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OECD Provides Update on Transfer Pricing Issues at July Public Consultation



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The Secretariat of the Organization for Economic Cooperation and Development (OECD) provided on July 7 an update on the status of various transfer pricing matters in connection with Actions 8, 9, and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan. The three-hour meeting, held at the OECD Conference Center in Paris, included a presentation by Andrew Hickman, head of the OECD's Transfer Pricing Unit, and Marlies de Ruyter, head of the Treaty and Transfer Pricing division, followed by a Q&A session. Although no final decisions have been made, the session highlighted areas in which progress has been made and those in which additional work will be needed to reach consensus.

The most anticipated and longest segment of the presentation was in connection with the status of the revisions to Chapter I of the OECD's transfer pricing guidelines following the December 19, 2014, release of the non-consensus discussion draft on risk, recharacterization, and special measures (the discussion draft), and the public consultation held March 19, 2015. That public consultation followed the submission by interested parties of over 1,000 pages of comments on the discussion draft.

The OECD did not release revised drafts; the materials provided for the presentations consisted of only a few slides.

Based on the presentation by the Secretariat and comments made by member country representatives, Working Party 6 appears to have reached consensus on some issues:

- **No Special Measures:** The lack of a need for so-called "special measures" (which would provide guidance departing from the arm's length standard, and would be applicable only in certain specific circumstances). Hickman, and at least one member country delegate, indicated that WP6 concluded there would be no need for departure from the arm's length standard in the guidance provided in the post-BEPS transfer pricing guidelines (including in the guidance on hard-to-value intangibles, or when dealing with cash boxes). This development, if found to be true, may be seen as a significant accomplishment for businesses and the U.S. delegates to WP6.
- **"Control Over Risk" Threshold Test:** For tax administrations to uphold the contractual allocation of risk to an affiliated enterprise within a multinationals enterprise (MNE), the affiliated enterprise allocated the risks must exercise "control over risks."
- **"Financial Capability" Threshold Test:** For tax administrations to uphold the contractual allocation of risk to an affiliated enterprise within an MNE, the affiliated enterprise allocated the risks must be capable of bearing the financial downside of the risks. However, it is unclear how financial capacity will be determined.
- **No Special Measures for Cash-Boxes but Debt Return:** Cash boxes (low-functionality entities that are highly capitalized) will be entitled to a risk-free rate of return unless they can exercise control over risk.

- **Moral Hazard Concept Eliminated:** The elimination of the notion of “moral hazard,” which was first introduced in the discussion draft and was heavily criticized in written comments submitted by businesses and other interested parties, appears to be agreed upon.
- **Risk Management Outsourcing Permitted:** Allowing the subcontracting of day-to-day risk management functions (for arm’s length consideration) as long as the subcontractor exercises “control over the risks” (within the meaning Chapter I will assign to the term).
- **Contracts Are the Starting Point:** Reversing the guidance provided in the discussion draft, the OECD appears to have reached consensus that contracts should be given significant weight and are the starting point for the accurate delineation of transactions (see below).
- **Transactions Must Be Accurately Delineated:** Requiring an accurate delineation of the controlled transaction, starting with an analysis of the contractual terms, and complemented with an analysis of the behavior of the parties and with a specific identification and analysis limited to *material* risks. WP6 has agreed that the risk analysis is on an equal footing with (rather than elevated above) the other two key elements of a functional analysis -- functions performed and assets used.
- **Ex-Post Results Can Differ From Ex-Ante Expectations:** The notion that it is acceptable for *ex-post* financial results to deviate from *ex-ante* expected results. However, there still appears to be quite a bit of disagreement between member countries as to how much differences between *ex-ante* expectations and *ex-post* results tax administrations will accept before adjusting either, based on (i) resolution of informational asymmetries (as provided in the HTVI guidance of Chapter VI); or (ii) a recharacterization of the party entitled to unanticipated downsides and upsides based on control over risk or financial capability to bear risks.
- **Recognition Guidance Back to 2010 Version:** Guidance will be provided on the *recognition* of an accurately delineated transaction (as is currently the case in the 2010 version of the transfer pricing guidelines under D.2 Recognition of the Actual Transactions Undertaken) rather than on the *non-recognition* of an accurately delineated transaction. Hickman indicated that WP6 went back to the “commercially rational manner” language of D.2.1.65 of the 2010 transfer pricing guidelines to determine whether a transaction should be recognized, and new examples are provided.
- **Financial Services Transactions:** Specific and separate guidance will be provided for financial services transactions.

