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Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk Recharacterisation, and Special Measures)" 1 December 2014 - 6 February 2015

The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk Recharacterisation, and Special Measures)" 1 December 2014 - 6 February 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise appreciates the efforts by the OECD to develop recommendations regarding revisions to chapter I of the Transfer Pricing Guidelines (the Guidelines).

The Draft is divided into two parts. The first part contains a revision to section D of Chapter I of the Guidelines and the second part contains options for some special measures. As set forth in the Draft, the aim of Actions 8-10 of the BEPS project is to assure that transfer pricing outcomes are in line with value creation. We support the aim of actions 8-10 and believe that if carefully drafted, it could satisfy the need to prevent BEPS as well as provide additional guidance and predictability for companies.

However, in our view the Draft does not deliver sufficiently on the above-mentioned objectives. We find that several of the new requirements outlined in Part 1 of the discussion draft are too ambiguous and onerous to be manageable. In particular, the principles set out in section D.2. seem to require risk identification and valuation at a level of detail which would be very difficult to comply with in practice. The Draft requires a substantially more detailed risk analysis than under current guidance, with more areas and analyses for MNEs to cover in their transfer pricing documentation. By way of example, bench-marking data is typically not available at the level of detail required to conduct the exhaustive risk analysis required throughout the document. We are therefore concerned that taxpayers despite their best intentions and efforts will fail or be seen to fail to comply with these new standards with an increased risk of double taxation, disputes and/or recharacterisation as a consequence.

In addition, while the guidance in the Draft may provide more information for MNEs to consider when pricing their internal transactions, it also provides tax authorities with many ways to challenge and scrutinize MNEs' transfer pricing policies, even when they have made a good-faith effort to be compliant.

The examples given in section D1 covers not just situations where contractual terms are ambiguous, incorrect or incomplete, but also genuine commercial transactions that are already in compliance with the Guidelines. This may lead some tax authorities to challenge and scrutinize transfer pricing policies, even in a situation where the transaction at hand is a genuine business transaction. In order to provide greater clarity, and to shift focus from genuine commercial transactions to transactions that are not in compliance with the Guidelines, we encourage the OECD to propose alternative examples.

Additionally, although we support the ambition to assist taxpayers and tax authorities in the implementation and follow up of transfer pricing models and policies by including examples, we think that the examples provided throughout the document are generally too simplified and frequently fail to identify several important aspects in commercial transactions (see further below). If the examples are to be kept, The Confederation of Swedish Enterprise believes that the Draft should clearly underline that they are included for illustrative purposes only and that they frequently are not applicable to related transactions. Otherwise, the measures and examples proposed might create misunderstandings and disputes.

The Draft also fails to address sufficiently the obstacle to find comparables to intra-group transactions. Risk management within an MNE is not equivalent to that between unrelated parties. Consequently, finding a comparable to a transaction between related parties will be very difficult. This will mean added uncertainty for MNEs that in good-faith try to comply with the transfer pricing rules.

Special measures, as suggested in Part II, create additional uncertainty for taxpayers. The Confederation of Swedish Enterprise believes that the analysis of

commercial and financial relations, together with (if necessary) the application of non-recognition rules, should be enough to guarantee a proper remuneration of the intragroup transactions within MNEs. For these reasons, we find no need for these special measures in order to avoid BEPS behaviors.

However, if they are to exist there must be a clear and consistently applied set of criteria for their application. It should be clearly expressed that they should apply only in exceptional cases. They also need to be applied consistently by all tax administrations in order to avoid an increase of tax disputes and potential double taxation.

Out of the suggested alternatives, we believe that option 5 is the most reasonable one. Appropriately designed CFC-rules have the potential to mitigate important BEPS behavior. It is important however that there is universal agreement on what is considered as an unacceptable tax level (and hence when CFC-taxation should be triggered).

