Deloitte.

Global Transfer Pricing

Arm's Length Standard

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In this issue:

OECD Issues BEPS Transfer Pricing Discussion Drafts

The Organization for Economic Cooperation and Development issued four public discussion drafts on transfer pricing topics during the week of December 15-19. This Special Edition of the Arm's Length Standard contains an analysis of the drafts prepared by Deloitte's Global Transfer Pricing group.

The discussion drafts – on risk, recharacterization, and special measures, the use of profit splits in the context of global value chains, dispute resolution mechanisms, and the transfer pricing aspects of cross-border commodity transactions – address some of the 15 actions in the OECD's Action Plan on Base Erosion and Profit Shifting, published in July 2013.

The OECD also released a discussion draft issued under Action 4 of the BEPS Action Plan, which calls for limiting base erosion via interest deductions and other financial payments. This discussion draft is a consultation document that seeks input on key issues concerning the design of rules to address base erosion and profit shifting using interest deductions and other financial payments. Action 4 calls for the development, among other things, of transfer pricing guidance "regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements." However, that transfer pricing guidance is not dealt with in the discussion draft.

The discussion draft on risk, recharacterization, and special measures includes a proposed revision to Section D of Chapter I of the transfer pricing guidelines emphasizing the importance of accurately delineating the actual transactions, and includes guidance on the relevance and allocation of risk. The draft proposes a new section that would permit the non-recognition of certain intercompany transactions. The draft also sets out options for some special measures, but stresses that those proposed measure have been only broadly outlined, and that significant design work would still be needed as the measures are further considered.
URL: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-tp-guidelines-risk-recharacterisation-special-measures.htm

The discussion draft on the use of profit splits in the context of global value chains examines eight scenarios in which it may be more difficult to apply one-sided transfer pricing methods to determine transfer pricing outcomes that are in line with value creation, and in which the application of a transactional profit split method may be appropriate. These scenarios provide the context for the OECD to pose questions on the application of the transactional profit split method. The responses to those questions will inform the OECD's revisions to the guidance on the use of the transactional profit split method in Chapter II of the transfer pricing guidelines.
URL: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf

A discussion draft issued under Action 14 (make dispute resolution mechanisms more effective) of the BEPS Action Plan adopts four organizing principles:
URL: http://www.oecd.org/ctp/dispute/discussion-draft-action-14-make-dispute-resolution-mechanisms-more-effective.pdf

- Ensuring that treaty obligations related to the mutual agreement procedure are fully implemented in good faith;
- Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes;
- Ensuring that taxpayers can access the mutual agreement procedure when eligible; and
- Ensuring that cases are resolved once they are in the mutual agreement procedure.

The draft then identifies 22 obstacles to the resolution of treaty-related disputes through the mutual agreement procedure (MAP) mechanism, and presents 34 options to address those obstacles.

The discussion draft on the transfer pricing aspects of cross-border commodity transactions proposes additional guidance clarifying that that quoted or publicly available prices can be used under the CUP method and the adoption of a deemed pricing date for commodity transactions between associated enterprises in the absence of evidence of the actual pricing date agreed by the parties to the transactions.
URL: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-commodity-transactions.pdf

The OECD has invited interested parties to submit comments on the discussion drafts by February 6, 2015, with the exception of comments on the dispute resolution discussion draft, which are due on January 16.

Deloitte's Transfer Pricing practice will be hosting three webcasts to discuss the discussion drafts in depth. Sign up for these complimentary webcasts:

- Americas Dbrief – New Proposed Changes to BEPS Transfer Pricing Rules: Risk, Recharacterization, and Profit Splits, January 28, 2:00 PM ET
  URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/january/dbriefs-new-proposed-changes-to-beps-transfer-pricing-rules-risk-recharacterization-profit-splits.html
- EMEA Dbrief – BEPS: Risk, Recharacterization, Special Measures, and Profit Splits, January 29, 12:00 PM Greenwich Mean Time
  URL:
  https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=3731&eventid=921228&sessionid=1&key=31288C13E46ABDECAF96641C6603FDB3
- Asia/Pacific Dbrief – OECD/G20 Discussion Drafts on Risk, Recharacterization, and Profit Splits, January 30, 2:00 PM Hong Kong time.
  URL:
  https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=1168&eventid=923474&sessionid=1&key=75DE74E746624059052EA355A1E1AFBE

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BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterization, and Special Measures)

The Organization for Economic Cooperation and Development on December 19, 2014, issued a non-consensus public discussion draft proposing changes to Chapter I of the transfer pricing guidelines.

The discussion draft addresses BEPS Actions 8, 9, and 10, which concern the development of:

1. "Rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation."
2. "Rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterized."
3. "Transfer pricing rules or special measures for transfers of hard-to-value intangibles."

The discussion draft is divided into two parts, each containing examples.

Part I contains a proposed new draft to replace Section D of Chapter I (Guidance for Applying the Arm's Length Principle) of the OECD transfer pricing guidelines. It increases the emphasis on identifying whether the substance of a transaction is consistent with the contractual relationships by broadly focusing on the economic circumstances of the commercial and financial relations between the parties, as well as enhancing the detailed guidance on performing a functional analysis. A new section on identifying risks in the commercial and financial relationships between the parties has been added. This new material focuses on managing and controlling risk, similar to the emphasis in the revisions to Chapter VI of the transfer pricing guidelines on intangibles, and significantly decreases the importance of contractual allocations of risk.

Part I concludes with new guidance on nonrecognition or recharacterization of the actual transaction that has taken place. This part provides a new requirement that the transaction must possess the fundamental attributes of arrangements between unrelated parties. The example illustrates a transaction that leaves the group worse off on a pre-tax basis and concludes that the transaction lacks the fundamental attributes of an arrangement between unrelated parties, even though many other arm's length elements of the transaction are present.

Part II of the discussion draft sets out options for "special measures." These are circumstances when the guidance might abandon the arm's-length principle to create a simple shortcut to assert a particular allocation of profit. The discussion draft contains five options for which comments are requested. Specific language implementing the options is not provided.

Comments are requested from interested parties by February 6, 2015. There will be a meeting to discuss the proposals March 19-20, 2015.

