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# BEPS Actions 8, 9 and 10: Risk, recharacterisation and special measures

On 19 December 2014 the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (‘BEPS’), released a Discussion Draft on Actions 8, 9 and 10 in relation to revisions to chapter I of the transfer pricing guidelines (including risk, recharacterisation, and special measures). This Action is focussed on updated and expanded guidance on the allocation and transfer pricing of risk within a multinational group and also when it may be appropriate for taxpayers’ transactions to be ‘recharacterised’ by tax authorities and alternative transactions substituted for tax purposes. In addition, ‘special measures’ are considered in relation to problem circumstances that give rise to specific BEPS concerns.

As with other Discussion Drafts on BEPS Actions, the proposals do not represent a consensus view from the G20/OECD governments involved but are designed to provide preliminary but substantive proposals for public analysis and comment.

## Deloitte Comments and Business Next Steps

The draft guidance on identification and allocation of risk within a multinational group is consistent with work already undertaken in respect of the transfer pricing of intangibles. In particular, it is logical that risk allocation correlates to the capability to manage and control it. Greater clarity on identifying and analysing risk within a complex business model will be helpful, including the examples. However, some businesses will be concerned by the compliance burden that may arise from the requirement to identify ‘options realistically available’ for every intra-group commercial transaction undertaken, especially in relation to ‘straightforward’ situations.

Recharacterisation of transactions remains a source for considerable concern given the difficulties in ensuring that two or more tax authorities agree (i) that recharacterisation is appropriate and (ii) what the alternative transaction for transfer pricing purposes should be. In transactions that involve capability and functionality in two countries, it will be difficult to determine the outcome, and there will be a high degree of subjectivity. This measure does not sit easily with the self-assessment basis for transfer pricing, together with penalties, operated by many countries. It would be helpful to require competent authority agreement before recharacterisation in order to assist with the prevention of double taxation.

The special measures under consideration relate to a narrow range of circumstances, some of which will arise only rarely. Considerable further work will be needed to ensure these are consistent with the outcome from other BEPS work, and in particular to ensure that double taxation is effectively resolved.

## Determining intra-group transactions, including in relation to risks

The Discussion Draft proposes a replacement of the section of the OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* in relation to determining transactions between related parties requiring pricing, and includes a number of examples. Whilst **contractual arrangements** are the starting point for considering transactions, it is the **conduct** of the parties that will be determinative. This is consistent with the OECD’s work in relation to the transfer pricing of intangibles. It is also consistent with the arm’s length principle in that commercial contracts between unrelated parties would be interpreted in the same way. The Discussion Draft says that transfer pricing applies also to transactions (transfers of value) that the group has not identified and which are therefore not subject to contractual terms. Examples may include know-how, technical assistance or synergies created by deliberate concerted action.

As well as identification of transactions, the Discussion Draft increases the emphasis on the importance of determining **economically relevant characteristics** of transactions that would be taken into account by third parties, and the need to include how the functions relate to the **wider generation of value by the multinational** group. As part of this analysis it would be necessary to consider the **options realistically available** to the group companies if they had been acting at arm's length. In particular, the Discussion Draft considers the difficulties that may arise in relation to **highly interdependent functions** carried out by fragmented parts of a group in order to achieve efficiencies or specialisation, and that these fragmented functions may require a separate coordination activity elsewhere.

The Discussion Draft emphasises that **identifying risks** is a critical part of a transfer pricing analysis and goes hand in hand with identifying functions and assets. The difficulties of identifying risks are noted, in particular in relation to intra-group transactions which, because of common control, may lack the divergence of interests between third parties. **Conduct** of the companies in relation to risks will determine the transactions to be priced, and the Discussion Draft emphasises that the **ability to control risk** is, between third parties, a critical factor. Control over risk is defined as the capability to make decisions to take on risk and whether/how to respond to risks. The Discussion Draft sets out a framework for analysing risk, taking into account:

- The nature and source, contractual allocation and impact of risks;
- How each risk is managed and borne within the group, whether in operating companies, by a separate company managing risks, or by a separate company that assesses, monitors and directs risk mitigation; and
- The transactions undertaken and the conduct of group companies relative to operational and contractual arrangements.

The Discussion Draft specifically asks for comments in relation to the lack of incentive to guard against risks when a group company is protected from the consequences, the risk-return trade-off in the context of operations within a group, and whether general concepts as set out in the Discussion Draft can and should be applied (with or without modification) to the financial services sector where risk is a core component of trade.

There is detailed additional guidance on sources of commercial risk including strategic or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and 'hazard' risks (eg adverse external events such as natural disasters), together with examples of the potential impact of risk. The Discussion Draft also considers risk management activities and the importance of determining where in the group capability and functionality exists to manage risks associated with business opportunities. In particular, consistent with the work on transfer pricing of intangibles, if an asset owner does not have the capability to control risks associated with the exploitation of an asset, the legal owner is considered in substance to only be providing financing equating to the cost of the asset. Similarly, financial capacity to bear risk is a relevant but not determinative factor in considering whether to allocate a risk return. A transfer of risk not supported by functions should be critically reviewed, and a risk transfer is likely to happen only if the transferee is well or better placed to manage risk than the transferor. A group company that does not control risk will not be allocated it and will not be entitled to unanticipated profits/losses.

## Recharacterisation ('non-recognition') of taxpayers' transactions

The Discussion Draft sets out new circumstances in which actual transactions may be disregarded by tax authorities for transfer pricing purposes. The test is whether transactions have the **fundamental economic attributes of arrangements between unrelated parties**. The Discussion Draft suggests group companies should have a

**reasonable expectation to enhance or protect their commercial or financial positions** compared to **other options realistically available** to them. A relevant consideration would be whether the multinational group would be worse off overall on a pre-tax basis.

The Discussion Draft recognises that recharacterisation is contentious because it can be a source of double taxation and dispute. It is recommended that **'every effort'** be made to determine the actual nature of the transaction (taking into account contractual arrangements and conduct) and apply arm's length pricing to it, and just because a transaction may not be seen between third parties does not mean that it should not be recognised.

Once the criteria for recharacterisation have been met, the assumption for transfer pricing purposes should be that there is an **alternative transaction** that gives the group companies the opportunity to enhance or protect their commercial or financial position. This replacement should compare as closely as possible to the commercial reality of independent parties in similar circumstances.

## Potential special measures

The Discussion Draft considers circumstances where it may be necessary to apply 'special measures' either within or beyond the arm's length principle to prevent BEPS. The Discussion Draft asks a number of questions and notes that significant design work will be required. There is a close interaction with other BEPS Actions, notably Action 3 on strengthening CFC rules and Action 4 on interest deductions. Further consideration will also be given to prevention of double taxation. Special measures are proposed in relation to:

**Hard-to-value intangibles** sold for a lump sum where projections and robust analysis are not made available;

**Inappropriate returns for providing capital** by reference to a hypothetical 'independent investor' test or 'thick' capitalisation by reference to capital ratios;

**Minimal functional entities** which lack the functional capacity to create value and rely on a framework of arrangements with other group companies leading to a mandatory profit split or CFC-style apportionment; and

**Ensuring appropriate taxation of excess (low-tax) returns**, including a primary CFC rule and a secondary rule to allocate taxing rights to other jurisdictions.

## Timetable

Comments are invited by 6 February 2015. A public consultation meeting will be held on the Discussion Draft at the OECD in Paris on 19-20 March 2015. Registration details will be published on the OECD website in due course.

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