The “financial ability” threshold requirement, along with the “control over risk” threshold requirement for a risk allocation to be respected by tax administrations is likely to affect a large number of MNEs that have low-risk contractual arrangements within the MNE. Specifically, if “control over risk” is deemed by tax administrations to be exercised by a low-risk service provider that is not financially capable (within the meaning Chapter I will assign to the term) rather than by a financially capable entrepreneur deemed to not exercise control, it is unclear to which entity within the MNE the guidance would allocate the difference between the expected return and the actual return.

When specifically asked about that important issue, de Ruiters indicated that the OECD probably will not address it in its final guidance, leaving the answer up to the specific tax administrations to determine. Failure to provide guidance on this specific point will likely create a level of uncertainty taxpayers may not be comfortable with.

Based on the Secretariat’s presentation and comments by member country representatives, WP6 does not appear to have reached consensus on the following issues:

- **Appropriate Threshold of “Control Over Risks”:** Both the exact definition of “control” and the level of control that will be required appear to be undecided. This is a critical issue, because it is one of the key tools tax administrations can use to reallocate risk from the party contractually allocated the risk. However, there appears to be greater recognition that comparable companies used in benchmarking analyses perform risk functions.
- **Tolerance for Ex-Post Results to Vary from Ex-Ante Expectations:** Although conceptually there seems to be agreement among WP6 members

that such differences are normal and not *per se* indicative of BEPS, in practice such differences still appear to raise a strong suspicion among some member countries that it is indicative of BEPS. The HTVI guidance will likely provide a threshold test applicable to HTVI (but not necessarily applicable outside of HTVI). As stated above, it remains unclear whether guidance on this issue will be provided in situations not covered by the HTVI rules.

These areas of contention are foundational, are linked, and have implications that extend beyond Chapter I of the transfer pricing guidelines. For example, the HTVI section of Chapter VI is directly affected by the *ex-post* versus *ex-ante* issue above, and the cost contribution arrangement guidance provided under Chapter VIII is directly affected by both issues above.

Although Michelle Levac, co-chair of WP6, and Hickman both made a point that the information provided by the Secretariat reflects only WP6's current thinking, and is not necessarily indicative of where WP6 will end up, encouraging progress appears to have been made since the public consultation of March 19. This cautious optimism should be tempered, as no actual language reflecting the points of consensus currently achieved can yet be examined; the devil in transfer pricing often hides in the details.

As discussed herein, WP6 faces significant remaining challenges, particularly timing, which is placing a lot of pressure on member country delegates and the Secretariat to resolve the remaining critical areas of differences. The OECD must finalize its revised transfer pricing guidelines by the last week of July 2015 to allow sufficient time for polishing, translating, and publishing the various papers (August 2015) for submission first to the OECD Committee on Fiscal Affairs ("CFA") for formal approval (September 2015), and then finally to the G20 Finance Ministers Meeting on October 8 for ratification. The final revised changes are expected to be released a few days prior to the G20 Finance Ministers' meeting.

Other updates provided by the Secretariat on July 7 include:

- WP6 has reached consensus on the commodity transaction guidance provided under Chapter II of the transfer pricing guidelines. The consensus draft has been submitted to the CFA for formal approval.
- All Action 13 deliverables, including the documentation requirements under Chapter V and country-by-country reporting will be combined into one report.
- Additional agreements have been reached on Dispute Resolution (Action 14) along two building blocks of (i) mandatory minimum standards and an associated monitoring process, and (ii) a voluntary commitment to mandatory and binding arbitration. Twenty countries have agreed to include binding arbitration in their income tax treaties.
- WP6 has decided that the special rules applicable to low-value services will not apply if the allocation to a particular country is "large." This provision was included to protect developing countries that were concerned they would be required to accept large service allocations without documentation of the benefits received.
- Guidance on financial transactions (Chapters I and VII), on profit splits (Chapter II), and on profit attribution to permanent establishments (Action 7) will not be part of the final deliverables to the G20 on October 8. The profit splits guidance is expected to be developed in 2016 and 2017; the profit attribution guidance is expected in 2016, and the timetable for guidance on financial transactions is unclear.
- WP6 will release additional implementation guidance on HTVI in 2016.
- The OECD has been tasked by various international organizations to develop a toolkit to assist developing countries in their implementation of BEPS.

Deloitte Tax will host a special webcast to discuss the OECD's HTVI and CCA discussion drafts, as well as other transfer pricing developments under the BEPS initiative. The webcast, "**OECD transfer pricing guidelines: Nearing the finish line,**" will take place Wednesday, July 15, at 2:00 PM ET.

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