Guidance on identifying commercial and financial relations

The redrafted Section D of Chapter I proposes that the economically relevant characteristics or comparability factors can be broadly categorized as follows:

- The contractual terms of the transaction.
- The functions performed by the parties to the transaction, taking into account assets employed and risks assumed and managed, including how those functions relate to the wider generation of value by the multinational group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
- 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 second bullet point represents the primary difference between the discussion draft and the current guidance.

The discussion draft emphasizes the conduct of the parties, not their contractual arrangements, in analyzing the functions actually performed, the assets actually employed, and the risks actually assumed.

The discussion draft states that the functional analysis should determine how value is generated by the group as a whole by focusing on the capabilities and contributions of each party to value creation. The functional analysis should identify the economically significant activities and responsibilities undertaken, assets used, and risks assumed and managed by each of the parties. This enhanced functional analysis is intended to play a significant role in determining who bears risk, the characterization of the transaction, and whether profit split is the best method.

The discussion draft expands upon the need to consider other options realistically available to the parties in deciding whether the transaction entered into – rather than an alternative transaction – best meets the commercial objectives of the parties, in part, by requiring an examination of the capabilities of the parties.

The discussion draft states that MNE groups may fragment activities into separate group companies that are dependent on central control and coordination to operate effectively. In such a situation, the functional analysis should identify the nature of the interdependencies and how the commercial activities are coordinated. This issue is also important in the discussion draft on profit splits that was also issued in December 2014. (For coverage of the profit splits discussion draft, see our article in this issue of the *Arm's Length Standard*).
URL: http://newsletters.usdbriefs.com/2015/Tax/ALS/150112_3.html

The discussion draft's emphasis on value creation and realistic alternatives could lead to controversy. Both terms could be susceptible to multiple interpretations. For example, what is value? Is value income, competitive advantage, synergies, economic power, asset ownership, or some other measure of value? Similarly, when is an alternative realistic? Does it mean that the parties must review all possible permutations of the transaction and chose only the transaction that maximizes some unknown quantum decided by the tax authorities?

The new guidance extends the concept of 'transactions' to include circumstances in which value is given even though the parties may not have recorded or intended a transaction. Examples are: when technical assistance has been granted, synergies have been created through deliberate concerted action, or know-how is provided through seconded employees. The creation of synergies is also discussed in the discussion draft on profit splits. The discussion draft notes that these transactions are unlikely to be formalized in contracts and they may not appear as entries in the accounting systems, but the process of functional analysis should consider these transactions.

Identification and allocation of risk

The discussion draft emphasizes that identifying risks is a critical part of a transfer pricing analysis, and goes hand in hand with identifying functions and assets. The discussion draft notes that there are difficulties in identifying risks in related-party contracts because many intercompany agreements may lack the divergence of interests that inevitably occurs between unrelated parties and, therefore, the contracts may be less explicit on many risk and risk management issues. The discussion draft states that the conduct of the entities and not the contractual arrangements will determine the transactions to be priced and the allocation of risk between the parties. The discussion draft emphasizes that the ability to control risk is, between third parties, a critical factor in deciding which party enjoys the reward, or suffers the consequence of controlling that risk. 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 analyzing 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 in managing risk relative to operational and contractual arrangements.

In this aspect, the draft follows the same path as has been used in the draft Chapter VI, transfer pricing of intangibles. Greater clarity on identifying and analyzing risk within a complex business model, including the additional examples, will indeed be helpful.

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 (for example, adverse external events such as natural disasters), together with examples of the potential impact of risk. The discussion draft states that a company’s ability to manage externally driven risk or general business risk is as important as internal risk and is likely to be a source of competitive advantage. The functional analysis should identify (1) these sources of risk, (2) the entity or entities that respond to and manage these risks, and (3) the impact of risk on value creation.

The discussion draft discusses risk management activities and the importance of determining where in the group the capability and functionality exists to manage risks. Risk management comprises both the capability along with the decision making function in three areas: (1) ability to make or decline risk-bearing opportunities; (2) ability to respond to risks as they arise; and (3) ability to employ risk mitigation strategies. The discussion draft states that simply providing a manufacturer with a cost plus or a distributor with a fixed operating margin does not address who performs the risk management activities and who should be compensated for those activities. Rather, the actual conduct of the parties as determined by the functional analysis will control.

The discussion draft states that at arm’s length the mere contractual allocation of risk without the ability to control risk is not likely to occur and, therefore, the mere contractual allocation of risk will not support a risk transfer for transfer pricing purposes. The discussion draft takes the position that among arm’s length parties there may be limited opportunities to transfer core risks because arm’s length parties may be unwilling to share insights on core competencies with third parties and, therefore, their willingness to take on risks related to core competencies will be limited. The discussion draft refers to the principles discussed in this paragraph as “moral hazards” and has requested comments on the role moral hazards should play in the allocation of risk between related parties.

The discussion draft takes the position that just because risks can be transferred does not mean that they would be transferred at arm's length. The discussion draft states that trading a more certain or lower risk return for a less certain or higher return, the "risk-return-trade-off," should not be used by itself to justify the appropriateness of the risk transfer. Rather, such a transfer is likely to take place only if the transferee is well placed or better placed to manage risk than the transferor. The discussion draft requests comments whether, under the arm's length principle, transactions should be recognized if the sole purpose is a risk-return shift. See also the discussion below on non-recognition of transactions.

The discussion draft recognizes that determining the allocation of risk and risk management between related parties is only the first part of a transfer pricing analysis. The second and equally important part is determining how the benchmarks or comparables allocate risk and risk management, compared to the tested party. The discussion draft recognizes that with respect to many routine transactions the benchmarks or comparables may have a similar risk profile and risk management activities. Distributors are used as an example. Additional examples and further elaboration would be helpful, because for many activities the benchmarks or comparables incur and/or manage risks similar to the tested party. In those cases, adjustment for risk or additional compensation for risk management activities would not appear to be required, because the return to the assumption and management of risk is already included in the results of the benchmarks or comparables.

Nonrecognition and recharacterization

The discussion draft sets out new circumstances in which actual transactions may be disregarded by tax authorities for transfer pricing purposes. To date, the guidance allows for the disregarding or recharacterization of actual transactions in only very limited circumstances:

1. The substance of the transaction differs from its form; or
2. The transaction differs from transactions between unrelated parties and the actual structure practically impedes determination of an appropriate transfer price.

