the information necessary to prepare those documents. For MNEs that do not prepare their transfer pricing documentation on a global basis, the new requirements will pose a substantial change. Even if they do prepare their documentation on a global basis, the new guidance is likely to require MNEs to compile and explain substantially more information than was traditionally included in documentation reports. The new requirements are likely to require new processes to collect, validate, analyze, and prepare transfer pricing documentation.

MNEs will need to ensure that the CbC report, master file, and the local files provide consistent information about their global and local operations and their transfer pricing policies. For MNEs that took a decentralized approach to transfer pricing documentation, the additional preparation or coordination requirements will likely necessitate the allocation of additional resources at headquarters.

Each MNE needs to determine the appropriate level of compliance with the soon-to-be-revised and varying global transfer pricing documentation requirements. It is likely that even though some countries, such as the United Kingdom and Ireland, will not adopt the master file and local file approach, they may nonetheless request that the MNE produce its master file upon audit. A risk-based approach will need to be adopted to balance the MNE’s tolerance for risk and its available resources. Tax executives will need to identify the impact of the revised guidance on their processes, measure the impact, prioritize the actions needed, develop an approach to centralize control over transfer pricing, communicate with the key stakeholders, and develop restructuring options, if necessary.

---

1 As of this writing, Australia, Canada, China, Germany, Ireland, the Netherlands, Poland, South Korea, Spain, the United Kingdom, and the United States have indicated that they would adopt the OECD’s proposed CbC reporting template. Other countries such as Finland, France, India, Israel, Italy, Japan, Korea, Luxembourg, Mexico, New Zealand, Norway, Singapore, Slovakia, South Africa, Sweden, and Taiwan have announced their support for the adoption of the CbC reporting template.
action is to begin the process for the preparation of the master file and the CbC report for the most recent year to identify gaps, and to begin to make strategic decisions on, for example, classification of the group members and their jurisdiction or residence and whether to have a single master file or one for each business line.

**Conclusion**

The revised guidance proposes a new paradigm for transfer pricing documentation that may cause many MNEs to rethink their current procedures to set, implement, monitor, document, and report their global transfer pricing policies. The new guidelines will require an MNE’s headquarters to implement new procedures that will allow it to locate, collect, store, validate, and assemble the information to meet the new requirements. The increase in transparency and the greater need for global consistency may require many MNEs to increase the resources devoted to transfer pricing issues.

**About the authors**

Mark Nehoray is a senior partner in the Los Angeles office of Deloitte Tax LLP, with over 33 years of public accounting and private industry experience, primarily in the international tax and transfer pricing areas.

Yoshihiro Adachi is a Transfer Pricing and Tax Management Consulting partner in the Tokyo office of Deloitte Tohmatsu Tax Co.

Jeroen Lemmens is a partner in the Brussels office of Deloitte Belgium and the Zurich office of Deloitte Switzerland.

Mark Nehoray
Los Angeles
mnehoray@deloitte.com

Jeroen Lemmens
Zurich
jlemmens@deloitte.com

Yoshihiro Adachi
Tokyo
yoshihiro.adachi@tohmatsu.co.jp
Dispute resolution mechanisms

The Organization for Economic Cooperation and Development (OECD) on October 5, 2015, released a final report on Action 14, “Making Dispute Resolution Mechanisms More Effective.” The goal of Action 14 is to develop solutions to address obstacles that prevent countries from resolving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties, and the fact that access to MAP and arbitration may be denied in certain cases. Although Action 14 is directed at tax authorities, taxpayers could benefit significantly from these actions by permitting timely resolution of disputes consistent with double tax treaties and the reduction in the number of cases of double taxation.

The Action 14 report includes references to Action 15, “Developing a Multilateral Instrument to Modify Bilateral Tax Treaties,” which will be critical to implementing the recommendations of Action 14. The multilateral instrument negotiations, which will include mandatory binding arbitration, have recently been joined by the United States.

Minimum standard and best practices

The guidance on dispute resolution includes a commitment by countries to implement a “minimum standard” or requirements on dispute resolution, consisting of specific measures to remove obstacles to an effective and efficient mutual agreement procedure (MAP). The specific measures include explanations and, in some cases, proposed changes to the OECD Model Tax Convention. Other suggested changes to the Commentary of the OECD Model Tax Convention will be drafted as part of the next update to the OECD Model Tax Convention to reflect the conclusions of the final report.

The dispute resolution final report also reflects an agreement that some responses to the obstacles that prevent the resolution of treaty-related disputes through the MAP are more appropriately presented as best practices rather than as part of the minimum standard for two reasons. First, unlike the elements of the minimum standard, these best practices have a subjective or qualitative character that could not readily be monitored or evaluated, and second, because not all OECD and G20 countries were willing to commit to them at this stage. Best practices are not requirements but are only suggestions that countries should consider adopting.

