OECD holds final public consultation on BEPS Actions 8-10 on transfer pricing

Executive summary

On 6-7 July 2015, the Organisation for Economic Co-operation and Development (OECD) held its final public consultation in connection with the Base Erosion and Profit Shifting (BEPS) project, which was focused on Actions 8-10 on transfer pricing. The meeting focused on the recently published discussion draft on Cost Contribution Arrangements (CCAs) and the discussion draft on Hard-to-Value Intangibles (HTVIs).

In addition, the OECD provided an update with respect to the other transfer pricing work streams of the BEPS project, including the work on risks, non-recognition and intangibles. The consultation was the final opportunity for stakeholders to engage directly with the OECD Secretariat and the country delegates who are responsible for the OECD's transfer pricing work.

Detailed discussion

Background

Since September 2014, the OECD has released several discussion drafts as part of its ongoing efforts in connection with BEPS Actions 8-10 on transfer pricing, including the discussion draft BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements\(^1\) and the discussion draft BEPS Action 8: Hard-to-Value Intangibles.\(^2\) The public consultation on 6-7 July 2015 was a dialogue among stakeholders, country tax officials, and the OECD Secretariat on key issues and concerns addressed in those comments. The consultation was hosted by OECD Working Party 6 (WP6), which is responsible for the OECD's work on transfer pricing matters.

The first day of the public consultation covered the discussion draft on CCAs (and specifically the aspects of determining participants in a CCA and measuring contributions) and the discussion draft on HTVIs. The second day covered the
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status of revisions to Chapter I (The Arm’s Length Principle) and Chapter VI (Special Considerations for Intangible Property) of the OECD Transfer Pricing Guidelines, which deal with issues related to risks, non-recognition and intangibles.

Government officials; representatives of multinational businesses, industry bodies and advisors, including EY representatives; and non-governmental organizations participated in the two-day consultation. The consultation was live-streamed by the OECD and a recording is available on the OECD website.

**Cost contribution arrangements**

CCAs are commonly used among business enterprises to share the contributions and risks involved in the joint development, production or acquisition of intangible assets, tangible assets or services. Important elements of the recently released discussion draft are the revised definition of a CCA, the revised requirements for a company to be recognized as a participant, and the proposed new guidance requiring each participant’s contribution to be measured at value rather than at cost.

The Netherlands delegate began the discussion of CCAs, stressing that WP6 has worked on aligning the proposed guidance in Chapter VIII of the OECD Transfer Pricing Guidelines with the work done on Chapter I and Chapter VI on risks, non-recognition and intangibles.

A key topic of discussion with respect to CCAs was whether a party whose role is limited to funding the development can be part of a CCA. The views of business and WP6 diverge significantly on this point. The OECD Secretariat asked why it is so important for business that a funding party can be part of a CCA. Business commentators stressed the difference from a legal and economic perspective between a CCA and a series of individual transactions. Based on this, business is of the view that individual participants do not have to be able to control all the risks covered by a CCA.

With respect to the proposed new guidance that each participant’s contribution should be measured at value rather than at cost, there seemed to be consensus that pre-existing intangibles should be valued at market value rather than at cost. Business commentators stressed, however, that ongoing contributions can be valued at cost, which is in line with third party behavior.

Business commentators also stressed the importance of practical guidance. CCAs often involve a large number of participants. Transfer pricing adjustments to CCAs would therefore trigger multilateral disputes. Business also urged that existing CCAs be grandfathered.

**Hard-to-value intangibles**

The recently released discussion draft on transfer pricing aspects of HTVIs proposes revisions to the existing guidance for such intangibles. The discussion draft proposes an approach based on arrangements, including contingent pricing arrangements that would have been made between independent enterprises at the time of the transaction.

The draft indicates that this approach is intended to protect tax administrations against the negative effects of information asymmetry when specific conditions are met.

The Australian delegate began the discussion of HTVIs, stating that the proposed guidance is fully within the arm’s length principle and that it should not be considered a special measure outside the arm’s length principle.

The discussion focused on the definition of HTVIs, which in the view of business commentators is too broad. A question was also raised by some of the country delegates and the OECD Secretariat as to whether the guidance should be applicable to intangibles in general and not limited to HTVIs only. Although a limited number of business commentators seemed to support this idea, the majority did not agree. Commentators also asked for clarity regarding the consequences if the specific conditions on HTVIs are met. In their view, the current draft is unclear as to the exact options a tax authority would have in such circumstances. A large part of the discussion focused on the exemptions and safe harbors for taxpayers and when the valuation applied by taxpayers for HTVIs should be accepted.