Although all options presented in the paper are still very sketchy and unclear, the Confederation of Swedish Enterprise does not support any of the other alternatives mentioned in the paper. The principles outlined in options 2, 3 and 4 seems to be based on rather extreme concepts and we fail to see how they could be developed into something which is sufficiently predictable, not overly onerous and which will not hamper genuine business activities. As for option 1, we see a risk that it may open up for arbitrary use of hindsight. A better approach in our view is to include general guidance on the use of adjustment clauses recommending that such instruments should be used when it can be expected in third party situations and also outlining some guidance on how such clauses typically are designed.

Specific Comments

Part I – Revision of Chapter I of the Guidelines

D1 Identifying the commercial or financial relations

It is essential for taxpayers to have as much certainty as possible regarding legal agreement they have entered into. Consequently, we welcome the statement in paragraph 3 that where a transaction has been formalized by the taxpayer through written contractual agreement, that contract should provide the starting point for delineating the transaction and how the responsibilities, risk and benefits are to be divided. Only if the contractual terms are ambiguous, incorrect or incomplete should they be clarified or supplemented by tax authorities based on the actual conduct of the parties.

We do welcome that examples are included in section D1 of the Draft as examples helps to assist MNEs in the implementation of transfer pricing policies and tax authorities auditing these policies. Unfortunately the proposed examples reflect common commercial situations and give little clarification of complex business transactions where the transfer pricing is not as straightforward. There is therefore a need for alternative examples which would help to more clearly illustrate the need to supplement or clarify contractual terms.

In paragraph 5 it is stated that “it should not automatically be assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties”. We believe that this paragraph needs to be redrafted. We encourage the OECD to acknowledge that the starting point should always be that the contractual terms do reflect the actual relations between the parties. To keep the language as proposed would give tax authorities the possibility to challenge almost any contractual agreement, no matter how small the identified divergent they might have found.

Paragraph 7 sets out to deal with transactions which the taxpayer has failed to identify. Although there could obviously be situations where a taxpayer deliberately or by mistake has completely failed to recognize or take into account transactions that represent significant values, once again it needs to be emphasized that the great majority of taxpayers are devoting significant resources to making sure that all relevant transactions are identified and adequately described.

Commercial and financial relations between associated enterprises may however sometimes be very complex, just as they may be between independent enterprises. It is crucial that tax administrations do not immediately jump to the conclusion that there are transactions which the taxpayer has failed to recognize or account for. A rather comprehensive understanding of the entire business of the taxpayer may very well be required to ensure that this “deemed transaction” is not in fact included or bundled with some other transaction, the pricing of which does in fact take into account also this “deemed transaction”. Also in this context the Draft would benefit from some kind of materiality threshold indicating that great care needs to be taken before starting to construct transactions not identified or recognized by the taxpayer. As the immediate consequence in most cases will be double taxation, tax administrations should abstain from such measures unless there is an apparent error or mistake made by the taxpayer which has a significant impact on the results.

In paragraph 8 an example is provided that aims to illustrate a situation where taxpayers have not identified a transaction. In the example a subsidiary receive a service from a third party for which they appear not to be charged, either through reimbursement or through a service charge from the entity paying for the service. It should be acknowledge that the service charge could be taken into account in the pricing of another transaction between the parties, and thus that the lack of direct charge do not necessarily mean that the service is provided for free.

In paragraph 12 of the Draft it is stated that when independent enterprises evaluates the terms of a potential transaction they will compare the transaction to other options realistically available to them. Only when there is no alternative offering a better opportunity to meet their commercial objectives will the enterprise enter into the transaction. Although this might be true from a theoretical standpoint, it does however not take into account the time pressure and limited information that may be available when making a business decision. The different options are in many situations not as clear to the enterprise making the decisions as paragraph 12 indicates. There is a risk that the tax authority deems a result that could not have been foreseen at the time.

The requirements in paragraphs 12 and 89 to document different options available when making a business decision will no doubt make for an increased compliance burden for taxpayers. The documentation should cover the transaction undertaken, alternative options considered and the option not to undertake the transaction. Compared to the previous rules, the proposed revision requires more information on each transaction, and potentially also documentation on more transactions. To identify and document all this will demand extensive resources. Additional guidance regarding this issue would be welcomed to ensure that the documentation requirements are well-balanced and not excessive.

