

Public Discussion Draft

BEPS ACTIONS 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



DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES)

19 December 2014

Public comments are invited on this discussion draft which deals with work in relation to Actions 8, 9, and 10 (“Assure that transfer pricing outcomes are in line with value creation”) of the BEPS Action Plan.

The Action Plan on Base Erosion and Profit Shifting, published in July 2013, identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement these actions.

Actions 8, 9, and 10 of the BEPS Action Plan relate to a number of closely related topics. These include the development of:

(i) “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.”

(ii) “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 recharacterised.”

(iii) “transfer pricing rules or special measures for transfers of hard-to-value intangibles.”

In accordance with this mandate, Working Party No. 6 on the Taxation of Multinational Enterprises has developed proposals set out in this discussion draft, which is divided into two parts.

Part I of this discussion draft contains a proposed revision to Section D of Chapter I of the Transfer Pricing Guidelines, and comments are invited on the revisions. The proposals emphasise the importance of accurately delineating the actual transactions, and include guidance on the relevance and allocation of risk. The Section provides guidance on determining the economically relevant characteristics or comparability factors of the controlled transaction. The revisions together with unchanged guidance from the current Section D delineate the features of the controlled transaction which then form the platform for comparison with uncontrolled transactions under the existing guidance found at, in particular, Chapters II and III. Part I concludes the revisions to Section D of Chapter I with further guidance on recharacterisation or non-recognition, including criteria determining when it would be appropriate for the actual transaction not to be recognised.

Part I encompasses issues at the heart of the arm’s length principle, on some of which specific input is sought by Working Party No. 6 before final guidance on these issues is drafted. These issues might be summarised as the extent to which associated enterprises can be assumed to have different risk preferences while they are also in fact acting collaboratively in a common undertaking. Specific questions have been raised in the discussion draft where such issues arise most prominently. Respondents are encouraged to recognise the objectives of Actions 8, 9, and 10 of the BEPS Action Plan, that is to assure that transfer

pricing outcomes are in line with value creation, in framing their responses to the specific questions.

Part II of this discussion draft sets out options for some special measures. As the BEPS Action Plan indicates, the main aim of the Transfer Pricing Actions (8-10) is to assure that transfer pricing outcomes are in line with value creation. The BEPS Action Plan also indicates that in order to achieve this aim “special measures, either within or beyond the arm’s length principle, may be required with regard to intangible assets, risk and over-capitalisation.” Part II of the discussion draft, therefore, outlines some options for potential special measures, and invites comments on them. These measures have been broadly outlined at this stage, and significant design work will need to be undertaken as the measures are further considered.

The options set out in Part II have a close interaction with other actions under the BEPS Action Plan, including Action 3 on strengthening CFC rules and Action 4 on interest deductions. The intention of including these measures in this discussion draft is to invite comments on these measures in advance of the public consultation on CFC rules foreseen in April 2015. With that, the public comments received will feed into the work on this area and will acknowledge the necessity to take account of the close interactions between the actions.

As mentioned in the Guidance on Transfer Pricing Aspects of Intangibles (2014), strong interactions exist between the bracketed and shaded sections of that document and matters covered by this discussion draft. Those bracketed and shaded sections will be completed during 2015 in conjunction with finalising the guidance contained in this discussion draft. Finalising the guidance contained in this discussion draft will also take into account any conforming amendments required to other parts of the Transfer Pricing Guidelines.

The views and proposals included in this discussion draft do not represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

This discussion draft is submitted for comment by interested parties. Comments should be submitted by **6th February 2015 (no extension will be granted)** and should be sent by email to **TransferPricing@oecd.org** in Word format (in order to facilitate their distribution to government officials). They should be addressed to Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration. Comments in excess of ten pages should attach an executive summary limited to two pages.

Please note that all comments received regarding this consultation draft will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective, or the person(s) on whose behalf the commentator(s) are acting.

A public consultation on the discussion draft and other topics will be held on 19-20 March 2015 at the OECD Conference Centre in Paris. Registration details for the public consultation will be published on the OECD website in due course. Speakers and other participants at the public consultation will be selected from among those providing timely written comments on the discussion draft.

PART I

It is proposed that the provisions of Chapter 1, Section D of the Transfer Pricing Guidelines be modified in the manner set out below. The proposals merge new and existing guidelines, and an indication of the derivation of paragraphs has been attempted to help commentators.

D. GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

D.1 Identifying the commercial or financial relations

1. [New] As stated in paragraph 1.6 a “comparability analysis” is at the heart of the application of the arm’s length principle, and is based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. There are two key aspects in such an analysis: the first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions attaching to those relations in order that the controlled transaction is accurately delineated; the second aspect is to compare the conditions of the controlled transaction with the conditions of comparable transactions between independent enterprises. This section of Chapter I provides guidance on identifying the commercial or financial relations between the associated enterprises and on accurately delineating the controlled transaction. This first aspect is distinct from the second aspect of considering the pricing of that controlled transaction under the arm’s length principle. Chapters II and III provide guidance on the second aspect of the analysis. The information about the controlled transaction determined under the guidance in this section is especially relevant for step 3 of the typical process of a comparability analysis set out in paragraph 3.4.

2. [New] The process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties. Establishing the conduct of the parties involves examination of all of the facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context to generate potential commercial value, how that interaction contributes to the rest of the value chain, and what the interaction involves in terms of the precise identification of the functions each party actually performs, the assets each party actually employs, and the risks each party actually assumes and manages.

3. [New and 1.52] A transaction is the consequence or expression of the commercial or financial relations between the parties, and, as discussed below, the manner in which the transaction has been formalised by the taxpayer should be reviewed in light of the actual conduct of the parties. Where a transaction has been formalised by the taxpayer through written contractual agreements, those agreements provide the starting point for delineating the transaction between the parties and how the responsibilities, risks, and benefits arising from their interaction are to be divided. The terms of a transaction may also be found in communications between the parties other than a written contract. Where no written terms exist, or where the conduct of the parties shows that the contractual terms are ambiguous, incorrect or incomplete, the delineation of the transaction should be deduced, clarified, or supplemented based on the review of the commercial or financial relations as reflected by the actual conduct of the parties.

4. [New] The following example illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or financial relations. Company P is the parent company of an MNE group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Company P and acts as a distributor for Company P's branded products, primarily supplying independent retailers. The contract between Company P and Company S states that Company S will provide distribution services. The contract is silent about any marketing and advertising activities that Company S should perform. Analysis of the commercial or financial relations between the parties shows that Company S performs extensive marketing and advertising activities in Country S that seek to develop brand awareness through sponsorship and media campaigns. Based on a review of the functions actually performed, it may be concluded that the written contract does not reflect the full extent of the commercial or financial relations between the parties. Accordingly, the analysis should not be limited by the terms recorded in the written contract, but should be based on the conduct of the parties, and will need to identify further how the parties determine the nature and scale of the brand-building activities, and how the activities are conducted and risks managed.

5. [1.53 - modified] It should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties. In transactions between independent enterprises, the divergence of interests between the parties ensures (i) that contractual terms are concluded that reflect the interests of both of the parties, (ii) that the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises. It is, therefore, particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties conform to the terms of any written contract, or whether the parties' actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterised or labelled by the taxpayer, or are a sham. Where conduct is not fully consistent with contractual terms, further analysis is required to identify the actual transaction. Where there are differences between contractual terms and factual substance, the conduct of the parties in their relations with one another, and what functions they actually perform, the assets they actually employ, and the risks they actually assume and manage, in the context of the consistent contractual terms, should ultimately determine the delineation of the actual transaction.