The OECD Secretariat concluded the discussion with three comments. First, he questioned how any safe harbor range of acceptable deviations between projections and actual results would be applied if it
were to be introduced, indicating that this would be an important issue for WP6 to discuss. Second, on the interaction between CCAs and HTVIs, he commented that WP6 is expecting that valuation of pre-existing contributions will mean that these pre-existing contributions will be treated as HTVIs. Finally, the Secretariat noted that WP6 will look at implementation of HTVIs as part of the follow up work to the BEPS project and that business input on this would be welcomed.

Status update on BEPS transfer pricing work streams
During the second day of the public consultation, the OECD Secretariat gave a full update on the status of the BEPS transfer pricing work streams, based on the current status of the OECD work in progress. The OECD intends that the transfer pricing guidance will be finalized in September 2015 and published shortly before the G20 Finance Ministers’ meeting on 8 October 2015. No further consultation documents will be issued. Although consensus has been reached on important issues, certain elements are still under discussion and there are likely to be further changes and developments with respect to the areas addressed in the update provided by the Secretariat.

Transfer pricing work to be continued in 2016 and 2017, after finalization of the reports with respect to the BEPS Actions, includes:

- Profit attribution to permanent establishments
- Implementation of HTVIs

Furthermore, the OECD and other international organizations (e.g., the United Nations, IMF and World Bank) have been given a mandate to develop a toolkit for developing countries on implementation of proposed BEPS transfer pricing measures. Particular aspects that will be dealt with include the lack of comparables, base eroding payments, and transfer pricing documentation.

Risk and non-recognition
WP6 has been working on the proposed guidance for Chapter I on risk and non-recognition. The current draft in progress reflects significant changes from the Discussion Draft of 19 December 2014. Consensus has been reached on many of the changes, although some important issues will have to be discussed by WP6.

One of the most important elements of the draft is delineating the actual transaction. This will remain a key element. Some countries have indicated that this is already a best practice.

Concern was expressed that the discussion draft reflected too much deviation from the parties’ contractual arrangements. In the draft in progress, greater clarity is provided on the role of contracts. Contractual arrangements form the starting point of the analysis. Knowing the parties’ conduct is relevant to assess whether there are contradictions between contractual arrangements and conduct, to fill in any gaps in the contractual arrangement and to interpret the contracts for transfer pricing purposes.

The section of the discussion draft that addressed risk was perceived as too theoretical. WP6 considers risk an important, relatively unexplored area in the Transfer Pricing Guidelines. Therefore, practical guidance has been incorporated as an integral part of the functional analysis. A materiality threshold was included, and control over risk has been clarified. The current draft no longer includes specific guidance on non-controllable risks. Financial capacity to assume a risk, which was generally ignored in the discussion draft, has been brought back in the current draft, on an equal footing with control.

Based on the comments received, the current draft does not include the moral hazard concept and recognizes risk-return trade-offs, which is considered to be fundamental.

In response to financial services industry concerns regarding the analysis of risks, WP6 recognizes the special character of risks in the context of financial services and this is included in the current draft.

For the practical application of the guidance to risk, an analytical framework is provided in the current draft, which includes:

1. Identification of economically significant risks with specificity
2. Identification of contractual assumption of the specific risk
3. Establishment of conduct and other facts for functional analysis

4. Determination of whether the contractual assumption aligned with the conduct and other facts and whether the party assuming the risk is exercising control over the risk and has the financial capacity to assume the risk

5. If the party assuming the risk does not control the risk or does not have the financial capacity to assume the risk, the allocation of the risk to the group company having the most control and having the financial capacity to assume the risk

6. Establishment of the price, taking into account the full functional analysis of the transaction, including the analysis on risk

The Chair of WP6 stressed that, although the above framework is included in the current draft, items 1 through 3 and issues with respect to financial capacity are still being discussed by WP6 and further work will be required.

Control over risk
In response to comments received, WP6 has incorporated in the current draft the notion that risk mitigation and preparatory work relating to the decision making may be outsourced. If such activities are outsourced, the group company in control of the risk should set the objectives of the outsourced activities, assess whether the objectives are met, and have responsibility for hiring or firing the service provider. The guidance recognizes that the parties performing risk mitigation activities and the parties making decisions that shape the policy environment in which the specific risks are assumed do not exercise control over the specific risk. It also reflects the view that the mere formalizing of the decision making in the form of, for example, minutes of a board meeting and signing of the documents of a board meeting does not qualify as exercising a decision making function sufficient to demonstrate control over risk.

In response to questions by business commentators, the OECD Secretariat stated that having board meetings does not imply sufficient control. One must also consider the decision making process and not only the formalizing of the decision at a location. Therefore, “flying in” board members would not meet the threshold of the control over risk test.

Financial capacity
In contrast with the discussion draft, financial capacity has been added as a relevant factor, on par with control. The relevant test relates to access to funding on the basis that the associated enterprise is operating as an independent party in the same circumstances as the associated enterprise.

“Cash boxes”
According to the OECD Secretariat, applying the above guidance to low or no functional entities (referred to as “cash boxes”) would lead to the following analysis. If the cash box is not exercising meaningful control, the risk would be allocated to the group entity that is performing such control functions. The non-recognition rules may also be applicable. As a result, a cash box with no or low functionality would get no more than a risk free rate of return for the funding itself. Other BEPS measures that could impact cash boxes are: include interest deductibility (BEPS Action 4), controlled foreign company rules (BEPS Action 3), and the minimum standard on treaty abuse (BEPS Action 6), as well as application of domestic anti-abuse rules. The OECD Secretariat indicated that the OECD is comfortable at this stage that no special measures are necessary. There will be some form of monitoring process going forward to see whether the proposed measures have the expected effect.

Recognition of the accurately delineated transaction
The title of this section of the current draft has been changed to recognition instead of non-recognition. The guidance builds on the existing guidance in the Transfer Pricing Guidelines, and therefore links to the notion of commercial rationality. New examples have been added that do not depend on behavior or on moral hazard.

Chapter VI on intangibles
No fundamental changes will be made to the proposed guidance developed in 2014 for the non-shaded text. However, corresponding changes based on the new guidance on risk and recognition of the accurately delineated transaction are necessary. Additional guidance on the allocation of the difference between the actual profits and the excepted profits is included; this allocation will be determined based on the way the risks that
were assumed by group companies play out. Information asymmetry issues and the risk of mispricing are addressed through the guidance on HTVIs.

**Commodity transactions**

Proposed changes to Chapter II on commodity transactions recently were approved by WP6. The guidance will be in line with the Discussion Draft of 16 December 2014.

**Transfer pricing documentation (BEPS Action 13)**

The work on transfer pricing documentation has been finalized. The three deliverables published to date will be combined in one document. No further guidance will be published.

**Low value adding services**

WP6 has reached broad agreement on implementing guidance similar to the discussion draft of 3 November 2014. However, changes have been made because some developing countries believed that the approach reflected in the draft could lead to excessive deductions. Therefore, countries will be allowed to require a full transfer pricing analysis if deductions are higher than a specified threshold.

**Profit splits**

As indicated, follow up work will be done in 2016 and 2017 on profit splits. It was stressed that the aim should be to identify the most appropriate method for the particular situation. The follow up work will be focused on the potential for useful guidance within the framework of the most appropriate method rule.

**Implementation**

The question was raised on how the proposed revisions and additions to the Transfer Pricing Guidelines will be implemented, specifically whether this could be done through dynamic interpretation of the Transfer Pricing Guidelines. The OECD Secretariat answered that the OECD will need to explain what part of the proposed guidance can be seen as the interpretation of the arm’s length principle as it was understood already. Many countries, however, have different mechanisms for implementation and there is no intention for the OECD to have a role in the deployment of those mechanisms. The potential for monitoring work going forward will be a key issue to be discussed by the OECD Committee on Fiscal Affairs (CFA) during its September 2015 meeting.

**Dispute Resolution**

The guidance on dispute resolution will contain two elements:

- A mandatory minimum standard with an associated peer review monitoring process.
- A voluntary commitment to mandatory and binding arbitration. Currently approximately 20 countries have indicated their commitment to arbitration. The multilateral instrument under BEPS Action 15 provides a means for implementation of such commitments.

The minimum standard recognizes that access to MAP should be provided for transfer pricing cases, even if Article 9 (2) is not included in the applicable treaty. Based on OECD statistics, 90% of existing MAP cases will be covered when the countries that have expressed commitment to mandatory and binding arbitration implement this commitment.

**Next steps**

WP6 will discuss the remaining BEPS transfer pricing issues during its July 2015 meeting. The CFA is expected to approve the reports on all the BEPS Actions in September, and the OECD Council is expected to approve them in early October. These reports will be discussed during the G20 Finance Ministers Meeting on 8 October 2015.

**Implications**

The discussion at the consultation underscores the significant progress made on the transfer pricing work streams of the BEPS project. Final reports are expected to be issued shortly before 8 October 2015. The status update provided by the OECD Secretariat gives a clear indication of the direction in which the work on the transfer pricing aspects of the BEPS project is moving, in particular with regard to risk and intangibles. Companies should evaluate the implications of the proposed additional guidance on transfer pricing for their intercompany transactions and the documentation thereof. Companies also should watch for the publication of the final reports reflecting revisions to the OECD Transfer Pricing Guidelines and should monitor development with respect to individual countries’ implementation of the new guidance. Finally, they should monitor the follow up work after issuance of the final BEPS reports in 2016 and 2017.
Endnotes

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