In addition to the examples provided in the Draft, it should be recognized that it is common for an agreement to be varied slightly without conducting a re-negotiation or amendment to the contract. This, however, does not mean that the contract is invalid. Tax Authorities should recognize that this can happen also between related parties without the need of significant supplementation or clarification.

D2 Identifying risks in commercial or financial relations

The Confederation of Swedish Enterprise shares the view that identifying risk is a critical part of transfer pricing analysis and agrees that this can give rise to difficulties. Therefore we welcome the intention of the Draft to give additional guidance and clarity regarding risk in section D.2.

However, identifying and valuing risk is very difficult task (at least before it materializes). It is also difficult to determine how risk is treated between unrelated parties. Although paragraphs 40 and 42 could support tax authorities in identifying and understanding risk, we are deeply concerned about the new and detailed standards set out in section D.2. Requiring analysis at this micro-level is virtually impossible to comply with in practice. The Draft seems to suggest that all risks should be identified and that the impact of each of those risks should be measured and analyzed in detail for each individual risk. With the number of legal entities and intra group transactions taking place in most MNEs, it is typically not possible to analyze every transaction and allocate reward for risk on a transaction by transaction basis, which in many situations seems to be required.

In principle, we agree with the assumption in para. 38 that it generally makes sense for third parties to be allocated a greater share of risks over which they have relatively more control. However, it needs to be acknowledged that risk allocation among third parties is far more complex and can be driven by a large number of factors which do not align with this general principle. By way of example, the perceived profit potential in a given business case, the perceived benefit for one of the parties or the valuation of a certain risk does frequently result in risk assumption which deviates from this general principle. As a concrete example, at arm's length, the assumption of credit risk may be accepted by an exporting market company even though the detailed day to day control of that risk lies closer to the importing dealer company on the basis that the market company considers the risk to be very low and the dealer company is not willing to take on the sales activity carrying that risk. Therefore, the guidelines should be clarified as to say that the theoretical principle suggested in this paragraph (and elsewhere) can only be a starting point in the analysis.

In paragraphs 44 and 45 examples are provided regarding the allocation of risk. We strongly question these examples. Indeed, the selection of a certain transactional currency between independent parties will typically indicate the agreed allocation of F/X-risks. However, the same rationale is often not applicable between related parties. Although the transactional currency may very well be selected to indicate the agreed allocation of F/X-risk, between related parties this may be driven by other factors such as lack of system support, global hedging considerations etc. In addition, local F/X-regulations may make it impossible also for independent parties to select the trading currency in a way which aligns the "conduct" with the desired risk allocation as established in the contractual terms. Consequently, we do not support the conclusion that a deviation between the contractual agreement and the functional currency should be viewed as an example where the contractual terms should be ignored based on the conduct of the parties.

We have the same concern regarding the example in paragraph 45 regarding inventory write-downs. Accounting principles are typically not developed with consideration to the underlying objectives of the arm's length principle. A write-down made in accordance with accounting rules has very little or nothing to with the allocation of risks between independent parties and we think that a risk allocation principle based on accounting standards often will be highly questionable from an arm's length perspective. Consequently, we urge the OECD to recognize this and to delete this reference in the Draft. If not, local tax authorities may question any sound arm's length risk allocation properly documented in agreements and TP-documentation based on the argument that it does not follow the conduct as indicated in the accounting.

It has been widely accepted by the majority of tax authorities that a party performing commercial activities could be insulated from commercial risk, provided of course that it is aligned with the substance required in chapter IX of the Guidelines. This has significantly facilitated compliance with the arm's length principle for MNEs with

complex value chains. It has equally reduced the compliance burden while at the same time enabled tax authorities to focus their resources on other transactions with higher risk. Paragraph 49 of the Draft could change this existing practice and result in additional costs for both companies and tax authorities, with little additional revenue as a result.

The Confederation of Swedish Enterprise is worried about the language in paragraph 55 of the Draft. It is suggested that risk management comprises three elements: (i) the capability to make decisions to take on or decline a risk-bearing opportunity, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk. Within a group, risk related decisions are taken every day at every level of the organization. At a strategic and often central level decisions are taken about investments, budgets, corporate control functions, escalation models, customer funding strategies etc. At the same time, local day-to-day decisions involving risks are taken about individual customers, product quality improvements, warranty handling, workplace safety etc. etc. (typically based on the centrally developed and communicated guidelines and instructions etc.). Apart from the difficulty of identifying and valuing risk at the level of detail suggested throughout the paper, we think that further guidance is needed on what “actual performance of risk making decisions” means in this respect. Without such guidance, we see a considerable risk of increased disputes among tax authorities about the proper allocation of risks for TP-purposes (in particular in cases where substantial risks has materialized). In addition we see considerable risks that fully commercial and legitimate transfer pricing models with centralization of risk and IP which have been built up and accepted by a large majority of the tax authorities around the world will be impossible to uphold. The consequences of such a change would be detrimental, not only since it would significantly drive compliance and disputes, but also considering the fact that the commercial risks that have materialized in the aftermaths of the financial crises, in particular in cases of centralized principal TP-models, may no longer warrant the future reward for the risk taking entity/country.

On this basis, we believe that the guidelines need to further clarify what types of decision making functions that are required to be able to manage, control and thereby assume risks from a transfer pricing perspective. As day-to-day decision making regarding risks can (and often is) outsourced in third party situations, we believe that these decision making function should evolve around strategic decisions and control function that you can expect to be in place in cases where the day-to-day risk management is outsourced between third parties. Although we share the view that further detailing would be valuable, we believe that the principles set out in Chapter IX of the Guidelines about risk and control provides a sound standard. Indeed, we fully recognize the need to prevent unacceptable allocation of risk (and IP) to entities or jurisdictions without proper capacity, power or substance to assume those risks. However, without further clarity in this respect, we believe that the

suggested new guidelines would significantly drive compliance, uncertainty and disputes.

Paragraph 63, stating that risks should be analysed with specificity, in conjunction with the following paragraphs, underpins a general concern that the level of detail in which risks are supposed to be identified, analysed and valued under the proposed new standards are not on par with what is achievable from a practical perspective. Although in theory, a full functional and comparability analysis to assess the contributions by all of the associated parties to which risk relates (as required in para. 65) may be valuable, the tools to make such an analysis is typically not available. Comparable data is typically not available at this level of detail and hence the required level of risk analysis will often not be possible to comply with in practice. We feel that the paper largely neglects these practical challenges. Without the possibility to put the new Guidelines into practice, we see a risk that taxpayers will fail to live up to the new standards despite their best efforts to comply.

We acknowledge the statement in Paragraph 67 that risks may be transferred for a fee at arm's length. We are concerned, however, with the use of the word "some" in the paragraph since it seems to suggest that this is more of an exception than the norm. We also question the implication later in this paragraph that a full transfer of core risks is unlikely to happen at arm's length. The paragraph seems to assume that some risks, such as strategic, marketplace, infrastructure and operational risks, are more stationary than other risks and that they subsequently cannot be transferred at arm's length between depended (or independent) parties. Although a marketplace risk clearly is stationary in the sense that it refers to a particular market, the paragraph fails to identify that the allocation of risk is not a question of transferring the risk as such. Instead it is a question of transferring the liability of a risk. Certainly in third party situations you can observe that the liability for certain market related risks are transferred to parties not operating physically in that market. Likewise, the *liability* to assume infrastructure risk may very well be allocated among third parties even though the risk itself geographically may be hard to relocate. On this basis, we believe that this paragraph needs to be closely reviewed.

As mentioned above, we appreciate the ambition to assist taxpayer and tax authorities in adopting and interpreting these new standards by providing examples. We do find these examples generally to be over simplified and overlooking much of the complex aspects of commercial business actives. The difficulty in providing clear and straightforward examples is e.g. highlighted in paragraphs 90 and 91. In the example, the fact that S1 is receiving 400 MUSD as an upfront payment for the IP is completely ignored. Although a cash rich and well consolidated company would probably not have conducted the transaction as outlined, a financially weak entity may very well make the deal at the terms set out in the example at arm's length. This holds true in particular if the alternative is a risk of bankruptcy due to insufficient cash flow.

D3 Interpretation and D4 Non-recognition

For MNEs, certainty regarding tax rules is crucial. In order to increase predictability, tax rules need to be applied in a consistent matter by tax authorities. A decision not to recognize a transaction should only be made as a last resort. We believe that the proposed Guidelines should contain additional safeguards for compliant taxpayers, ensuring that they are not wrongfully caught by non-recognition.

When reading paragraph 85-87, the impression is given that all MNEs establish complex and fragmented structures to maximize their transfer pricing outcome. This is not the case. It needs to be acknowledged that the majority of taxpayers are compliant and interested in building good relationships with tax authorities. The key concern for most MNE groups is to have certainty in their tax affairs, not to maximize the outcomes of their transfer pricing.

Moral Hazard

1. Under the arm's length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

The Confederation of Swedish Enterprise believes that the concept of imputed moral hazard and contractual incentives may be difficult to apply for many MNEs.

Naturally, independent parties try to safeguard themselves in agreements against potential moral hazards on the side of their contractual partners. The level of detail in agreements will depend on volume and inherent risk of the transaction and the experience with the particular business party. Applicability for intercompany transactions will depend on industry and the availability of reliable data. Certain industries have more or less standard conditions in which also local legislation and consumer organizations play a role.

Availability of data like third party contractual terms is key. MNEs applying the T.N.M.M. or data base benchmarking against external companies will face extreme difficulties to apply the concept of imputed moral hazard and contractual incentives in their transfer pricing model. The simple reason for this is that the contractual terms of external companies found in a benchmark study are not known. The above leads to the conclusion that the concept of moral hazard must be made much clearer before it can be introduced in the BEPS concept.

2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

In any Joint Venture a MNE may have this as a common element with a third party. Hence, it is not correct that this is only an element in a transaction with an associated entity. As such the internal contract can be the basis for assessing how the risks are placed.

One can split the risks mentioned in paragraph 42 into two categories of business risks; routine risks and non-routine risks. The difference between routine and non-routine risks is the availability of market and in house data about the occurrence of a certain risk. Routine risks can to a certain extent be quantified and benchmarked. Even in industries with high availability of risk data like insurance, certain seldom occurring events with big impact like war, nuclear explosions and flooding may be excluded from risk coverage.

The non-routine risks in 42 a) and b) are difficult if not impossible to benchmark. The insight in core competencies and future market opportunities may often be subjective but this insight has a big influence on future results. It may therefore lead to a transfer pricing model where routine operational companies receive routine profits and low risks. Residual results and risks are, and should be, allocated to the strategic decision taking functions/entities like global/regional or product division HQ that are supposed to have that insight. This will also be what is reflected in the internal agreement as it is in an external.

In relation to paragraph 43, and for the avoidance of doubt, it should be made clear that the focus is not on functional currencies but rather on the situation when the conduct of the parties deviates from the contractual agreement. If conduct and contract is aligned then parties must be free to agree on currency, F/X-risk placement etc.

3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm's length principle?

The example in paragraphs 90 and 91 describes an extreme and overly simplified case where functional trademark ownership seems to remain fully in S1 and the legal ownership is transferred to S2. S2 seems to have no insight in the business at all. This transaction as described faces the risk of non-recognition. The economic ownership seems to be split between entrepreneur S1 and the investor in the trademark S2. The moral hazard theory suggests that S2 is only entitled to a routine profit and S1, the entrepreneur with all insights should receive the residual return on the intangible, since S1 is the sole functional owner.

Modern practise within MNEs is clearly different and more complex than in the example in paragraphs 90 and 91. The core issue is the organisation of risk management as described in section D.2.5: MNEs have cross border "virtual" organisations, global specialist functions, product and or regional divisions and even specific project teams operating from several and changing business locations. The virtual organisations can manage the core business and core business risks, usually

under guidelines, policies and (monitoring) procedures set by the Global or Division HQ. The virtual organization in our example operates and works with no connection to each and every legal entity and jurisdiction. This further proves that the example used is not relevant for MNEs in many, if not all, cases.

The core question therefore is whether a Global or Division HQ or IP company should bear risk and therefore be entitled to risk (and intangible) related returns if it sets strategic targets and provides strategic funding but under strict guidance: policies & procedures and monitoring outsourced tactical management and execution to virtual organisations. The strategic and not the routine risk must be the key element.

Risk-return trade-off

4. Under the arm's length principle, should transactions between associated enterprises be recognised where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognised, how should they be treated?

Yes, in practise both independent companies and MNEs enter into transactions with the sole effect to shift risk. A company will consider transferring a risk if the economic impact of the risk can be significant and beyond control of the company. As mentioned in paragraph 67 some routine risks can be priced.

Similar to routine functions there are routine risks, risks that can be benchmarked with external market data and which can be swapped against cost of insurance or a financial instrument. Clear examples are: a) insurance coverage against risks for costs of medical treatment, destruction or damage of property and liability or b) the use of financial instruments to mitigate the fluctuations of foreign currencies, commodity prices and interest levels.

To a certain extent the risks mentioned in paragraphs 42 c)-e) can be seen as routine risks that can be priced and transferred on a sole base.

Important business risks and sometimes also the potential impact of such risks are indicated in MNEs annual reports. Transfer Pricing documentation reports should therefore also include a risk paragraph, which summarises the most important risks, their potential impact and whether the risk can be priced/benchmarked or not. For many MNEs this is already the case.

Tax authorities should proceed cautiously before considering not recognising the transfer of risks and risks related income to the investor mentioned in example 65. In practise investors may not have detailed knowledge to assess, monitor and direct risk mitigation actions but may simply rely on the advice of external experts. Examples are investments in private equity, hedge-funds, stocks, real estate, commodities, bonds, options, futures or insurance underwriting where the mitigation

actions are managed by external advisors against a certain fee, whereby the advisor does not bear risk.

In this respect, and as indicated in our comments above, we have serious concerns about the principles and consequences of risk management in paragraph 55. The risk management decisions and capabilities to assess, monitor and direct risk taking and mitigation may in practise be spread over various layers and functions within a MNE. It is virtually impossible to allocate risks and risk related income over all layers and functions involved. This could be illustrated by the following example:

Example

In this example the MNE HQ is based in country A, the division HQ is based in country B, and factories in country C and D and group/division support functions in country D and E.

In a specific consumer durables industry there is a mature geographical market for a specific product. Future sales will depend on replacement sales and product innovations. Due to decline in the economy, entrance of new players and improved production technology there is production overcapacity in the industry and within a specific MNE division. There is a declining sales and EBIT trend for the division responsible for this product/market combination.

In a specific year group staff notices that the declining trends are getting worse. The Group Marketing department buys marketing services from an external service provider. The external market data include sales volumes, average sales price and consumer spending power per country. Group Marketing analyses the external market data and reports market trends to Group management. The Group Controlling and Accounting departments analyse and report the financial performance of each division to Group management.

Based on this input Group Departments Group Management decides that the responsible division should take action to stop declining sales by improving product portfolio, restore profitability by cutting purchase costs of external sourced materials and cutting overhead and production facilities within the division. A division taskforce with team members from various countries and supported and monitored by Global Departments and external consultants develops plans to meet the targets.

It appears that the factory in country C has a location disadvantage compared to other manufacturers in same region, including factory D. The labour and social contribution costs per unit and transportation costs per unit to most relevant markets are very high compared to other countries. The factory in country C would be lossmaking if it could only invoice at standard production costs per unit, based on average labour costs in the region plus a profit markup.

The factory in Country C supported by division task force, based in A, B, C, D and external consultants prepares a plan to become more cost competitive.

This example illustrates that decisions and risk mitigating actions, including directing, accessing, monitoring and executing are taken at various levels, by various functions and in various countries. It would in practise be impossible, and also incorrect, to allocate risks and risk related income over all layers, functions and countries involved.

This real life example differs significantly from the assumed risk management model in paragraph 55, which suggest that the capability to take decisions and assess, monitor and direct outsourced decisions are all based in the same location.

5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm's length principle?

6. In the example at paragraphs 90 and 91, how should risk-return trade-off implications be taken into account under the arm's length principle?

Comments on questions 5 and 6:

As mentioned previously, this is an extreme and oversimplified example not relevant for most MNEs. The example in 90 and 91 is an extreme situation in which the transaction most likely should not be recognised. Company S1 still performs all relevant functions like before and Company S2 performs only administrative functions. In this example it should be investigated which functions/company truly takes the Company S2 risk related decisions and whether the functions in Company S2 in practise have any decision taking authority at all. Company S2 most likely has an effective management based at the HQ of S1 and should be taxed accordingly. If the transaction is recognized at all, Company S2 should bear only the investment risk on its lump-sum payment, S2 risks are the interest rate risk and default risk of S1. Company S2 should get a routine return on its lump sum investment with a return rate comparable with a long term bond of parent company S1. The example cannot and should not form part of an important document like the one now discussed.

7. Under the arm's length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to "prove" that the transaction is economically rational)?

b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm's length principle, or falling outside the arm's length principle?

The real questions are whether there is a business rationale for shift in risk and whether the risk management function are indeed managed by the transferee. If the answer to those questions is yes, than the risk taking party should be compensated appropriately for taking the risk.

The example in 90 and 91 will most likely lead to non-recognition since there is no business rationale and no functions with the transferee that effectively manage the risk.

In relation to question a) recognised transactions which also include a shift of risk should be valued according to standard valuation techniques like DCF method. The most problematic part in such a valuation is the reliability of forecasts rather than setting an appropriate discount rate. Both MNEs and tax authorities should be careful of a duplication of uncertainties and opportunities in used forecasts and discount rate.

In relation to b) the tools to attack these types of fake transactions, for which BEPS is intended, are already available in the current OECD transfer pricing guidelines. MNEs should provide tax authorities access to all relevant information to judge the validity and valuation/benchmarking aspects of the transaction. Tax authorities should properly train specialists, including language skills, to evaluate transfer pricing aspects.

The concept of non-recognition, also referred to as recharacterisation should only be applied in situations comparable to examples 90-91, where the transaction clearly lacks the fundamental economic attributes of arrangements between unrelated parties and when tax savings appear to be the leading motive to structure a transaction in a specific way.

The main and biggest risk for a MNE and for its shareholders is the risk of double taxation. In order to provide certainty and predictability for the MNE and its shareholders, non-recognition can and should not be available to the tax authorities in other than exceptional cases.

It must be clear when non-recognition can be considered and it must and should follow main principles under the rule of law, meaning legal certainty and predictability. Only if it is apparent that the leading motive is tax driven then non-recognition is to be allowed. In cases where a proper and genuine business case

exists then the tax authorities cannot use the measure to non-recognize the transaction.

Part II - Special measures

Special measures create additional uncertainty for taxpayers. The Confederation of Swedish Enterprise believes that the analysis of commercial and financial relations, together with (if necessary) the application of non-recognition rules, should be considered enough to guarantee a proper remuneration of the intragroup transactions within MNEs. For these reasons, we find no need for these special measures in order to avoid BEPS behaviors.

If they are to exist there must be a clear and consistently applied set of criteria for their application. It should be clearly expressed that they should apply only in exceptional cases. They also need to be applied consistently by all tax administrations in order to avoid an increase of tax disputes and potential double taxation.

Option 1: Hard-to-value intangibles

Option 1 will likely lead to complications and increased administrative burden. MNEs should have the freedom to choose the form of the transaction within the boundaries of the at arm's length principle. Introducing a special measure available to the tax authorities that would allow them to use the benefit of hindsight in a re-assessment for tax purposes is not aligned with the above discussion on strategic risk. Early development projects are always a "hard to value intangible" and introducing a new element in this context would create great uncertainty.

This is nothing new and is also considered in a third party transaction. If the risk by one party is viewed to be manageable or that it is unlikely to materialize then he is willing to pay more. On the other hand if the risk is difficult to assess and viewed as likely to materialize then he is willing to pay less. This is already covered in any valuation report and is as such then already included as basis for a business decision (irrespectively if they are internal or external).