Current guidance points to the dangers of pricing something other than the actual transaction, something with which many agree.

The discussion draft states that there is a need for nonrecognition because MNEs can fragment their operations into multiple entities with the knowledge that the consequences of allocating assets, functions, and risks to separate legal entities is overridden by control. Therefore, a transaction should be respected for transfer pricing purposes only if it has the "fundamental economic attributes of arrangements between unrelated parties and commercial rationality." The discussion draft suggests that in entering into a transaction each group company should have a reasonable expectation to enhance or protect its own commercial or financial positions, compared to other options realistically available to them. A relevant consideration would be whether the multinational group would be better or worse off overall on a pre-tax basis.

A new example illustrates the nonrecognition concept. In the example, S1 owns a valuable trademark it uses in its business and engages in extensive marketing to enhance and promote the trademark. S1 sells the trademark to S2, a company in a low-tax jurisdiction, for $400 million. S2 employs individuals who have the capabilities to assess, monitor, and direct the use of the trademark. S2 also enters into a contract with S1 to provide extensive marketing that will enhance and maintain the trademark. The royalty to be paid by S1 to S2 will provide S2 with a financing return. S2 has no ability to exploit the trademark other than its contract with S1. The costs incurred by S2 are considered duplicative of the costs incurred by S1, but will be more than offset by the tax savings. The example concludes that S1 has not enhanced its commercial interest by entering into the transaction and would have been better off by not entering into the transaction. Therefore, the transaction lacks the fundamental economic attributes of arrangements between unrelated parties and should not be recognized. The example concludes that the trademark should be considered to be owned by S1.

It is likely that this new approach to nonrecognition will garner significant comment, possibly including the following themes:

- The approach is likely to increase uncertainty, controversy, and potentially double tax since even under the arguably stricter approach previously adopted, experience of tax audits for business reorganizations or asset sales shows that recharacterization is routinely suggested, and this approach is likely to increase the number of those controversies;
- S1 may have substantially increased its commercial and financial position by freeing up cash to invest in other activities and reducing its cost of capital, considerations not included in the example's analysis and therefore be better off;
- Tax authorities could take many paths to recharacterizing a nonrecognized transaction, which could make transfer pricing documentation challenging and lead to the possible imposition of documentation or other penalties.
- The proposal is contrary to the conclusion reached in the proposed guidance in Chapter VI. The analysis in Chapter VI leads to the conclusion that S2 does own the intangible (i.e., not ignoring the actual transaction) but the payment by S2 to S1 would result in the majority of intangible related return arising in S1. Hence, the 'appropriate' intangible return is achieved under proper application of the arm's length principle without resorting to nonrecognition or recharacterisation of the actual transaction.

Potential special measures

The question whether there is a need for "special measures" either within or beyond the arm's length principle to prevent BEPS was raised at the commencement of the BEPS project. At that time, there was concern that application of the arm's length principle permitted base erosion and profit shifting in some circumstances, particularly in the context of intangibles and centralized business models. Those questions were raised before work on interrelated actions – including Action 3 (strengthen CFC rules), Action 4 (interest deductions), Action 8 (intangibles transfer pricing) and Actions 9 and 10 (transfer pricing risk and capital) had progressed. Given those proposed changes, it is possible that the proper application of arm's length transfer pricing principles, together with other proposed changes, means that special measures are not required. Adoption of special measures would amount, in those limited circumstances, to the abandonment of the arm's length principle and the adoption of an alternate form of profit apportionment. This may be a backward step for the application of the arm's length principle, which, while challenging at times, has achieved in most situations the elimination of potential double taxation over many years.

Nonetheless, the discussion draft suggests that special measures may be needed to eliminate any residual BEPS risk because of information asymmetries between taxpayers and administrators, and the relative ease with which MNEs can allocate capital to low-taxed, low-functioning entities.

The discussion draft considers circumstances where it may be necessary to apply special measures to prevent BEPS. It then poses a number of questions commenters are asked to consider. The discussion draft notes that significant design work will be required if such steps are to be taken, and notes that further consideration will also be given to the prevention of double taxation.

The discussion draft proposes special measures for:

- Hard-to-value intangibles sold for a lump sum when contemporaneous robust projections and analysis are not made available to tax authorities. The discussion draft suggests either requiring the taxpayer to prove the robustness of its projection, or adoption of a U.S.-style commensurate with income provision. The clear danger here is that tax authorities that do not accept the arm's length standard may use hindsight to assert that the conditions for application of the special measure are met.
- Inappropriate returns for providing capital by reference to a hypothetical "independent investor" test or "thick" capitalisation by reference to capital global ratios. However, this may be unnecessary in light of work on Action 4, dealing with interest deductions, and Action 8, dealing with intangibles.
- Minimal functional entities that 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 controlled-foreign-corporation-style apportionment. However this might be unnecessary once the transfer pricing guidelines are amended as a result of Actions 8, 9, and 10.
- Ensuring appropriate taxation of excess (low-tax) returns, including a primary CFC rule and a secondary rule to allocate taxing rights to other jurisdictions. Again, this might be unnecessary in light of amendments to the transfer pricing guidelines as a result of Actions 8, 9, and 10 and the tightening of CFC rules under Action 3.

Conclusion

The discussion draft is not a consensus document, and there are indications that not all governments have fully embraced the direction taken by the discussion draft. The OECD recognizes that there may be alternative views, and has requested comments on several controversial concepts, such as the notion of moral hazards and the risk-return-trade-off which permeate the new discussion on risk and lead to the inclusion of the nonrecognition section. Companies should review the discussion draft carefully and make any concerns known to the OECD.

Deloitte will be drafting comments on the Discussion Draft. If you would like to discuss your concerns or the potential impact of the Discussion Draft on your company, please contact your local Deloitte adviser. Comments are due February 6, 2015.

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BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains

The OECD on December 16th issued a non-consensus discussion draft on the use of profit splits in the context of global value chains in connection with Action 10 of the Action Plan on Base Erosion and Profit Shifting (BEPS) to develop "rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to…(ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains."