The report includes a peer review process that will encourage tax authorities to adopt the minimum standards and many of the best practices, and the first reviews will be published by the end of 2017. The OECD has had previous success with its peer monitoring program in relation to transparency and the Tax Information Exchange Agreement network, and it is intended that this publication of countries’ law and practice in relation to resolving disputes will be a useful enforcement mechanism.

Minimum standard

The minimum standard includes specific measures to ensure the timely, effective, and efficient resolution of treaty-based disputes. The minimum standards adopts three organizing principles:

1. Countries Should Ensure that Treaty Obligations Related to the Mutual Agreement Procedure are Fully Implemented in Good Faith and that MAP Cases are Resolved in a Timely Manner.

The guidance states that the dispute resolution mechanism provided by Article 25 of the OECD Model Tax Convention forms an integral and essential part of the obligations assumed by a contracting state in entering into a tax treaty; as such, the provisions of Article 25 must be fully implemented in good faith, in accordance with their terms, including providing taxpayers access to MAP. The guidance emphasizes that taxpayers should have access to MAP even in situations in which the tax authorities are applying domestic or treaty anti-abuse rules to determine if the application of the anti-abuse rule is consistent with the treaty.

Countries should commit to seek to resolve MAP cases within an average time frame of 24 months and that countries’ progress toward meeting that target will be periodically reviewed on the basis of the statistics prepared in accordance with the agreed reporting framework.

2. Countries Should Ensure that Administrative Processes Promote the Prevention and Timely Resolution of Treaty-Related Disputes.

The guidance provides that appropriate administrative processes and practices are important to ensure an environment in which competent authorities are able to fully
and effectively carry out their mandate to take an objective view of treaty provisions and apply them in a fair and consistent manner to the facts and circumstances of each taxpayer’s specific case. The elements for this minimum standard are intended to address a number of different obstacles to the prevention and timely resolution of disputes through the MAP that are related to the transparency of the MAP process and the internal operations of a tax administration and the competent authority function. For example, the guidance recommends that countries should ensure that the staff in charge of MAP processes has the authority to resolve MAP cases in accordance with the terms of the applicable tax treaty, without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue.

Moreover, the guidance states that countries should not use performance indicators for their competent authority functions and staff in charge of MAP processes based on the amount of sustained audit adjustments or maintaining tax revenue. More appropriate performance indicators could include the number of MAP cases resolved, or the time taken to resolve a MAP case.

3. Countries Should Ensure that Qualified Taxpayers can Access the Mutual Agreement Procedure.

The guidance suggests a number of changes to Article 25 to make it easier for taxpayers to access MAP, such as permitting a request to either competent authority or, in the absence of such a change, implementation of a bilateral notification system.

To ensure that qualified taxpayers can access the mutual agreement procedure, the guidance recommends, among other things, that countries’ published MAP guidance should identify the specific information and documentation a taxpayer is required to submit with a request for MAP assistance. Countries should not limit access to MAP based on the argument that insufficient information was provided if the taxpayer has provided the required information. Countries should also adopt measures to ensure that domestic law time limits do not prevent the implementation of competent authority mutual agreements.

Best practices

The work mandated by Action 14 also identified a number of best practices related to the three general objectives of the minimum standard. These best practices, which are not part of the minimum standards, include a recommendation for countries to implement:

- Bilateral advance pricing agreement (APA) programs.
- Appropriate procedures to permit, in certain cases and after an initial tax assessment, taxpayer requests for the multi-year resolution through the MAP of recurring issues for filed tax years.
- Appropriate measures to provide for a suspension of collections procedures during the period a MAP case is pending. The suspension should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy.
- Adequate training programs for tax examiners to make them aware of the MAP procedures and the consequences of making an international adjustment.
- Appropriate procedures to facilitate recourse to MAP.
- Procedures to permit access to MAP for taxpayer-initiated adjustments.

Countries should include in their published MAP guidance an explanation of the relationship between the MAP and administrative and judicial remedies under domestic law. Such public guidance should address, in particular, whether the competent authority considers itself to be legally bound to follow a domestic court decision in the MAP or whether the competent authority will not deviate from a domestic court decision as a matter of administrative policy or practice.

Framework for monitoring mechanism

The guidance on Action 14 reflects the consensus that implementation of the minimum standard should be evaluated through a peer monitoring mechanism to ensure that the commitments embodied in the minimum standard are effectively satisfied. Although the peer monitoring mechanism could be considered a soft enforcement tool, it is hoped that the implementation of the monitoring system will make it more likely that tax authorities will adopt the minimum standards quickly and effectively.