6. [New] The following example illustrates the concept of differences between written contractual terms and conduct of the parties, with the result that the actual conduct of the parties delineates the transaction. Company S is a wholly-owned subsidiary of Company P. The parties have entered into a written contract pursuant to which Company P licenses intellectual property to Company S for use in Company S's business; Company P also agrees to provide technical services to Company S, and Company S agrees to compensate Company P for the licence and services with a royalty. Observation of what the parties actually do establishes that Company P performs contract negotiations with third-party clients, provides regular technical services support to Company S, and regularly provides staff to help Company S deliver client contracts. A majority of customers insist on including Company P as joint contracting party along with Company S, although fee income under the contract is payable to Company S. The analysis of the commercial or financial relations indicates that Company S has never been capable of providing the contracted services without significant support from Company P, and is not developing its own capability. Company S does not seem to be operating as a licensee. Under the contract, Company P has given a licence to Company S, but in fact manages and influences the business risk and output of Company S in a manner that indicates it has not transferred risk and function consistent with a licensing arrangement, and acts not as the licensor but the principal. The identification of the actual transaction between Company P and Company S should not be limited by the legal form of the contract. Instead, the actual transaction should be determined from the capabilities and conduct of the parties, leading to the conclusion that the

parties have incorrectly characterised or labelled the transaction as a licence whereas in fact Company S provides services to Company P.

7. [New] In some circumstances the actual outcome of commercial or financial relations may not have been identified as a transaction by the taxpayer, but nevertheless may result in a transfer of value, the terms of which would need to be deduced from the conduct of the parties. For example, technical assistance may have been granted, synergies may have been created through deliberate concerted action, or know-how may have been provided through seconded employees or otherwise. These relations may not have been recognised by the MNE, may not have been formalised in contracts, and may not appear as entries in the accounting systems. Where the transaction has not been formalised, all aspects would need to be deduced from available evidence of the conduct of the parties, including what functions are actually performed, what assets are actually employed, and what risks are actually assumed and managed by each of the parties.

8. [New] The following example illustrates the concept of determining the actual transaction where a transaction has not been identified by the taxpayer. In reviewing the commercial or financial relations between Company P and its subsidiary companies, it is observed that those subsidiaries receive services from an independent party engaged by Company P. Company P pays for the services, the subsidiaries do not reimburse Company P and there is no service agreement in place between Company P and the subsidiaries. The conclusion is that, in addition to a provision of services by the independent party to the subsidiaries, there are commercial or financial relations between Company P and the subsidiaries, which transfer potential value from Company P to the subsidiaries. The analysis would need to determine the nature of those commercial or financial relations from the conduct of the parties, and would need to determine the terms and conditions of the identified transaction.

9. [1.34 - modified] The process of identifying the commercial or financial relations and accurately delineating the transaction also starts the process of identifying the economically relevant characteristics of the transaction. This is important since the application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable circumstances, and those circumstances need to take into account economically relevant characteristics. Before making comparisons with uncontrolled transactions, it is vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction.

10. [New] The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations of the associated enterprises to the delineated transaction can be broadly categorised as follows:

- The contractual terms of the transaction.
- The functions performed by the parties to the delineated transaction, taking into account assets employed and risks assumed and managed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
- The characteristics of 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.

11. [New] Economically relevant characteristics or comparability factors are used in two separate but related ways in a transfer pricing analysis. The first way relates to the process of accurately delineating the transaction for the purposes of this chapter, and involves establishing the characteristics of the transaction, including its terms, the functions performed, risks assumed and assets used by the parties, the nature of the products or services transferred, and the circumstances of the parties, in accordance with the categories set out in the previous paragraph. Such characteristics are economically relevant factors that independent enterprises take into account and weigh in evaluating potential transactions and the terms of those transactions.

12. [1.34 – modified] Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a better opportunity to meet their commercial objectives. In comparing one option with another, independent enterprises consider any differences between the options that would significantly affect the potential to meet those objectives. For example, one enterprise is unlikely to accept a price offered for its product by an independent commercial enterprise if it knows that other potential customers are willing to pay more under similar conditions, or are willing to pay the same under more beneficial conditions. Independent enterprises will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options. Therefore, identifying the economically relevant characteristics of the transaction is essential in delineating the transaction and in revealing the range of characteristics taken into account in reaching the conclusion that the transaction adopted offers a better opportunity to meet commercial objectives than alternative options.

13. [1.34 – modified] The second way in which economically relevant characteristics or comparability factors are used in a transfer pricing analysis relates to the process set out in Chapter III of making comparisons between the controlled transactions and uncontrolled transactions in order to determine an arm's length price for the controlled transaction. In order to make such comparisons, taxpayers and tax administrations need first to have identified the economically relevant factors of the controlled transaction. As set out in Chapter III, differences in economically relevant factors between the controlled and uncontrolled arrangements need to be taken into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

14. [1.35 – modified slightly] The extent to which the economically relevant characteristics matter in delineating the transaction and determining comparability will depend upon the nature of the controlled transaction and the pricing method adopted. All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy an equivalent product on otherwise comparable terms and conditions but at a lower price from another party. Therefore, as discussed in Chapter II, Part II, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. However, the method becomes a less reliable substitute for arm's length transactions if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profit margins earned in similar uncontrolled transactions. The comparison provides an estimate of the gross profit margin one of the parties could have earned had it performed the same functions for independent enterprises and therefore provides an estimate of the payment that party would have demanded, and the other party would have been willing to pay, at arm's length for performing those

functions. Other methods, as discussed in Chapter II, Part III, are based on comparisons of net profit indicators (such as profit margins) between independent and associated enterprises as a means to estimate the profits that one or each of the associated enterprises could have earned had they dealt solely with independent enterprises, and therefore the payment those enterprises would have demanded at arm's length to compensate them for using their resources in the controlled transaction. Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison. Therefore, in no event can unadjusted industry average returns themselves establish arm's length prices.

15. For a discussion of the relevance of these factors for the application of particular pricing methods, see the consideration of those methods in Chapter II.

D.1.1 Functional analysis

16. [1.42 – modified] In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed and managed by the parties to the transactions. The analysis focusses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy, and risk management discussed in section D.2.4. For this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution that the parties make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

17. [New] The actual contributions, capabilities, and other features of the parties can influence the options realistically available to them. For example, an associated enterprise provides logistics services to the group. The logistics company is required to operate warehouses with spare capacity and in several locations in order to be able to cope in the event that supply is disrupted at any one location. The option of greater efficiency through consolidation of locations and reduction in excess capacity is not available. Its functions may, therefore, be different to those of an independent logistics company which did not offer the same capabilities to reduce the risk of disruption to supply.

18. [New] In other situations, the controlled arrangement may require reduced capabilities to what might typically be required in uncontrolled arrangements. For example, an independent insurance provider offers diversification that the party seeking insurance may not have. However, in a group situation, the group may already have a wide range of assets in a range of locations such that some of the value of diversification that is implicit in the insurance premium charged by an independent insurer is already provided by the group companies. The additional capabilities the group may have in this situation would likely lead to a different fee to that charged by an independent insurance company to a customer lacking such attributes.

19. [New] Therefore, the process of identifying the economic circumstances of the commercial and financial relations should include consideration of the capability of the parties, how under the arm's length

hypothesis such characteristics affect options realistically available, and whether similar capability is reflected in potentially comparable arm's length arrangements.

20. [1.44 – unchanged] The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

21. [New] A particular feature relevant in a functional analysis is that an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialisation, secure in the knowledge that the fragmented activities are under common control for the long term and are co-ordinated by group management functions. There may be considerable interdependencies between the fragmented activities. For example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions may require considerable co-ordination in order that the separate activities interact effectively. Sales activities are likely to be highly dependent on marketing, and fulfilment of sales, including the anticipated impact of marketing activities, would require alignment with stocking processes and logistics capability. That required co-ordination may be performed by some or all of the companies performing the fragmented activities, through a separate co-ordination function, or through a combination of both. Risk may be managed through contributions from all the parties, or performed mainly by the co-ordination function. Therefore, when conducting a functional and risk analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and, if so, the nature of the interdependencies and how the commercial activity to which the parties contribute is co-ordinated.

22. [1.45 – modified slightly] Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

23. [1.46 - modified] The types of risks to consider include, among others, specific market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of specific property, plant, and equipment; risks related to the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth. Relevant risks may also include more general entrepreneurial risks related to the commercial success or failure of the business or of specific products and services. See section D.2 for a more detailed discussion of the relevance of risk.

D.1.2. Characteristics of property or services

24. [1.39 – mainly unchanged] Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in delineating the transaction and in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property. For further discussion of some of the specific features of intangibles

that may prove important in a comparability analysis involving transfers of intangibles or rights in intangibles, see Chapter VI paragraphs 6.113-6.124.

25. [1.40 - unchanged] Depending on the transfer pricing method, this factor must be given more or less weight. Among the methods described at Chapter II of these Guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered (see in particular paragraph 2.15). Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the gross profit margin or mark-up on costs (see in particular paragraphs 2.23 and 2.41). Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods (see in particular paragraph 2.69). This however does not mean that the question of comparability in characteristics of property or services can be ignored when applying these methods, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

26. [1.41 - unchanged] In practice, it has been observed that comparability analyses for methods based on gross or net profit indicators often put more emphasis on functional similarities than on product similarities. Depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of the comparability analysis to include uncontrolled transactions involving products that are different, but where similar functions are undertaken. However, the acceptance of such an approach depends on the effects that the product differences have on the reliability of the comparison and on whether or not more reliable data are available. Before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction.

D.1.3 Economic circumstances

27. [1.55 – final sentence added] Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth. The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences. More detailed guidance on the importance in a comparability analysis of the features of local markets, especially local market features that give rise to location savings, is provided in Section D.6 of this Chapter and in paragraphs 9.148 to 9.153.

28. [1.56 – largely unchanged] The existence of a cycle (e.g. economic, business, or product cycle) is one of the economic circumstances that should be identified. See paragraph 3.77 in relation to the use of multiple year data where there are cycles.

29. [1.57 – largely unchanged] The geographic market is another economic circumstance that should be identified. The identification of the relevant market is a factual question. For a number of industries, large regional markets encompassing more than one country may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant.

30. [1.58 - unchanged] In cases where similar controlled transactions are carried out by an MNE group in several countries and where the economic circumstances in these countries are in effect reasonably homogeneous, it may be appropriate for this MNE group to rely on a multiple-country comparability analysis to support its transfer pricing policy towards this group of countries. But there are also numerous situations where an MNE group offers significantly different ranges of products or services in each country, and/or performs significantly different functions in each of these countries (using significantly different assets and assuming significantly different risks), and/or where its business strategies and/or economic circumstances are found to be significantly different. In these latter situations, the recourse to a multiple-country approach may reduce reliability.

D.1.4 Business strategies

31. [1.59 – largely unchanged] Business strategies must also be examined in delineating the transaction and in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

32. [1.60 - unchanged] Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

33. [1.61 - unchanged] Timing issues can pose particular problems for tax administrations when evaluating whether a taxpayer is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits. If in the future those increased profits fail to materialize because the purported business strategy was not actually followed by the taxpayer, legal constraints may prevent re-examination of earlier tax years by the tax administrations. At least in part for this reason, tax administrations may wish to subject the issue of business strategies to particular scrutiny.

34. [1.62 - unchanged] When evaluating whether a taxpayer was following a business strategy that temporarily decreased profits in return for higher long-run profits, several factors should be considered. Tax administrations should examine the conduct of the parties to determine if it is consistent with the purported business strategy. For example, if a manufacturer charges its associated distributor a below-market price as part of a market penetration strategy, the cost savings to the distributor may be reflected in

the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. A market penetration strategy of an MNE group could be put in place by the manufacturer or by the distributor acting separately from the manufacturer (and the resulting cost borne by either of them). Furthermore, unusually intensive marketing and advertising efforts would often accompany a market penetration or market share expansion strategy. Another factor to consider is whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length transactions a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product through a trademark or trade name or increases goodwill associated with the product, this situation should be reflected in the analysis of functions for the purposes of establishing comparability.

35. [1.63 - unchanged] An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not of itself allow the strategy to be ignored for transfer pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the business strategy is unsuccessful but nonetheless is continued beyond what an independent enterprise would accept, the arm's length nature of the business strategy may be doubtful. In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued. In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

D.2 Identifying risks in commercial or financial relations [This section is substantially new]

36. Risk is inherent in commercial activities. Businesses undertake commercial activities because they seek opportunities to make profits, but those opportunities carry uncertainty that the required resources to pursue the opportunities will not generate the expected returns. Identifying the risks included in commercial or financial relations is a critical part of a transfer pricing analysis. Although discussed in a separate section to functions and assets, identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated enterprises and of accurately delineating the transaction or transactions.

37. Identifying risks is critical since the assumption of risks associated with a commercial opportunity affects the profit potential of that opportunity in the open market, and the allocation of risks assumed between the parties to the arrangement affects how profits or losses resulting from the transaction are allocated at arm's length through the pricing of the transaction. Therefore, in making comparisons between controlled and uncontrolled transactions and between controlled and uncontrolled parties it is necessary to analyse what risks have been assumed, what functions are performed that relate to or affect the impact of these risks and how these risks are allocated.

38. Risks can give rise to difficulties in a transfer pricing analysis. This is partly because risks can be hard to identify, and so this section provides guidance on the nature and sources of risk relevant to a transfer pricing analysis in order to help with the identification process. In addition, difficulties may arise because contracts between associated enterprises may lack the divergence of interests shown in contracts between independent parties; therefore, an examination should also be made of the conduct of the parties in relation to the relevant risks and of the consequence of this conduct on delineating the actual transaction

including the actual allocation of risk between the associated parties. In identifying the allocation of risk attention should be paid to how the parties actually manage the risk identified. Between third parties, the assumption of risk without the control exerted by management over the risk is likely to be problematic because (i) it is difficult for the party assuming risk to evaluate the required additional expected return when the factors affecting the risk outcomes are determined by another party; and (ii) there would likely be considerations of moral hazard in an arm's length situation were one party to assume risk without safeguards to manage the behaviour of the party creating its risk exposure. In arm's length transactions it generally makes sense for the parties to be allocated a greater share of those risks over which they have relatively more control. For example, suppose that Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B. In such a case, Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does.

39. [Based on 9.23 and 9.28] Control over risk should be understood as the capability to make decisions to take on the risk and decisions on whether and how to respond to the risk, as set out more fully in Section D.2.5. Control should not be interpreted as being limited to the decision to adopt risk mitigation measures, since in assessing risks businesses may decide that the uncertainty associated with some risks, after being evaluated, should be taken on and faced with little or no mitigation in order to create and maximise opportunities.

40. The guidance in this section is ordered to mirror the following framework for analysing risk:

- Taking into account the nature and sources of risk, what are the specific risks included in the commercial or financial relations of the parties?
- How are those specific risks allocated in contractual arrangements? How are the risks assumed? Do the specific risks relate to operational activities from which the risks arise?
- What is the potential impact of those specific risks?
- How is each risk actually managed by the members of the MNE group? How does risk management related to the risk influence the occurrence or the impact of the risk?
- Does the party contractually assuming the risk either (a) perform the operational activities from which the risk arises, (b) manage the risks, or (c) assess, monitor, and direct risk mitigation?
- What are the actual transactions undertaken? Are the contractual arrangements in relation to the risk allocation, the operational activities to which the risk relates and risk management aligned with the conduct of the parties?

Additional points

Sections D.2, D.3, and D.4 in particular give rise to several issues at the heart of the application of the arm's length principle, on some of which Working Party No. 6 specifically invites comments before final guidance is drafted. In summary, the issues tend to involve the extent to which associated enterprises can be assumed to have different risk preferences while they may also in fact be acting collaboratively in a common undertaking under common control. In commenting on all matters raised by the entire discussion draft, respondents are invited to consider the following additional points in the context of the established framework of the arm's length principle.

Moral hazard

A number of issues can be grouped around the term “moral hazard” which refers to the lack of incentive to guard against risk where one is protected from its consequences. The term is used (for example in paragraphs 62 and 67) to introduce the concept that unrelated parties would seek to avoid moral hazard that may arise in situations where one party assumes a risk without the ability to manage the behaviour of the party creating its risk exposure. The concept extends to the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided.

These concepts are used to support the observation that between unrelated parties it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. In turn, these concepts are used to determine the allocation of risk between associated enterprises based on which party manages and controls the risk.

Between associated enterprises, however, the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other. Instead, the associated enterprises may operate collaboratively in order to maximise MNE group profits. The adverse effects of moral hazard may in practice not occur.

In commenting on this point, respondents are invited to consider the following questions:

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

Risk-return trade-off

A further set of issues can be grouped around the term “risk-return trade-off.” The concept is specifically mentioned in paragraph 71, but is implicit throughout. The economic concept establishes equivalence on a present value basis between a higher but less certain stream of income and a lower but more certain stream of income. The principle supports the associated notion that it is economically rational to take on (or lay off) risk in return for higher (or lower) anticipated nominal income. Between unrelated parties, for example, the sale of a risky income-producing asset may reflect in part a preference of the seller to accept a lower but more certain amount of nominal income and to forego the possibility of higher anticipated nominal income it might earn if it instead retained and exploited the asset (the discount rate applied to the anticipated nominal income provides a link in deciding whether the seller is “better off” in selling or retaining the asset).

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?
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?
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?

Financial Services Sector

8. Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?

D.2.1. The nature and sources of risk

41. There are many definitions of risk, but in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. A company is likely to direct much attention to identifying uncertainties it encounters, and in developing appropriate risk management strategies which are important to shareholders seeking their required rate of return. Risk is associated with opportunities, and does not have downside connotations alone; it is inherent in commercial activity, and companies choose which risks they wish to seek out in order to have the opportunity to generate profits. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. Downside risk occurs when the anticipated favourable outcomes fail to materialise. For example, a product may fail to attract as much consumer demand as projected. However, such an event is the downside manifestation of uncertainty associated with commercial opportunities to which companies are likely to devote considerable attention in order to reap the positive returns from having pursued the opportunity in the face of risk. Such attention may include management activities around determining the product strategy, how the product is differentiated, how to identify changing market trends, how to anticipate political and social changes, and how to create demand. The significance of the risk depends on the context: a different flavour of baked beans may not be the company's sole product, the costs of developing, introducing, and marketing the product may have been marginal, the success or failure of the product may not create significant reputational risks so long as business management protocols are followed, and decision-making may have been effected by delegation to local or regional management who can provide knowledge of local tastes. However, ground-breaking technology or an innovative healthcare treatment may represent the sole or

major product, involve significant strategic decisions at different stages, require substantial investment costs, create significant opportunities to make or break reputation, and require centralised management that would be of keen interest to shareholders and other stakeholders.

42. Risks can be categorised in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk. The following non-exclusive list of sources of risk is not intended to suggest a hierarchy of risk. Neither is it intended to provide rigid categories of risk, since there is overlap between the categories. Instead, it is intended to provide a framework that may assist in ensuring that a transfer pricing analysis covers the range of risks likely to arise from the commercial or financial relations of the associated enterprises, and from the context in which those relations take place. Reference is made to risks that are externally driven and those that are internally driven in order to help clarify sources of uncertainty. However, there should be no inference that externally driven risks are less relevant because they are not generated directly by activities. On the contrary, the ability of a company to face, respond to and manage externally driven risks is likely to be a source of competitive advantage and sustained returns over the long term. Importantly, guidance on the possible range of risk should assist in identifying risks with specificity. Risks which are vaguely described or undifferentiated will not serve the purposes of a transfer pricing analysis seeking to delineate the actual transaction and the actual allocation of risk between the parties.

- a) Strategic risks or marketplace risks. These are largely external risks caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes. The assessment of such uncertainties may define the products and markets the company decides to target, and the capabilities it requires, including investment in intangibles and tangible assets, as well as in the talent of its human capital. There is considerable potential downside, but the upside is also considerable if the company identifies correctly the impact of external risks, and differentiates its products and secures and continues to protect competitive advantage. Examples of such risks may include marketplace trends, new geographical markets, and concentration of development investment.
- b) Infrastructure or operational risks. These are likely to include the uncertainties associated with the company's business execution and may include the effectiveness of processes and operations. The impact of such risks is highly dependent on the nature of the activities and the uncertainties the company chooses to assume. In some circumstances breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence; whereas successful management of such risks can enhance reputation. In other circumstances, the failure to bring a product to market on time, to meet demand, to meet specifications, or to produce to high standards, can affect competitive and reputational position, and give advantage to companies which bring competing products to market more quickly, better exploit periods of market protection provided by, for example, patents, better manage supply chain risks and quality control. Some infrastructure risks are externally driven and may involve transport links, political and social situations, laws and regulations, whereas others are internally driven and may involve capability and availability of assets, employee capability, process design and execution, outsourcing arrangements, and IT systems.
- c) Financial risks. All risks are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by economic shock or credit crisis, but can also be internally driven through controls, investment decisions, credit terms, and through outcomes of infrastructure or operational risks.

- d) Transactional risks. These are likely to include pricing and payment terms in a commercial transaction for the supply of goods, property, or services.
- e) Hazard risk. These are likely to include adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but insurance may not cover all the potential loss, particularly where there are significant impacts on operations or reputation.

D.2.2. Allocation of risk in contracts

43. [Based on 9.13] The allocation of risk should be analysed as part of the first aspect of a comparability analysis which is to identify the commercial or financial relations between the associated enterprises in order that the controlled transaction is accurately delineated. A written contract may set out the allocation of risk. In line with the discussion above in relation to contractual terms (see Section D.1), it must be considered in each case whether an allocation of risk contained in written contracts is consistent with the factual substance of the transaction as reflected in the conduct of the parties. Where differences exist between contractual terms related to risk and the conduct of the parties, the parties' conduct in the context of the consistent contractual terms should generally be taken as the best evidence concerning the actual allocation of risk.

44. [Based on 9.14 and 1.48] Assume for example, that a manufacturer, whose functional currency is US dollars, sells goods to an associated distributor in another country, whose functional currency is euros, and the written contract states that the distributor assumes all exchange rate risks in relation to this controlled transaction. If, however, the price for the goods is charged in euros, the currency of the distributor, then aspects of the written contractual terms do not reflect the actual commercial or financial relations between the parties. The transaction should be delineated by the actual conduct of the parties in the context of the contractual terms, rather than by aspects of written contractual terms which are not in practice applied.

45. [9.15] The principle can be further illustrated by the situation of a foreign associated enterprise which assumes all the inventory obsolescence risks by written contract. When examining such a risk allocation, it may be relevant to examine, for example, where the inventory write-downs are taken (i.e. whether the domestic taxpayer is in fact claiming the write-downs as deductions), and where decisions regarding production volumes and inventory levels are taken. Evidence may be sought to confirm that the parties' conduct supports the allocation of these risks in accordance with the contract.

D.2.3. How risks are assumed

46. Assumption of core risks is likely to be rooted in a MNE group's operational functions, and is not always limited to the party in which the outcome of the risk materialises. Take for example commodity price risk, which materialises when a sale is made to an independent customer. Company P is the parent company of an MNE group operating in the commodities sector. Company S1, a subsidiary of the group, conducts mining operations in country S, producing commodity C. The MNE group establishes a subsidiary, Company S2 in country Y. Company S2 undertakes the marketing and sales of the commodity to independent customers. Company S2 enters into a contract with S1 whereby S2 agrees to purchase 100% of S1's production of commodity C for the next 10 years. The transfer price payable is to be determined based on a discount to the prices achieved by S2 in its sales to independent customers.

47. In this case, while Company S1 has a guaranteed buyer for 100% of its production of commodity C, it is still exposed to significant market risk: prices it receives for its production of commodity C are dependent on market prices achieved by S2. Company S2 may be able to optimise pricing at the margins,

but no party is likely to be able to materially influence the market prices for commodity C, and is a risk taken on and faced by the MNE group. Instead, the mitigation of price risk within the MNE group focuses on the supply side and involves the management of strategic risks related to the investment decisions affecting risk-bearing opportunities, the capability to influence risk outcomes operationally through varying production capacity, as well as the operational management of production costs. The functional analysis should determine which party or parties enable the MNE group to respond to and manage the effect of price risk assumed in its operations. Where functions are in more than one company, the analysis should also consider which functions have more impact on risks assumed; for example, whether there is inflexibility in varying production levels due to the high fixed costs involved, and whether the most effective response to price pressures lies in operational production efficiencies.

D.2.4. Potential impact of risk

48. Determining the impact of risk and the significance of how risk and uncertainty may affect a transfer price depends on the broader functional analysis of how value is created by the MNE, the activities that allow the MNE to sustain profits, and the role of the specific entities within the MNE group in contributing to that value.

49. In the situation of an integrated MNE group, risk outcomes can affect many group companies. For example, production supply problems are not limited in their impact to production operations, but can affect sales volumes and profitability for other group companies, and potentially cause reputational harm. Another example is product risk. It can have a significant impact on the developer of the product, but it will also have an impact on the volumes manufactured by production companies and sold by distribution companies; there may be an impact on cost of borrowings and on reputation of all parties, and ultimately on commercial viability. Although the manufacturer or distributor strictly speaking may not be allocated product risk, they are affected by the outcome of product risk because of the group interdependencies and long term co-operative relationship with a shared interest in providing a dedicated, exclusive sales channel which conflicts with the opportunity to diversify their dependence by operating for other parties. Blanket statements that one or another party performing commercial activities is insulated from all commercial risk and that pricing should be based on the determination of risk-free returns should be carefully scrutinised.

50. The principle set out in paragraph 48 that the impact of risk depends on how value is created may be illustrated by the following examples which consider the functions of managing relations with suppliers in the context of how risks are managed in exploiting opportunities and creating value.

51. In the first situation the MNE distributes heating oil to consumers. The functional analysis establishes that the product is undifferentiated, the market is competitive, the market size is predictable, and players are price-takers. In such circumstances, the ability to influence margins may be limited. An important value driver relates to the credit terms obtained from the oil producers and a key risk is the financial risk of funding working capital efficiently. The functional analysis establishes that all discussions with the oil producers are conducted directly by the parent company and that the personnel of the local distributor do not have any involvement in securing the terms. The credit terms achieved are crucial to the local distributor's margin since they fund working capital, whereas competitors that cannot obtain similar credit terms have to borrow to support working capital. In this example, the working capital risk remains assumed by the distributor since it retains the functions which contribute to management of the risk of buying and selling products, determining pricing to customers, managing invoicing and collection from customers, and determining volumes; however, the facts and circumstances of the case may indicate that working capital risks are managed in part by means of the additional functions of the parent company.

52. In the second situation, a multinational toy retailer buys a wide range of products from a number of third-party manufacturers. Most of its sales are concentrated in the last two months of the calendar year,

and a significant risk relates to the strategic direction of the buying function, and in making the right bets on trends and determining the products that will sell and in what volumes. Trends and the demand for products can vary across markets, and so the expertise of the local group distributor is needed to evaluate the right bets in the local market. The effect of the buying risk can be magnified if the retailer can negotiate a period of exclusivity for a particular product with the third-party manufacturer. However, exclusivity is unlikely to be granted by the manufacturer unless it is convinced that the party to which it grants exclusivity will provide it with greater benefits than would be provided by entering into exclusive arrangements with another party or than would be provided if it were to grant no exclusivity at all. The negotiations to convince the manufacturer are conducted by the parent company which has a longer relationship with the manufacturer and has been able to demonstrate capability to market products appropriately. Here strategic buying risks are managed by the local subsidiary, but the opportunity to capitalise on those risk decisions is enhanced by the activities of the parent.

53. Importantly, the business risks have not been transferred from the distributors, but their impact is enhanced or mitigated by the functions and capabilities of another party. The facts in both examples could be revised to illustrate situations where buying functions have been transferred, so that the parent assumes the buying function and procures products on behalf of the sales subsidiaries. However, such a revision to the facts would bring the examples within the definition of business restructurings, and guidance on the treatment of the internal reallocation of functions and risks would be supplemented by specific references in Chapter IX.

D.2.5. Risk management

54. Business functions respond to the sources of risk described above. Risk is inherent in commercial activities and activities to manage risk will be carried out. Many of these risks are sought out and assumed by companies in order to generate profit-making opportunities, and the appropriate management of these risks affects a company's performance. Risk management, therefore, does not eliminate risk but assesses risk together with the associated opportunities and determines appropriate risk mitigation strategies.