The discussion draft does not contain specific proposed modifications to the OECD's transfer pricing guidelines, but rather, presents eight scenarios whereby the profit split method could potentially be applicable, and solicits comments from interested parties to elaborate on these scenarios regarding the relative reliability of such methods. The eight scenarios reflect many of the themes in the proposed changes to Chapter VI of the OECD's transfer pricing guidelines on intangibles and Chapter I on risk. The discussion draft is an attempt to define an applicable transfer pricing method, if rights to intangible returns are split between the developer and others under Chapter VI or the multinational enterprise's operations are determined to be integrated and interdependent, which creates valuable synergies, as suggested in the proposed revisions to Chapter I.

To date, taxpayers' unilateral use of profit splits has been confined for the most part to a narrow set of circumstances or to situations in which taxpayers obtain government agreement as part of an advance pricing agreement or mutual agreement procedure. The fact that no language has been proposed may suggest that governments are struggling to find an approach that would enable profit splits to be reliably applied in a broader, more general context. It also may reflect the concerns of some countries regarding the direction of the changes in Chapters I and VI.

The discussion draft contains several scenarios in which the parties appear to have intended to share the operations and risks of the business, but leaves unanswered the question whether taxpayers in similar situations could have structured their business in a different way so that profit split is not the most reliable method. In the past few years, many businesses have structured their business using principal companies, or have employed cost sharing or other arrangements to avoid some of the perceived difficulties in applying the profit split method.

Importantly, the discussion draft does not suggest specific solutions to many of the issues that made profit splits challenging for MNEs to apply, including:

- The lack of comparable or transactional profit splits;
- Allocation keys to split profits that do not end up being simply a form of formulary apportionment;
- Determining the income and expenses to derive the profits to be split;
- Treatment of losses;
- Creation of partnerships for tax and commercial purposes;
- Reduction in the protection of the rights afforded to separate entities with respect to creditors;
- Splitting profits between more than two entities and the impact of transfer pricing adjustments to routine entities on participants splitting profits.

The discussion draft requests comments on how to address many of these concerns; others are unaddressed.

Method selection

Consistent with proposed guidance in Chapter VI, the discussion draft cautions that one-sided methods, including the comparable uncontrolled price (CUP) method and the transactional net margin method (TNMM), are generally not reliable methods for intangibles transactions. The discussion draft asks whether the applicability of the profit split methods can be expanded beyond intangibles to include routine transactions that may take place in a “highly integrated” business model, in part because independent comparable companies performing a single activity cannot provide the same level of integration with a company’s operations as a wholly owned subsidiary. For example, it is stated that a comparable company providing only warehousing, logistics, sales, or marketing activities could not provide the same level of integrated service as a wholly owned subsidiary providing the same service but in combination with other wholly owned subsidiaries. Some will question the validity of this statement.

Specifics of OECD guidance on profit split methods

Below we describe briefly each one of the scenarios in the discussion draft.

Value Chains

In Scenario 1, three controlled manufacturers located in the same region with similar capabilities coordinate their product offerings and investments through a Leadership Board on which all three are represented. This scenario assumes that all IP licensing and tangible product transactions can be analyzed using other methods. The Leadership Board effectively creates a three-way controlled “transaction” that the discussion draft appears to suggest can only be analyzed using the profit split method. Although a profit split may appear reasonable in this factual situation, it may be possible that the MNE group did not structure the transaction as described above, but rather as a more typical principal/contract manufacturing structure, and the tax authorities, after performing a detailed functional analysis, determined that the “substance” of the parties’ activities was better described as above than as the MNE group had structured the transaction. See the discussion draft on risk and recharacterization.

Even if a profit split method is applied to determine target profit levels for each enterprise, the results of the profit split would still need to be reflected in the individual transactions among the entities as payments for goods or services. Otherwise, the profit split approach may lead to a virtual partnership, with tax and legal business liability implications extending beyond transfer pricing.

Multisided Business Models

In Scenario 2, the discussion draft offers the example of an MNE in which Company A offers advertising services and related technologies, such as targeting and user interfaces to clients, charging a fee to the client per click on hosted advertisements. Company B offers free online services to end-user customers and gathers information on their behavior, location, and personal information, which is used to enhance the value of the advertising sold by Company A.

Many may question whether the activities of Company A are fundamentally different than the activities of comparable companies or that the services Company A provides are fundamentally more valuable than the services of third parties because of integration with or the control that Company B exercises over Company A.

Unique and Valuable Contributions by a Distributor

The discussion draft discusses the application of the transactional profit split method in scenarios in which both parties make “unique and valuable contributions.” Scenario 3 presents the example of a distributor whose “activities constitute a key source of competitive advantage for the Group” because the distributor:

- Develops very close relationships with customers;
- Provides on-site services;
- Carries an extensive stock of spare parts;
- has a highly proactive maintenance program to detect likely problems before they arise; and
- Provides extensive advice to customers on equipment choice, makes modifications for particular local conditions, and for maximizing performance efficiency and effectiveness of the customer’s operations.

As part of this scenario, the discussion draft asks whether the definition of “unique and valuable contributions” in Chapter VI intangibles guidance should be expanded to include the activities defined above. Some may question why comparable independent distributors in similar industries cannot be found that provide similar activities.

Integration and Sharing of Risks – Joint Development of Intangibles

The discussion draft argues that in addition to integrated value-added functionalities, some MNEs operate in a manner that shares significant business risks, which should also be compensated but may be difficult to analyze without a profit-split methodology. In Scenario 4, Company A develops a complex technological product and outsources development of certain critical components to related entities, Companies B and C. All entities are required to conduct intensive research and development to develop their respective components, and each bears the potential for failure. Thus, the risk of the final product is shared among all entities. In this case, the application of the profit split method appears to be predicated on the taxpayer's choice to jointly develop the intangibles and spread the product development risks among three legal entities. A profit split method may more reliably align with the taxpayer's desire to share intangible development costs and risks among the three entities. However, the parties may not have structured the transaction as described above. Company A may have entered into a contract research agreement with Companies B and C but failed to manage and control the "important functions" described in the proposed revisions to Chapter VI and, therefore, the tax authorities in Countries B or C may have concluded that in substance the transaction is more like the transaction described in this example than a contract research structure.

Fragmentation – Limited Functional Entities: The discussion draft notes, without providing a scenario, that occasionally in the operation of a complex MNE, necessary functions may be fragmented among multiple subsidiaries, such as separation of distribution activities into specialized activities such as logistics, warehousing, marketing and sales, etc. The guidance notes that it may be difficult or impossible to find comparables for such specialized functions, and thus a transactional profit split method may be appropriate.

An MNE may require the services of multiple entities, performing routine functions, but it is unclear why the MNE would not be able to attribute reliable returns to those entities based on the profitability of functionally similar independent companies through a reliable application of the TNMM. In fact, one may argue that independent companies provide more functions, for example sales and marketing activities, and are subject to more risks than related companies.

Lack of Comparables for Distributors Sharing Regional Customers

In Scenario 5, the discussion drafts asks how reliable comparables may be found for a group of controlled distributors that generate both wholly local business and regional-level business for all companies within the region by developing relationships with large customers spanning the region. This is a common fact pattern that some taxpayers address through the use of "cost sharing" arrangements whereby the cost of maintaining relationships with global customers are shared among the companies that make sales to such global customers in proportion to reasonably anticipated benefits. Other alternatives may achieve similar results.

Use of the TNMM range in connection with profit split: In Paragraph 32, the discussion draft attempts to reconcile the TNMM with a profit split. The discussion draft suggests that taxpayers could adopt a policy that varies distributor returns within the TNMM range as the global profitability of the enterprise increases or decreases, allowing for some flexibility.

Aligning Taxation with Value Creation

The discussion draft notes that the OECD, as part of the BEPS Action Plan, is attempting to revise its rules to align taxation with value creation. The draft notes that a common criticism of allocation key techniques used in profit split methodologies is the difficulty in verifying the accuracy of such keys. The discussion draft refers to the first example of the three manufacturers operating in the European market, and assumes that any post-royalty residual profits are split between the three controlled manufacturers based on three factors: production capacity, headcount, and value of production, which are intended to reflect capital investment, labor, and the contribution to actual output, respectively. To some, this would appear reasonable, but there is a consideration that this example is rarely seen in the real world. One concern is that any set of allocation keys adopted in tightly drawn examples could be used in factual patterns that are not so tightly drawn. In other fact patterns, such an allocation could resemble formulary apportionment. Also, the suggested profit split approach among these entities may give rise to a partnership.

RACI Matrix: In Scenario 6, the discussion draft questions whether a qualitative functional analysis can be converted to a more scientific profit split by using a responsibility assignment matrix that assigns each entity to one of the following four levels for each function:

- R: Responsible
- A: Accountable
- C: Consulted
- I: Informed.

The discussion draft concedes that RACI does not consider risks and assets separately, but rather assumes that they are aligned with the functions. The RACI analysis is applied to "each of the group's key value drivers." The scenario neither enumerates the key value drivers considered, nor how the RACI matrix can be calculated to arrive at profit shares.

Ex Ante **vs.** ***Ex Post*** **Results**

The discussion draft notes that sometimes there are significant differences between *ex ante* and *ex post* results. In those cases, a profit split method can determine from the outset how parties will determine the share of uncertain outcomes.

In Scenario 7, two related enterprises agree to assume responsibility for the development of the two key components of a product. They agree to share residual profits on a 30-70 basis, based on the relative size of projected development costs. However, each party assumes its own development cost overrun risks. Therefore, the actual development costs would not necessarily be split on a 30-70 basis between the parties. The discussion draft solicits comments on how to deal with unanticipated events or results in applying a transactional profit split.

In Scenario 8, the discussion draft notes that sometimes profit split methods can be used on an ex-ante basis to determine arm's length royalties. In this scenario, Company P conducts the basic R&D for a product, with subsidiary Company S performing marketing activities and some late-stage development. Risk-weighting the expenditures using development stage success rates, the costs and consequently the profits are split 80-20. P's expected profit is then converted to a royalty rate. However, depending on how much actual sales differ from projected sales, the transfer pricing policy of a royalty rate may result in a different split of profits than was originally indicated by the profit split method.

The discussion draft acknowledges that a direct application of a profit split method based on actual profits would require "end of year calculations to true-up the profits to equate to the profit split ratio," and this may create administrative compliance issues. The draft asks about the pros and cons of allowing a royalty implementation of a profit split method.

Losses

The existing OECD transfer pricing guidelines note that references to "profits" should be applied equally to "losses," however, the discussion draft includes a scenario whereby profit split methods may be applied differently when losses are split rather than profits.

In Scenario 9, a banking group trades a structured financial product through an integrated model in different time zones. Profits are allocated using a profit-split method that places the greatest weight on compensation to its traders, including bonus performance. However, there may be significant losses, and the correlation between bonus compensation and loss will not be equivalent to the correlation between bonus compensation and profit in profitable times. Consequently, the methodology includes adjustments when losses are incurred, based on analysis of the compensation policy and the circumstances in which losses are incurred.

Question 31: Concerns regarding availability of financial data

The discussion draft asks whether the concerns expressed in the OECD transfer pricing guidelines regarding the reliability of profit split methods remain valid. These concerns are summarized as follows:

- Accessing Foreign Data: "Associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates."
- Measuring Consolidated Profits: "It may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies."
- Segmented Operating Expenses: "When the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities."

Experience suggests that for many companies these concerns remain.

Conclusion

Profit splits generally have been used unilaterally by MNEs in a few defined situations in which the structured economics of the transaction clearly called for a profit split, and in advance pricing agreements and other situations directly involving a government's consent. The discussion draft clearly illustrates the challenges of reliably applying the profit split method on a more general basis to a broader range of potential transactions.

The use of profit split as the most reliable method in many cases discussed in the draft is based on the assumption that one-sided methods are not reliable because adequate comparables do not exist due to the integrated, interdependent, synergistic operation of many MNEs. This issue goes to the heart of the application of the arm's length standard, and is likely to be the subject of vigorous debate in the context of this discussion draft and the discussion draft on risk and recharacterization.

Comments on the discussion draft are due to the OECD by February 6, 2015.

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BEPS Action 14: Make Dispute Resolution Mechanisms More Effective

The Organization for Economic Cooperation and Development on December 18, 2014, released a public discussion draft pursuant to Action 14, "Make Dispute Resolution Mechanisms More Effective," of the Action Plan on Base Erosion and Profit Shifting. The Action Plan recognizes that the actions to counter BEPS must be complemented with actions that ensure certainty and predictability for businesses, and Action 14 – "Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under [the mutual agreement procedure] MAP, including the absence of arbitration provisions in most treaties and that fact that access to MAP and arbitration may be denied in certain cases" – an important component of this recognition, should be readily welcomed by taxpayers in the new uncertain BEPS world.

The discussion draft includes the preliminary results of the work carried out pursuant to Action 14 to identify the obstacles that prevent countries from resolving disputes under the MAP and to develop possible measures to address these obstacles. According to the discussion draft, it must be read in the broader context of the intention to introduce a three-pronged approach designed to represent a step change in the resolution of treaty-related disputes through the MAP. This three-pronged approach would:

1. Consist in political commitments to effectively eliminate taxation not in accordance with the OECD Model Tax Convention on Income and on Capital (such political commitments reflecting the political dimension of the BEPS project),
2. Provide new measures to improve access to the MAP and improved procedures (this discussion draft describes the envisaged measures) and
3. Establish a monitoring mechanism to check the proper implementation of the political commitment.

This three-pronged approach is intended first to take advantage of "political commitments" (by referencing the BEPS project) to encourage governments to make the recommended policy decisions and then to encourage governments to take specific measures to address potential obstacles. The third prong is an after-the-fact monitoring mechanism to ensure that the political commitments are achieved.

Importantly, the views and proposals included in the discussion draft do not represent the consensus views of either the Committee on Fiscal Affairs or its subsidiary bodies, but rather are intended to provide stakeholders with substantive proposals for analysis and comment. The discussion draft states that not all countries associated with the OECD/G20 BEPS project agree that mandatory and binding arbitration is an appropriate tool to resolve issues that prevent competent authority agreement in a MAP case.

Guiding principles

The discussion draft states that the work on Action 14 is expected to result in a political commitment to substantially improve the MAP process through the adoption of specific measures intended to address the obstacles that currently prevent the resolution of treaty-related disputes. The political commitment and the measures through which it will be implemented will be guided by the following four principles:

1. Ensuring that treaty obligations related to the mutual agreement procedure are fully implemented in good faith;
2. Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes;
3. Ensuring that taxpayers can access the mutual agreement procedure when eligible; and
4. Ensuring that cases are resolved once they are in the mutual agreement procedure.

For each of these principles, the discussion draft identifies obstacles to the resolution of treaty-related disputes through the MAP mechanism and presents options to address these obstacles.

Ensuring that treaty obligations related to the mutual agreement procedure are fully implemented in good faith: The discussion draft identifies two obstacles that may prevent the full implementation of Article 25 of the OECD model treaty.

First, the discussion draft notes that, although paragraph 2 of Article 25 provides that competent authorities “shall endeavor” to resolve a MAP case by mutual agreement, it has been argued that the absence of an “obligation” to resolve a MAP case is itself an obstacle to the resolution of disputes. The discussion draft therefore suggests that language could be added to OECD Commentary on Article 25 that states that “the undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith,” and that “the competent authorities are obliged to seek to resolve the case in a principled, fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law.”

Second, the discussion draft notes that some countries take the position that, in the absence of paragraph 2 of Article 25, they are not obligated to make corresponding adjustments or to grant access to the MAP with respect to the economic double taxation that may otherwise result from a primary transfer pricing adjustment by a treaty partner. The discussion draft offers a seemingly simple solution to address this issue by ensuring that paragraph 2 of Article 9 is included in tax treaties, using the multilateral instrument envisaged by Action 15, when appropriate.

Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes: The discussion draft recognizes that appropriate tax administration practices are important to ensure an environment in which competent authorities are able to fully and effectively carry out their mandate. Various obstacles can stand in the way of the effectiveness of the MAP process, including the lack of independence of the competent authority from a tax administration's audit or examination function, insufficient resources (lack of personnel, funding, training, etc.) or when the competent authority is evaluated based on inappropriate performance indicators. Further, competent authorities may not employ their authority under Article 25(3) to preempt potential disputes by reaching mutual agreement on matters of a general nature involving treaty interpretation or applications, countries may not have implemented bilateral advance pricing agreement (APA) programs, or countries may fail to consider the implications of a taxpayer's MAP or APA case for other tax years.

The discussion draft recognizes that field auditors in some countries may seek to influence taxpayers not to utilize their right to initiate the mutual agreement procedure, for example, by entering into a settlement with the taxpayer under which the tax authorities will agree not to apply penalties in return for the taxpayer's waiver of its right to seek MAP assistance, or by entering into a settlement with the taxpayer under which the tax authorities will agree to a lower audit adjustment in return for the taxpayer's waiver of its right to seek MAP assistance. In the authors' experience, options such as these are presented to taxpayers all too frequently during audits.

The OECD is working in parallel with the Forum on Tax Administration's MAP Forum (the FTA MAP Forum)[1] on administrative procedures that promote the prevention and resolution of treaty-related disputes. The FTA MAP Forum has recognized that audit programs not aligned with international norms with respect to either principle or procedure may significantly hinder the functioning of mutual agreement procedures. Audit practices are therefore a strategic focus of the FTA MAP Forum. The discussion draft notes that the results of the work on Action 14 and the work of the FTA MAP Forum will be complementary and mutually reinforcing.

The discussion draft presents a number of options to attempt to overcome the obstacles described. The majority of these options propose that participating countries commit to adopt certain best practices contained in the OECD Manual on Effective Mutual Agreement Procedures.[2] The discussion draft also provides the option that participating countries could commit to implement bilateral APA programs, and the implementation of procedures to permit taxpayer requests for MAP assistance with respect to recurring issues and the rollback of APAs. The authors welcome the options presented by the discussion draft, but recognize the inherent difficulty in getting countries to effect real changes to overcome many of these obstacles.

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[1] See the "Multilateral Strategic Plan on Mutual Agreement Procedures" A Vision for Continuous MAP Improvement" at: http://www.oecd.org/site/ctpfta/map-strategic-plan.pdf
[2] Available at: http://www.oecd.org/ctp/38061910.pdf

Ensuring that taxpayers can access the mutual agreement procedure when eligible: The discussion draft delineates eight potential obstacles that may prevent taxpayers from appropriately accessing the MAP or place an undue burden on taxpayers seeking MAP. The obstacles include complexity and lack of transparency of the procedures to access and use the MAP, excessive or unduly onerous documentation requirements to request the MAP, unclear access to MAP when domestic or treaty-based anti-abuse rules have been applied, cases in which a competent authority unilaterally considers that a taxpayer's objection is not justified, the interaction between domestic law remedies and the MAP, the potential financial issues associated with the requirement that the disputed tax be paid to access the MAP, time limits to access the MAP, and issues related to self-initiated foreign adjustments.

The discussion draft presents a number of options to attempt to overcome the obstacles described. These include:

- A commitment by countries to develop and publicize rules, guidelines, and procedures for the use of the MAP, and to identify the office that has been delegated the responsibility to carry out the competent authority function (along with contact details).
- A commitment by countries to identify the specific information and documentation that a country is required to submit with a request for MAP assistance, seeking to balance the burdens involved in supplying such information.
- Clarify the availability of MAP access when an anti-abuse provision is applied.
- A commitment by countries to a bilateral notification and/or consultation process when the competent authority to which a MAP case is presented does not consider the taxpayer's objection to be justified.
- Clarify the meaning of "if the taxpayer's objection appears to be justified" in the Commentary on Article 25.
- Amend Article 25(1) to permit a request for MAP assistance to be made to the competent authority of either contracting state.
- A commitment by participating countries to clarify the relationship between the MAP and domestic law remedies, including the publication of clear guidance on the relationships between the MAP and domestic law remedies.
- Clarify issues connected with the collection of taxes and the mutual agreement procedure, including potentially changing the commentary on Article 25 to address the suspension of collection procedures pending resolution of a MAP case.
- Clarify issues connected with time limits to address the mutual agreement procedure, including in their treaties the second sentence of paragraph 2 of Article 25 ("Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States").
- Changes to the commentaries on Articles 7, 9, and 25 to clarify the circumstances when double taxation could be resolved under the MAP in the case of self-initiated foreign adjustments.

Ensuring that cases are resolved once they are in the mutual agreement procedure: The discussion draft notes that some of the main obstacles to the resolution of treaty-related disputes through MAP are issues related to MAP processes, including lack of a principled approach to the resolution of MAP cases; lack of cooperation, transparency, or good competent authority working relationships; absence of a mechanism, such as MAP arbitration, to ensure the resolution of all MAP cases; issues related to multilateral MAPs and APAs; and issues related to consideration of interest and penalties in the MAP.

These obstacles are likely to become more prevalent as a result of the work on BEPS and the potential introduction of new tax treaty and transfer pricing rules.

The discussion draft explores various options to assist with overcoming these obstacles. Many of these center around adopting the relevant best practices currently included in the OECD Manual on Effective Mutual Agreement Procedures. The discussion draft also discusses the main policy and practical issues connected with MAP arbitration and options to address them. It is clear from reading the discussion draft that not all OECD countries intend to adopt mandatory binding MAP arbitration, and the options included attempt to address this by proposing that countries consider tailoring the scope of MAP arbitration to encourage countries to adopt a MAP arbitration provision with a limited scope rather than no provision at all, and the potential amendment of Article 25(5) to permit the deferral of MAP arbitration in appropriate circumstances. The discussion draft also requests specific comments on the preferred default form of decision-making in MAP arbitration (for instance, the independent opinion approach or baseball arbitration).

One of the long-standing key issues affecting taxpayers is the need for effective mechanisms to resolve multijurisdictional international tax disputes. While the discussion draft acknowledges the issue in light of the substantial increase in the pace of globalization and identifies situations in which multilateral situations can occur, the discussion draft does not fully develop options to address these issues. The discussion draft provides three examples of such multilateral situations:

1. Triangular cases (when an enterprise of State A transfers goods or services through its permanent establishment situated in State B to an associated enterprise situated in State C, and an adjustment to the transfer pricing of the transfer is made by the tax administration of State B);
2. Situations in which an adjustment in one state results in cascading adjustments in other states; and
3. Situations in which an entity that is a member of an MNE group performs certain functions for the benefit of a number of associated enterprises and different transfer pricing adjustments are made to the resulting charges in the various states of residence of these associated enterprises.

The discussion draft also requests that commentators provide other examples of multilateral situations that raise issues for the MAP.

Conclusion

The discussion draft in its opening remarks makes clear the OECD's observation that international tax and transfer pricing controversy has increased, and we infer its expectation that in the uncertain BEPS world, tax related controversy will continue to rise around the world. The discussion draft also appropriately notes that Action 14 represents a unique opportunity to remedy the existing cumbersome MAP, plagued with impediments and inefficiencies, on a broad, rather than treaty-by-treaty scale.

In light of this, the discussion draft on BEPS Action 14 should be welcome reading for taxpayers. As noted at the outset, the discussion draft states that it should be read in the broader context of the intention of the OECD to introduce a three-pronged approach designed to represent a step change in the resolution of treaty-related disputes through the MAP. The OECD expects that the work on Action 14 will result in a political commitment to substantially improve the MAP process through the adoption of specific measures intended to address the obstacles that currently prevent the resolution of treaty-based disputes, guided by the four principles described above.

The OECD has invited interested parties to submit comments on the discussion draft by January 16, 2015, and comments received will be made available to the public.

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BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions

The OECD on December 16, 2014, released *BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions*. The document outlines Working Party Number 6's considerations of transfer pricing issues that may arise from cross-border commodity transactions that may lead to base erosion and profit shifting.

The review is part of the Base Erosion and Profit Shifting (BEPS) Action Plan #10, which states that "work needs to be undertaken to develop 'rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to … (iii) provide protection against common types of base eroding payments.'"

In the discussion draft, Working Party Number 6 has proposed:

1. Insertion of additional guidance in Chapter II of the OECD's transfer pricing guidelines related to the appropriateness and application of the comparable uncontrolled price (CUP) method to analyze related-party commodity transactions; and
2. Research to be undertaken by the Tax and Development Program to identify common adjustments to quoted commodity prices to improve the reliability of quoted prices for use with the CUP method. The research will initially cover iron ore, copper, and gold.

The deadline for submitting comments on the discussion draft is February 6, 2015, and a public consultation regarding the discussion draft (and other topics) will be held March 19-20. The deadline for completion of Action Item #10 is September 2015.

CUP method

The OECD initiated its review of the transfer pricing issues related to related-party commodity (defined in the discussion draft as a “physical product for which a quoted price is used by independent parties to set prices”) transactions because countries have expressed concerns about base erosion and profit shifting from the following factors:

- The use of pricing date conventions that appear to enable adoption by the taxpayer of the most advantageous quoted price;
- Significant adjustments to the quoted price or the charging of significant fees to the taxpayer in the commodity-producing country by other group companies in the supply chain (e.g., processing, transportation, distribution, marketing); and,
- The involvement in the supply chain of entities with apparently limited functionality, which may be located in tax-opaque jurisdictions with nil or low taxation.

In response to the above, the OECD has proposed clarifications and additional guidance to be included in the transfer pricing guidelines. Specifically, the discussion draft proposes that additional guidance be added to the existing language in Chapter II to the effect that:

- The CUP method can be an appropriate transfer pricing method for commodity transactions between associated enterprises for which a quoted or public price is available;
- Quoted or publicly available prices can be used under the CUP method as a reference to determine the arm’s length price for the controlled commodity transaction; and
- The adoption of a deemed pricing date for commodity transactions between associated enterprises in the absence of evidence of the actual pricing date agreed by the transacting parties.

The discussion draft notes various sources of “quoted prices.” These include quotations from commodity exchanges, and from transparent price reporting or statistical agencies, or governmental price-setting agencies. Prices or indexes from reporting or statistical agencies may serve as a reference for an arm’s length price if they are used by unrelated parties. Use of indexes as a reference for arm’s length prices will likely require taxpayers to evaluate how indexes may be used, including how actual prices vary from the reference index, in negotiating commodity transaction prices with unrelated parties. In addition, the use of indexes as arm’s length benchmarks may broaden the pool of tangible goods that meet the definition of “commodity.”

The discussion draft also provides various examples of adjustments that may be applied when applying the CUP method to related-party commodity transactions. Examples of such differences include: physical features and quality, volumes traded, timing and terms of delivery, different processing functions performed or required, transportation costs, insurance, and foreign currency terms. If the CUP method becomes the default transfer pricing method to test related-party commodity transactions, taxpayers that support related-party commodity transactions with methods other than the CUP method may need to consider how results from their primary analysis may be reconciled with the results from the CUP method.

The discussion draft also proposes specific additions to the transfer pricing guidelines to address how dating of a transaction affects the selection of the comparable arm's length benchmark. Taxpayers that do not have clear policies or documentation of when prices are set should consider documenting (and implementing in practice) when a related-party transaction is priced to avoid the use of shipment date as the deemed date for pricing the transaction.

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BEPS Action 4: Interest Deductions and Other Financial Payments

The discussion draft on interest deductions and other financial payments issued Dec. 19 notes at the very outset that the use of debt "is perhaps one of the most simple of the profit-shifting techniques available in international tax planning."

Scope

The BEPS Action Plan calls for Action 4 to develop, among other things, transfer pricing guidance "regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements." However, such transfer pricing guidance is not a topic dealt with in the discussion draft. The discussion draft deals with the *other* mandate of the Action Plan under Action 4; namely, to develop:

> …recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations.

Thus, the discussion draft focuses on options for designing statutory limitations on the deductibility of payments that truly represent interest (or interest equivalents), rather than how to appropriately set the prices for financial transactions between controlled taxpayers. (Even with respect to the options it does describe, "these do not represent conclusions on the content of any best practice recommendations, but are intended to provide stakeholders with substantive options for analysis and comment.")

Ultimately, the discussion draft states, "[t]he two topics covered by Action 4 (interest deductibility and transfer pricing guidance) will be closely co-ordinated to ensure an overall coherence between the outputs."

This alert focuses on the few transfer pricing-related points that are touched on by the discussion draft; Deloitte Tax will shortly issue an analysis of the interest deductibility options set forth in the discussion draft.

Interest deductibility limitations and transfer pricing: To put the transfer pricing implications of the discussion draft in context, it is helpful to understand what the discussion draft says about how interest deductibility limits in general might best be designed. The draft discusses in depth the design choices for a number of different options, focusing on what it calls "general interest limitation rules": those that set an overall limit on the amount of interest expense that a taxpayer can deduct by linking interest deductibility either to:

1. The relevant attributes *of the group* to which the taxpayer belongs ("the group's overall position"), or
2. Fixed ratios of interest to attributes *of the taxpayer* (e.g., debt-to-equity, interest-to-EBITDA, and interest-to-assets ratios).

These represent two of what the discussion draft counts as six broad types of approaches to limiting interest deductibility that appear in existing laws. One of the other three is described as: "Arm's-length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties." The discussion draft reflects that the drafters "agreed that arm's length tests…should not form part of this consultation process." It gives the following reasons:

> An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances, and should not disturb genuine commercial behaviour. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules. The concerns are that existing arm's length tests may not be fully effective against base erosion and profit shifting because they only apply to intra-group payments and they permit deductible interest to be supported by non-taxable assets or income, such as investments in subsidiaries. While it might be possible to introduce new arm's length tests without these limitations (for example, by applying an arm's length rule to all of an entity's debt and by disregarding non-taxable assets and income when assessing whether an arm's length test is met), such rules would be burdensome to apply and enforce, and may still prove ineffective.

Paragraph 22. The other three types of interest deductibility limitation rules listed in the discussion draft are:

1. Targeted anti-avoidance rules that disallow interest expense on specific transactions,
2. Withholding tax on interest payments, and
3. Rules that disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who it is made to.)

Near the end of the discussion draft, it states that the extent to which Action 4 transfer pricing guidance in respect of related-party financing transactions is required:

> …will be dictated in part by the types of interest limitation rule included in a best practice recommendation and how widely these are adopted. For example, under a group-wide test an entity can still claim a deduction for interest expense on intragroup debt, but as the total amount of interest that can be deducted is limited, countries adopting a rule may view the pricing of individual instruments as less of a [BEPS] risk. Countries which do not adopt a group-wide test on the other hand may still require guidance on the pricing of related party financing.

Paragraph 224. Thus, it could well be that future guidance on the transfer pricing aspects of financial transactions will see its purported *BEPS-related* relevance muted by the approach ultimately taken to deductibility limitation. Of course, the Action 4 transfer pricing guidance that ultimately does result from the BEPS project might still be of great interest to taxpayers that engage in financial transactions with related parties in the ordinary course of their business. For now, however, those anticipating such guidance will have to wait for further developments.

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