The guidance sets out the general features of the monitoring mechanism. All OECD and G20 countries, as well as jurisdictions that commit to the minimum standard, will undergo reviews of their minimum standard (including an evaluation of the legal framework provided by a jurisdiction’s tax treaties and domestic law and regulations, the jurisdiction’s MAP program guidance and the implementation of the minimum standard in practice). The core output of the peer monitoring process will come in the form of a report. The report will identify and describe the strengths and any shortcomings that exist and provide recommendations as to how the shortcomings might be addressed by the reviewed jurisdiction.

Commitment to mandatory binding MAP arbitration

The OECD and G20 countries did not reach consensus on the adoption of arbitration as a mechanism to ensure the resolution of MAP cases, as many in the United States had hoped. While the final report notes that a group of 20 countries has committed to adopt and implement mandatory binding arbitration, it is clear that even within this group of countries there are differing views on the scope of such a provision. These countries include Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States. These countries were involved in more than 90 percent of the outstanding MAP cases at the end of 2013, as reported to the OECD. It should be noted that the list does not include many developing (non-OECD) countries that have increased their transfer pricing enforcement activities in recent years. A mandatory binding MAP arbitration provision will be developed as part of the negotiation of the multilateral instrument envisaged by Action 15 of the BEPS Action Plan.
Multilateral instrument

BEPS Action 15 calls for the negotiation of a multilateral instrument to modify existing tax treaties to efficiently implement the tax treaty measures developed in the course of the BEPS project, and eliminate the need to renegotiate the existing global network of more than 3000 tax treaties. The inaugural meeting of an ad hoc group to develop the multilateral instrument began on November 5, 2015, with an ambitious schedule to complete its work in 2016. To date, 90 countries have announced their participation in the discussions. The United States, which initially declined to participate, has now indicated its willingness to do so.

The multilateral instrument is expected to include changes to the MAP including mandatory binding arbitration, where applicable.

Not all countries are expected to participate in all aspects of the multilateral instrument. For example, some countries may be willing to amend their tax treaties to include provisions on dual resident structures or treaty abuse issues, while other countries may believe that their current treaties adequately cover those issues, or they may simply decline to include those provisions in their treaties.

The multilateral MAP and arbitration provisions are particularly relevant to address transfer pricing controversy. While global experience with mandatory arbitration provisions is not reported publicly, it appears that in the United States such provisions have been somewhat successful in effecting MAP settlements in a timely manner.

Conclusion

The results of the OECD/G20 actions on BEPS in general, and the new rules on risk and intangibles in particular, have increased the importance and need for factual inquiries. Experience suggests that tax rules that rely on interpretation of the facts tend to increase the number of controversies between taxpayers and tax administrators. In this environment, the guidance on dispute resolution should be a welcome roadmap for tax authorities and taxpayers to improve MAP. The guidance will not directly help the process in many countries that are under pressure because of large caseloads and insufficient personnel resources. But the guidance, along with the peer review system, hopefully will encourage countries to devote the necessary resources for an effective and efficient MAP process that will result in real improvements to achieve the stated goal of ensuring certainty and predictability for business.

The guidance on dispute resolution should be a welcome roadmap for tax authorities and taxpayers to improve MAP, but the guidance will not directly help the process in many countries that are under pressure because of large caseloads and insufficient personnel resources.
About the authors

Kerwin Chung is a managing principal in Deloitte Tax LLP’s Washington National Tax Office, and leader of the firm’s National Advance Pricing Agreement (APA) and Mutual Agreement Procedure (MAP) group.

Kerwin Chung
Washington, DC
kechung@deloitte.com

Kirsti Longley is a director in Deloitte Tax LLP’s Washington National Tax Office, and a member of the firm’s National Advance Pricing Agreement and Mutual Agreement Procedure group.

Kirsti Longley
Washington, DC
kilongley@deloitte.com

Alan Shapiro is a senior advisor to Deloitte Tohmatsu Tax Co. He works with the organization’s largest multinational companies to develop and implement transfer pricing strategies. For over 25 years he has specialized in the full range of transfer pricing issues.

Alan Shapiro
Tokyo
alan.shapiro@tohmatsu.co.jp
About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms.

Deloitte provides audit, consulting, financial advisory, risk management, tax and related services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte’s more than 210,000 professionals are committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte network”) is, by means of this communication, rendering professional advice or services. No entity in the Deloitte network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

Copyright © 2015 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited.