A swift look at the OECD discussion drafts on BEPS plus one chart setting out timelines

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During the short days before Christmas, when most of us were busy closing transactions or making last-minute year-end reviews to financials, the OECD released several BEPS (Base Erosion and Profit Shifting) discussion drafts, amounting to hundreds of pages, that will have an impact on how we look at transfer pricing, and taxation in general, during 2015 and beyond.

The deadline for public comments on these discussion drafts occurs early in 2015. The most impactful way for multinational enterprises to affect the Action Plan is for those stakeholders to **provide comments directly to the OECD**. A public consultation meeting is scheduled to be held in Paris at the OECD Conference Centre also in early 2015.

This article reviews, in reverse chronological order, the discussion drafts recently issued.

BEPS ACTIONS 8, 9 AND 10 (**"ASSURE THAT TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION"**)

On December 19, 2014, the OECD released a discussion draft titled "**Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures).**" Public comments are invited on this discussion draft before February 6, 2015.

If you can only read one of the discussion drafts, we would recommend you *read this one*. It is the most comprehensive, closet to final and most relevant for all multinationals. And if you have time and energy left, we would also urge you to submit comments to the OECD because when this document is made final, you may wish that you had provided your point of view earlier.

This draft builds on earlier work from the OECD about intangibles (**Guidance on Transfer Pricing Aspects of Intangibles**) and follows up on some questions that were left open or vague in Chapter 9 on business restructurings, which is now four years old. It breaks the discussion into two parts: (1) proposed revisions to Section D of Chapter I of the OECD Transfer Pricing Guidelines, and (2) special measures with respect to intangible assets, risks and over-capitalization.

The draft adds clarifications to Section D of Chapter I, which discusses the arm's-length principle, about identifying intercompany transactions and how to apply the comparability factors. These are useful clarifications because Chapter III (comparability analysis), which was introduced in 2010, was confusing at times because it called for benchmarking processes that began with the necessary step of performing a comparability analysis *before* selecting the most appropriate transfer pricing method and *before* benchmarking. Adding this clarification in Chapter I (the arm's-length principle), which sets the foundations of the OECD Guidelines, is a clear improvement.

The draft also features a completely new Section D.2 of Chapter I, which addresses more difficult concepts that go to the heart (and key weaknesses) of the arm's-length principle. For example, the draft mentions the concept of "moral hazard," referring to a lack of incentive to guard against risk when one is protected from its consequences (*e.g.*, when a group company is a contract manufacturer).

The question raised for comment is: what role does this "moral hazard" play in determining arm's-length conditions? The answer is not straightforward and adds a new level of complexity to the application of the arm's-length principle.

Here is another idea mentioned in this discussion draft that hopefully will prompt you to **react and submit comments**:

> "57. The performance of risk management may have an important effect on determining arm's length pricing between associated enterprises, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements

> (see Section D.2.2) determine the respective contributions to risk management. Therefore, one may not infer from the fact that the price paid between associated enterprises for goods or services is set at a particular level, or by reference to a particular margin, that risks have been managed among those associated enterprises in a particular manner. […]
>
> 61. In determining the proper allocation of risk among members of an MNE group for transfer pricing purposes, consideration should be given to where the capability and functionality exist in the group to manage the risks associated with business opportunities. An allocation of risk to a group company that is unable to control risk associated with a business opportunity creates a tension between risk allocation and the conduct of the parties. The mere contractual allocation of risk is not likely to be seen at arm's length without the ability to control that risk."

Section D.2 is full of examples to clarify this key idea, which is not original, as it was already included in the first sections of Chapter IX (business restructurings).

Finally, Part I of the draft expands on the subject of re-characterizing transactions and adds a few additional examples to those already included in Chapter IX, focusing specifically on the "substance commercial and financial relationships of the parties."

Part II of the discussion draft is less elaborate and includes a number of open questions. It discusses the possible use of "special measures," which were anticipated in the September 2014 Guidance on Transfer Pricing Aspects of Intangibles.

SPECIAL MEASURES

Option 1: Hard to value intangibles (HTVI) and Inappropriate returns for providing capital

The measure targets circumstances where the taxpayer:

- fixes the price either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and
- does not contemporaneously document those projections and make them available to the tax administration.

The measure would permit the tax administration to presume that a price adjustment mechanism would have been adopted and as a result may rebase the calculations based on the actual outcome, imputing a contingent payment mechanism. A contingent payment mechanism may include any price adjustment made by reference to contingent events, including the achievement of financial thresholds such as sale or profits, or of development stages.

The idea behind this concept is well known in some countries (commensurate with income) and was already implicit in earlier versions of the OECD Guidelines (Annex to the prior version of Chapter 6 of 1991).

Option 2: Independent investor

The option is for cases where a capital-rich, asset-owning company − for example, an intangible owner − depends on another group company − for example, an R&D services provider − to generate a return from the asset. The option supposes that an independent investor having the option of investing in either of the two companies (i.e. the capital-rich, asset-owning company or the company that the former relies on to generate a return from the asset) would consider which company offered the better investment opportunity, taking into account expertise in conducting risk-managed activities to generate a return on the investments and the level of risk and potential return.

Option 3: Thick capitalization

This option depends on determining and applying a thick capitalization rule based on a pre-determined capital ratio. The effect of this option would be to determine the amount of capital in excess of this ratio, and then to deem interest deductions on the excess capital which would reduce the profitability of the capital-rich company and produce deemed interest income in the company providing the excess capital.

Option 4: Minimal functional entity

More often than not, especially transactions transferring key business risks or intangibles, one of the parties to the transaction has minimal functions. This targeted special measure focuses on a level of functionality that, where lacking, would cause the profits of that entity to be reallocated. This sounds like a form of formulary apportionment using functions or people as allocation keys.

Option 5: Ensuring appropriate taxation of excess returns

This option entails the application of a primary rule in the form of a controlled foreign corporation (CFC) rule, and a secondary one to prevent non-taxation. The primary rule could apply when a CFC earns excess returns in a jurisdiction and the CFC's average effective tax rate in that jurisdiction over the preceding three years is below a certain threshold percentage (referred to below as x percent). Where the primary rule applies, excess returns would be subject to tax in the parent jurisdiction at that rate of x percent, less any foreign taxes paid. Excess returns would however need to be defined.

BEPS ACTION 14

The OECD's Action 14 discussion draft ("**Make dispute resolution mechanisms more effective**"), issued on December 18, 2014, discusses the needs for improving dispute resolution mechanisms. Such improvements are needed in order for the resolution process to be an effective means for resolving controversy and preventing double taxation.

The draft lays out several of the obstacles the OECD expects to face in this issue, but it lacks strong recommendations or solutions. The OECD has stressed that a consensus on this issue has not been reached, but that the discussion draft was issued to provide stakeholders with substantive proposals for analysis and comment.

BEPS ACTION 4

On December 18, 2014, the OECD released discussion draft on Action 4 ("**Interest deductions and other financial payments**"). The draft examines existing approaches to interest deductible payments and identifies specific questions where input is required to further work on these issues.

The draft suggests two key approaches: one that allocates the group's overall interest expense to individual entities, and another that allocates based on a fixed ratio rule, regardless of the overall debt levels. However, the allocation of interest based on annual financial data could create uncertainty in the level of deductible interest in local jurisdictions. The introduction of the cap poses similar concern in which external interest expense may not be fully deductible for tax purposes.

The OECD acknowledges that proposals on the issue of interest deductions would require all countries to adopt the same rules, which is, in practice, a complicated endeavor involving competing pressures from different governments.

BEPS ACTION 10

On December 16, 2014, two discussion drafts were released. The first discussion draft is about the **use of profit splits in the context of global value chains as part of the work**. This is a very preliminary draft, with more than 30 open questions that seem more like the type of questions that would be raised in a brainstorming session. It is the beginning of "something" but that something may not be very daunting compared to the anxieties people may have around the issue of formulary apportionment.

The other discussion draft is about the application of the Comparable Uncontrolled Price (CUP) method to **commodities trading**. The draft discusses at length the importance of commodities for developing countries and notes that even the application of the CUP method could lead to base erosion and profit shifting.

The draft proposes a new paragraph to be included in Chapter II specifying that "in the absence of reliable evidence of the actual pricing date agreed by the associated enterprises, tax administrations may deem the pricing date for the commodity transaction to be the date of shipment as evidenced by the bill of landing or equivalent document depending on the means of transport."

BEPS ACTION 6

On November 21, 2014, the OECD invited public comments on a discussion draft which deals with follow-up work mandated by the Report on Action 6 ("**Prevent the granting of treaty benefits in inappropriate circumstances**") of the BEPS Action Plan. This is a follow up from the OECD report on Action 6 issued in September 2014, which was not finalized due to the possible effects of open deliverables due in 2015.

This draft discusses the Limitations of Benefit rule and issues related to the treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds. The discussion draft also identifies various issues on which there will be follow-up work.