55. [Based on 9.23 and 9.24] Risk management comprises three elements: (i) the capability to make decisions to take on or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (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, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation. Control over risk as set out in paragraph 39 involves the first two elements of risk management; that is the decisions to take on the risk and decisions on whether and how to manage the risk, including the actual performance of the decision-making function. Where a decision is made to outsource risk mitigation as described in (iii), control of the risk would require capability to assess, monitor, and direct the outsourced measures that affect risk outcomes, together with the performance of such assessment, monitoring, and direction.

56. In a group situation, risk management may be carried out at several levels, and not solely by the legal entity that incurs risk through its operations. The board and executive committees may set the level of risk the company is prepared to accept in order to achieve commercial objectives, and to establish the control framework for managing and reporting risk in its operations. Line management in business segments, operational entities, and functional departments may identify and assess risk against the commercial opportunities, and put in place appropriate controls and processes to address risk and influence the risk outcomes arising from day-to-day operations. The opportunities pursued by operational entities require the ongoing management of the risk that the resources allocated to the opportunity will deliver the anticipated return. These functions all contribute to risk management.

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. For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw material as a consequence of its being remunerated by another group company on a cost plus basis that takes account of its actual costs. The implication of the claim is that the other group company assumes the risk. However, the key point to address is whether there exists an operational or financial risk associated with raw material price fluctuation, and if so how that risk is managed in the business. If the other group company in fact manages the risk and has the expertise and capability to do so, then it would be appropriate to determine how that function operates, where its costs are borne, and how the function should be rewarded. If however, the manufacturer manages the risk, then it is performing risk management, for which it should be rewarded. Furthermore, the cost plus basis in this example potentially could be claimed to protect the manufacturer from a wide range of risks, not just raw material costs (for example, utilisation, price fluctuations of other inputs), and a similar analysis of how the business manages these risks would be required before concluding that the manufacturer does not play a role in risk management. The wider risks around product specialisation, sophistication of manufacturing, quality control, flexibility to switch production, and other factors determined by the functional analysis are also relevant to determining appropriate pricing.

58. If budgeted costs were used instead of actual costs in this example, then the principle remains that attention should be paid to the functions of the parties in relation to risk management, rather than determining that the pricing arrangements adopted themselves determine how risks are managed. In the case of budgeted costs, specific additional attention should be paid to how budgets are determined, and how potential differences between budgets and outcomes are risk managed.

59. The functional analysis should carefully consider how risks are managed before concluding, for example, that only the product developer manages product risk. It may be the case that a distributor has played a significant role in determining the nature and specifications of products likely to meet its predictions of trends in its market, and therefore shares in the product risk management.

D.2.6. Actual conduct

60. The parties' assumption of risk does not in itself determine that they should be allocated the risk for transfer pricing purposes. It is relevant to enquire how the risks are controlled in the business, as well as which party's functions enable it to face and mitigate the risks associated with business activities. Consider the example of product recall risk: under the written contract this is assigned to the distributor, and the distributor is allocated a higher margin as a result. Assume, however, that the business has not had any product recalls, notwithstanding the fact that the risk is recognised in its financial reporting. Further, assume that the functional analysis reveals stringent supplier audit programmes, extensive testing protocols, mandatory training, and a culture of improvement. Risk management is in fact performed by the manufacturer, and the distributor has no involvement and no capability to assess the risk or effectively monitor risk mitigation. In such a circumstance, the group's risk management is actually performed and controlled by the manufacturer, and accordingly the manufacturer should attract the outcome of upside and downside risk instead of the distributor. The distributor's activities make no reference to the consideration of the risk it bears under the contract, whereas the manufacturer's functions cover all aspects of product risk management. Under these circumstances, the risk in question should be allocated to the manufacturer based on the conduct of the parties, and not be allocated to the distributor based on the terms of written agreements.

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. A customer's contract with an unrelated insurance company, for example an individual's car insurance certificate, could be perceived as a contractual allocation of risk from the perspective of the customer, but the insurance company will have the relevant capabilities to assess, underwrite and manage the insurance risk. To the extent that ability to control a risk is lacking in a group situation, then the arrangements would not support the contractual allocation of that risk for transfer pricing purposes.

62. If a supplier determines what products a distributor should sell, at what price, the volumes shipped, and what promotional campaigns the distributor should implement, then that supplier is performing some functions affecting the risks associated with the distributor's business opportunities. At arm's length the carrying on of those functions would affect the terms agreed by the parties, including risk assumption. In an arm's length situation, the distributor would find it difficult to determine the additional return it should seek to recover from the supplier if it were to assume stock obsolescence risk since the tools by which that risk can be managed, and the activities which influence that risk, are determined by the supplier. The distributor would need safeguards provided by the ability to control the risk were it to assume the risk. There would likely be considerations of moral hazard in an arm's length situation were the distributor to underwrite stock obsolescence without such safeguards, since it may encourage the supplier to maximise its returns at the expense of the distributor. Therefore, at arm's length the risk is more likely to be assumed by the party which manages the risk or which, if risk mitigation measures are outsourced, controls the risk.

63. Risks should be analysed with specificity, and it is not the case that risks and opportunities associated with the exploitation of an asset, for example, derive from asset ownership alone. Ownership brings specific investment risk that the value of the asset can increase or may be impaired, and there exists risk that the asset could be damaged, destroyed or lost (and such consequences can be insured against). However, the risk associated with the commercial opportunities potentially generated through the asset is not exploited by mere ownership. Consider the example of a company which owns specialist equipment, the main risk associated with which is utilisation. Another group company provides specifications for the equipment, operates the equipment, provides skilled personnel, markets the equipment's capabilities to third-party customers, and engages with those customers to provide production services. The company which owns the equipment does not have any capability to exploit its ownership or functionally manage its key risk, but instead all risk management associated with exploiting the asset, enhancing upside risk and mitigating downside risk, is performed by the other group company. In such circumstances of high dependency the risk management would require appropriate reward. In this example, the return allocated to the risk management may be high since utilisation is a core risk affecting the asset-owner's income stream. If the asset owner does not control the risk, that is, it does not monitor, assess, and direct the mitigation measures that are purportedly outsourced, then the risk associated with exploitation of the asset may be allocated to the party actually performing risk management, and with that exercising control over the risk. Such a conclusion may also be warranted if the asset owner has no or no sufficient safeguards or incentives in place for the party performing the risk mitigation functions to perform in an optimal fashion, since this factor may indicate that the asset owner cannot monitor, assess, and direct the risk mitigation measures. If the asset owner does not have capability to control risks associated with the exploitation of the asset, the legal owner of the asset is in substance providing only financing equating to the cost of the asset, and should be remunerated on that basis.

64. The relationship between cash investment in a business undertaking and risk is a complex one. In uncontrolled transactions, the party making cash investments in a business generally will ask for an appropriate security or guarantee to cover the credit risk. However, even in uncontrolled transactions a cash investor sometimes is willing to make cash investment in a risky business undertaking without any security or guarantee. In the latter case, the cash investor is likely to consider the possible impact of the risks and the risk management of the business when making the investment decision. If no other risk mitigation measures are available, such as for example diversification, the investor may wish to be able to assess, monitor and direct risk mitigation measures in order to protect its investment.

65. In a transfer pricing analysis, it is very important to conduct a full functional and comparability analysis to assess the contributions by all of the associated parties to the activities to which the risks relate. Based on the full functional and comparability analysis, it is appropriate to consider separately the appropriate return to the cash investment and any risk premium that may be associated with risk management. If the investor has no capability to mitigate the investment risk itself or to assess, monitor, and direct risk mitigation functions, and therefore is reliant on another party to perform risk management, then an assumption that an entity investing cash in a project without performing risk management is therefore entitled to all of the residual returns after rewarding routine functions is unlikely to be sustainable in a transfer pricing analysis. Paragraphs 6.60 and 6.61 together with Example 7 of Chapter VI further illustrate this point in the specific context of investment in funding intangible development.

66. Financial capacity to bear risk is a relevant but not determinative factor in considering whether a controlled party should be allocated a risk return. As stated in Chapter IX, a high level of capitalisation by itself does not mean that the highly capitalised party carries risk (paragraph 9.32). MNE groups, unless subject to capital adequacy regulations, can determine the capital structure of subsidiaries without explicit consideration of actual risk in that subsidiary. For the same reason, a low level of capital in a controlled enterprise, should not prevent the allocation of risk to the company for transfer pricing purposes where such allocation is justified under the guidance of this Chapter.

67. Some risks may be transferred for a fee at arm's length. Common risks transfers would typically come under the last two headings in paragraph 42, transactional risk and hazard risk. Examples of risk transfer include debt factoring, exchange rate hedges, or fire insurance. Some financial risks, such as interest rate risk, may also be transferred. There are more limited opportunities to transfer core risks involving strategic, marketplace, infrastructure, and operational risks, and risk transfer of core capabilities may involve strict conditions and is unlikely in an arm's length situation to cover all potential losses. At arm's length companies may be unwilling to share insights about their core competencies with third parties for fear of losing intellectual property or market opportunities. Third parties may be unlikely to provide insurance for core competencies unless they have significant information about and control of potential outcomes due to moral hazard that the incentive to manage risk by the insured party is lowered.

68. In circumstances where risk has been transferred, such as in a currency hedge, and the functional analysis has determined that the risk is economically significant, then an arm's length fee for the risk transfer would need to be determined, and the upside and downside risk consequences would be allocated in accordance with the terms of the hedge. Similarly, where economically significant bad debt risk is transferred through a factoring arrangement, an arm's length fee would need to be determined for the transfer, taking into account whether the arrangement is with or without recourse, and the income and costs associated with debt collection would be allocated to the factoring activity.

69. Often a MNE group will centralise treasury functions with the result that the implementation of risk mitigation strategies relating to interest rate and currency risks are performed centrally in order to improve efficiency and effectiveness. It may be the case that the operating company reports in accordance with group policy a currency exposure, and the centralised treasury function organises a financial

instrument that the operating company enters into. As a result, the centralised function can be seen as providing a service to the operating company, for which it should receive compensation on arm's length terms. More difficult transfer pricing issues may arise, however, if the financial instrument is entered into by the centralised function or another group company, with the result that the positions are not matched within the same company, although the group position is protected. In such a case, an analysis of the conduct of the parties may suggest that the treasury function is not entering into speculative arrangements on its own account, but is taking steps to hedge the specific exposure of the operating company and has entered into the instrument essentially on behalf of the operating subsidiary. As a consequence the treasury company provides a service. Further, the centralised treasury function could identify that there already exists a natural hedge within the group, with the result that the group position is protected without further action. However, the position of the individual group companies is not protected.

70. The fact that some risks can be transferred does not mean they would be at arm's length. Risk transfer has cost implications, and part of a company's risk management is to determine the potential size of the risks associated with the opportunity, what risks it wants to retain and manage through internal processes and controls, and what risks it wishes to transfer in exchange for a reduction in volatility.

71. In risk transfers between associated enterprises the risk-return trade-off should not be used on its own to justify the appropriateness of any risk transfer. In particular, a risk transfer not supported by functions should be critically reviewed. In a debt factoring arrangement between independent enterprises, for example, the seller discounts the face value of its receivables in return for a fixed payment, and so accepts a lower return but has reduced its volatility and laid off risk. The factor will often be a specialised organisation which takes on risk and has functional capabilities to manage the risk and generate a return from the opportunity. Neither party will expect to be worse off as a result of entering into the arrangement, essentially because the factor is more capable of managing the risk than the seller and terms acceptable to both parties can be agreed. However, it does not follow that by analogy any exchange of potentially higher but riskier income for lower but less risky income between associated enterprises is justifiable for transfer pricing purposes. Where the party taking on risk does not have the capabilities to manage its risks and generate a return from the opportunity, this may lower the price it would be prepared to pay compared to the situation in which it was able to manage its risks, and may mean terms acceptable to both parties could not be agreed.

72. In analysing the transfer of risk, it is relevant to consider whether the arrangement provides the opportunity for both parties to the arrangement to enhance or protect their commercial or financial position on a risk-adjusted basis (the return adjusted for the level of risk associated with it). This means that risk transfer is likely to happen only if the transferee is well placed or better placed to manage risk than the transferor. Circumstances meriting particular scrutiny include those where the transferee has no risk management capability, and those where risk management is performed by the transferor.

D.2.7. Transfer pricing consequences

73. At this stage in the analysis, the following aspects will have been established: the contractual arrangements relating to risk allocation, the operational activities to which the risk relates, the risk management, and the consideration of the conduct of the parties in relation to risk. As a result the analysis has identified the specific risks associated with the delineated transaction and precisely how those risks are managed and how they are allocated. The transfer pricing consequences arising from the actual transaction then need to be considered. The outcome of the analysis will affect transfer pricing in a number of possible ways.

74. In many situations no separate compensation for risk management will be required since risk management is embedded within other transfers, with the result that it is implicitly included in the market

price for products or services. For example, the market price for goods will be affected by the management of strategic risks, along with infrastructure and operational risks, and other risks. Another example is that of a manufacturing service which includes quality control audits, charged as part of the service fee.

75. In these situations the analysis of risk helps to determine comparability. Where potential comparables are identified, it is relevant to determine whether they include the same level of risks and management of risks. For example, the exclusivity negotiated for certain toys outlined in the example in paragraph 52 may mean that the price is not comparable to otherwise similar goods provided without exclusivity. In the manufacturing service example in paragraph 74, if quality control is performed by the transacting party rather than by the service provider, then the service fee may need to be adjusted.

76. Some controlled and uncontrolled parties and transactions are likely to present a common set of risks. For example, distributors may present a fairly homogeneous set of risks such that the functions of the controlled distributor can reliably be benchmarked by reference to profit margins of uncontrolled distributors. However, such an assumption needs to be tested in the functional analysis by establishing how the functions of the controlled party contribute to risk management, the impact of the risks, and whether those functions, and other functions, differ to the functions of uncontrolled parties.

77. In circumstances where, the party providing risk management is not in the supply chain for goods and services, the transfer pricing consequences are likely to be that a fee is required to be paid reflecting the value of the risk management. That fee may be determined from reliable comparable uncontrolled arrangements. In the example of oil distribution provide in paragraph 51, the parent's contribution could be considered to have two parts: its ability to secure credit could be interpreted as reflecting the strength of its balance sheet as well as the expertise of the senior management. As a result a fee could be computed in two parts; one by reference to a guarantee fee, another by reference to high value consultancy services.