It is not reasonable to expect the same level of documentation and sophistication in adjustment clauses for intangible transactions with relative low value.

In highly uncertain situations it may be problematic to adjust the tax and accounting implications retrospectively if the original transaction was done via a lump sum payment. Can the transferor effectively receive corporate income tax back in the tax year when the transaction is done if the value is adjusted downwards five years

later? As stated above the paramount objective is to avoid double taxation and to ensure a predictable tax and business environment.

It is important to understand which elements in a valuation are highly uncertain and beyond control of the transferee. After all it is not logical that a transferor of an intangible should bear operational, transactional and hazard risks of the transferee if these risks are not directly related to the transferred intangible.

A transferee will try to seek coverage for market place risk beyond its control; payment is therefore linked to a specific development or event like government approval for medicines. This risk coverage can be achieved either via the purchase price of the intangible or via a price adjustment clause.

A trademark or technology royalty rate is normally set as a percentage of sales or per sold unit. The royalty rate setting depends on available benchmark material like third party royalty agreements and expected intangible related income for the licensee.

Both licensor and licensee will make projections of their respective income of the license agreement but retrospective royalty rate adjustments are not common. The question is how the transaction should be characterised if the licensor's royalty is directly depending on the profit of the licensee's enterprise, which is more a joint venture than the license of an intangible. Tax treatment of joint ventures is totally different from intangible related income.

In conclusion, we see a risk that option 1 it may open up for arbitrary use of hindsight. A better approach in our view is to include general guidance on the use of adjustment clauses recommending that such instruments should be used when it can be expected in third party situations and also outlining some guidance on how such clauses typically are designed.

Option 2: Independent Investor

It is unclear to us what option 2 is exactly aiming at. It appears to be very subjective and we fail to see how this option could be developed into a rule which is sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities. Consequently, we do not support this option.

Option 3: Thick capitalization

The tax treatment of both interest deduction and interest income should be based on the same set of ratios and rules.

The rationale of financing business activities and assets is mainly driven by the risk characteristics of the asset. Higher embedded risk implicates a lower debt /equity ratio.

Reference can be made to the Basel 2 and 3 guidelines for banks. Some entities may hold high liquidity and have high equity in anticipation of future acquisitions, so tax savings are not the leading motive.

In both thin and thick capitalisation situations it should be investigated whether there are sound business reasons for the financial transactions or whether only tax saving is the leading motive for a financial transaction.

The capital ratio varies considerably between MNEs in differing sectors. As with option 2, we fail to see how this option could be developed into a rule which is sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities. Therefore, we do not support this option.

Option 4: Minimal functional entity

There is a rationale for introducing minimum thresholds of functionality, both qualitative and quantitative, depending on the type of activities that entities are involved in and the industry in which the MNE operates.

Whether an entity is only involved in intercompany transactions is not an effective threshold for functionality. Should it make a difference whether a principal company has external transactions because it operates with a sales agent/toll manufacturer structure? The key question is whether an entity has the core functions to run its business.

It will be difficult to set pre-determined factors to allocate profits, but also assets and risks if a legal entity would fail the functionality threshold.

As stated above in relation to options 2 and 3, we fail to see how this option could be developed into a rule which is sufficiently clear and adaptable to various market conditions and industries and which do not hamper genuine business activities and we consequently do not support this option.

Option 5: Ensuring appropriate taxation of excess returns

CFC legislation leads to taxation of untaxed profits in the parent jurisdiction. Whether or not the taxes related to excess returns economically belong there is another matter. Therefore, maintaining and enforcing the arm’s length principle via

the transfer pricing guidelines is the correct way to tax excess profits where they should be taxed.

If there are sound business reasons to use a certain jurisdiction, such a business decision should be accepted without the risk of CFC-taxation.

However, in comparison with the other options in the Draft, we believe that option 5 is the most reasonable one. Appropriately designed CFC-rules have the potential to mitigate important BEPS behavior. Importantly, however, there needs to be a universal agreement on what is considered as an unacceptable tax level (and hence when CFC-taxation should be triggered).

On behalf of the Confederation of Swedish Enterprise

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