BEPS ACTION 10

On November 3, 2014, a discussion draft on **"Proposed modifications to Chapter VII of the Transfer Pricing Guidelines relating to low value-adding intra-group services"** was released. This modified chapter is mostly a rewrite of the existing Chapter VII. It provides more flexibility for the use of the indirect allocation method and a safe harbor (markup on total cost of providing the service plus no less than 2 percent and no more than 5 percent) in case the intercompany service is classified as "low value-adding."

It also provides some guidance of what would be considered a low value-adding service and in which context. Intra-group services which form a part of "the core business of the Multinational Enterprise (MNE)" cannot be considered low value-adding services. The safe harbor also cannot be applied if the "low value-adding" service is also provided to third parties; in that case, the market price applies.

Finally, the following activities would not be considered as qualifying for the application of the safe harbor:

- Services constituting the core business of the MNE group
- Research and development services
- Manufacturing and production services
- Sales, marketing and distribution activities
- Financial transactions
- Extraction, exploration or processing of natural resources
- Insurance and reinsurance
- Services of corporate senior management.

BEPS ACTION 7

On October 31, 2014, the OECD released its discussion draft (**"Artificial avoidance of PE status"**) related to Action 7, addressing issues related to the artificial avoidance of PE status. The draft includes proposals for changes to the definition of permanent establishment found in the OECD Model Tax Convention. We have previously discussed this at length in our November newsletter.

VAT GUIDELINES RELATED TO ACTION 1 – TAX CHALLENGES OF THE DIGITAL ECONOMY

On December 18, 2014, the OECD issued discussion drafts of two new elements of its international VAT/GST guidelines.. These guidelines address issues of double taxation and unintended non-taxation resulting from inconsistent international application of VAT. These discussion drafts relate to (i) the place of taxation of business-to-consumer supplies of services and intangibles (B2C Guidelines) and (ii) supporting provisions for consistent interpretation and appropriate implementation of the principles in the guidelines. Although these VAT guidelines are not part of the BEPS action plan, they relate to Action 1. The draft recommends that countries implement a simplified registration and compliance regime to facilitate compliance for non-resident suppliers.

For those with appetite for more, allow us to mention that the OECD also released a 30-page "executive summary" of their 2014 work.

At this pace, the OECD has likely left behind even the most avid readers, never mind the tax managers of most companies.

In the following chart, we recap the status of each of the 15 Action Items, featuring key dates around each draft.

Action	Current and Soon-to-be Released Discussion Drafts	DD issued	Request for Inputs	Public Consultation	Deliverable Release
1. Tax challenges of the digital economy		√	√	√	√
	Addition: VAT B2C Guidelines	Dec 18 '14	Feb 20 '15	Feb 25 '15	
2. Hybrid mismatch arrangements		√	√	√	√
3. CFC rules	CFC Rules	Early Apr '15	+ 30 days	May 12 '15	Sep 15
4. Deductibility of interest and other financial payments	Interest Deductions	Dec 18 '14	Feb 6 '15	Feb 17 '15	Sep 15 / Dec 15
5. Harmful tax practices		√	√	√	√

Action	Current and Soon-to-be Released Discussion Drafts	DD issued	Request for Inputs	Public Consultation	Deliverable Release
6. Prevent treaty abuse		√	√	√	√
	Follow-up work on BEPS Action 6	Nov 21 '14	Jan 9' 15	Jan 22 '15	
7. Artificial avoidance of PE status	Prevent the Artificial Avoidance of PE Status	Oct 31, '14	Jan 9' 15	Jan 21 '15	Sep '15
8. TP for intangibles (Part 1)		√	√	√	√
TP for intangibles (Part 2)	Low Value Adding Services	Nov 3 '14	Jan 14 '15	Mar 19-20 '15	Sep 15
	Commodity Transactions	Dec 16, '14	Feb 6 '15		
9. TP for risks and capital	Profit Splits	Dec 16 '14	Feb 6'15		
	Risk, Characterization & Special Measures	Dec 19 '14	Feb 6 '15		
10. TP for other high-risk transactions	Cost contribution arrangements (CCAs) Intangibles – Ownership (hard to value)	Early Apr '15	+ 30 days	June '15	
11. Data on BEPS and actions addressing it	Economic Analysis	Early Jan '15	+ 30 days	Mar 27 '15	Sep 15
12. Aggressive tax planning arrangements	Disclosure Rule	Late Mar '15	+ 30 days	May 11 ' 15	Sep 15
13. TP documentation		√	√	√	√
14. Treaty dispute resolutions mechanisms	Dispute Resolutions	Dec 18 '14	Jan 16 '15	Jan 23 '15	Sep 15
15. Multinational instrument for amending bilateral tax treaties		√	√	√	√

Find out more about issues around BEPS by contacting the authors.