78. The difference between ex-ante and ex-post prices discussed in particular in Chapter VI arises in large part from risks, the outcome of which could not be accurately predicted. In determining if any party or parties should have profits adjusted to take into account the difference between the expected outcome and the actual outcome, consideration should be paid to the nature of the risks and which party or parties control these risks. A party which does not control risk will not be allocated the risk and therefore will not be entitled to unanticipated profits (or required to bear unanticipated losses).

D.3. Interpretation [This section is substantially new]

79. Following the guidance in the previous two sections, the transfer pricing analysis will have identified the substance of the commercial or financial relations between the parties, including how the parties actually operate in those relations, their functions in relation to the risks assumed, how those risks are allocated, and the capabilities they provide including the assets they bring to bear. The analysis will also have identified how value is created by means of those functions, assets, and risks, and how the value creation of the parties relates to the wider value chain in which the MNE operates.

80. In performing the analysis, conditions of arrangements between the parties may have been deduced in the absence of formal recognition from observation of how the parties actually operate. Formal conditions recognised in contracts may have been tested against conduct, and found not to be aligned with the substantive arrangements. How the parties have formalised the arrangements may have been found not to match the conduct of the parties. In addition, risk allocation may have been aligned with where risks are actually managed (including controlled). Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and accurately delineated the actual transaction.

81. At this point the analysis turns to interpreting the actual transaction as accurately delineated. Every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle. The various tools and methods available to tax administrations and taxpayers to do so are set out in the following chapters of these Guidelines.

82. However, in exceptional circumstances the transaction as accurately delineated may be interpreted as lacking the fundamental economic attributes of arrangements between unrelated parties, with the result that the transaction is not recognised for transfer pricing purposes. Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement. It is the fundamental underlying basis of the arrangements that matters, not whether the same transaction is observable between independent parties. The scope for non-recognition of the actual transaction is discussed in section D.4 below. Unless the strict criteria for non-recognition set out in that section are met, the conclusion should be that the transaction as accurately delineated is recognised.

D.4. Non-recognition [This section is substantially new]

83. This section sets out circumstances in which the transaction between the parties as accurately delineated can be disregarded for transfer pricing purposes. The section discusses why there is a need for non-recognition when the transaction does not have the fundamental economic attributes of arrangements between unrelated parties, and determines the criteria for non-recognition. The term non-recognition is intended to convey the same meaning to that understood to be conveyed by the term recharacterisation.

84. Because non-recognition can be contentious and a source of double taxation, it is recommended that every effort is made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and that non-recognition is not used simply because determining an arm's length price is difficult. Where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply. Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons. The key question is whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the fundamental attributes of an arm's length arrangement is not an appropriate application of the arm's length principle.

D.4.1 Why is there a need for non-recognition?

85. The underlying reason that may mainly generate an interest from tax administrations in non-recognition of arrangements made by taxpayers is that the transfer pricing analysis would otherwise attempt under the arm's length principle to price a transaction that does not have arm's length attributes. Attributes of non-arm's length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.

86. Except in certain regulated sectors, MNE groups have freedom to control their structures, including shareholding, capitalisation, and legal form. Structures based on multiple separate legal entities allow for separate legal ownership of assets, and location of activities and risks according to contracts

between the separate legal entities. Theoretically, there is no limit to the number of legal entities in an MNE group, and a group could, and sometimes does in practice, put individual contracts, assets, or risks into separate entities, with the result that the performance of activities can be conducted by a different legal entity to the one which owns assets or contractually bears risks. As a consequence, transactions between the legal entities proliferate, and the nature of those transactions derives from the designated circumstances of the separate legal entities created by the MNE group.

87. Since MNE groups can control the environment in which transactions occur, including the number of separate legal entities, their capital structures, legal ownership of assets, and contractual arrangements, and since the resulting transactions derive from the environment created by the MNE group, it should not follow that this environment alone determines where profits arise for transfer pricing purposes. Instead it should be determined whether the resulting transactions have arm's length attributes. The application of the arm's length principle is hampered if it is being applied to price an arrangement which does not have the fundamental economic attributes of arrangements between unrelated parties.

D.4.2 The concept of fundamental economic attributes of arrangements between unrelated parties and commercial rationality

88. The concept of the fundamental economic attributes of arrangements between unrelated parties gives greater definition to the test of commercial rationality which underpinned the discussion of non-recognition in the 1995 and 2010 versions of these Guidelines. That commercial rationality test requires consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner, but can be challenging to apply since, as the Guidelines themselves acknowledge, controlled parties do enter into arrangements which differ from those adopted by independent parties. That test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done. In addition, the test can be interpreted as having two legs (commercial rationality and whether the structure adopted practically impedes the determination of an appropriate transfer price) which must be met, as opposed to interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality. The two legs can lead to the assertion that if you can find a price, the arrangement is not commercially irrational, with a resulting emphasis on the quality of the process of determining an "appropriate" price rather than on whether it is appropriate in the first place to try to find a price for something which lacks the fundamental economic attributes of arrangements between unrelated parties.

89. In order for the transaction as accurately delineated to be recognised for transfer pricing purposes, the transaction should exhibit the fundamental economic attributes of arrangements between unrelated parties. An arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis, compared to other opportunities realistically available to them at the time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them, then the transaction would not be recognised for transfer pricing purposes. In applying the criterion, it is relevant to consider whether there exists an alternative for one or more of the parties, including the alternative of not entering into the transaction, which does provide the opportunity to enhance or protect their commercial or financial positions. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis. The criterion may be illustrated by the example in the following paragraph.

90. Company P is the parent company of a MNE group and conducts business in Country P. Company S1, a subsidiary also doing business in Country P, owns a valuable trademark that it has developed and exploits by selling its products using this trademark. To maintain and enhance the value of

this trademark, Company S1 performs extensive marketing functions. Company S1 sells all its products using this single trademark, and its business strategy depends on exploiting this particular trademark. The trademark of Company S1 is transferred to Company S2, based in a low tax location, in exchange for a lump sum payment of \$400 million. As a part of this agreement, Company S2 grants a licence to Company S1 to use the trademark in exchange for an annual royalty payment. Company S2 enters into a service agreement with Company S1 that provides that extensive marketing functions with regard to the maintenance and enhancement of the trademark will be undertaken and managed by Company S1. Company S2 has several employees with capability to assess, monitor, and direct the use of the trademark by Company S1, and costs of \$10m, but has no capability to exploit the trademark. Those employees make annual reports approving the activities performed by S1. Following the principles in sections D.1 and D.2 of this Chapter, and also the principles in Chapter VI, the royalty payable by S1 to S2 is set under the terms of the contract to equate to the value of a financing return. The MNE group intends that the additional costs to the Group of Company S2's operations will be offset by the tax savings attributable to the royalty deduction in Company S1.

91. Based on the facts as set out in this example, it is difficult to see how, if the parties were independent, S1 is afforded the opportunity to enhance or protect its commercial or financial position through the transaction. Company S1 is likely to have lost commercial value in that it no longer owns the trademark that is key in generating its income, and is subject to additional risk in that it is reliant on another party, Company S2, a company treated as independent under the arm's length hypothesis, being willing to license the trademark to it and not to take actions which might enhance value for itself but potentially detract from Company S1. Company S1 is also theoretically subject to the constraints of the terms agreed with S2 on ongoing activity related to the maintenance and enhancement of that trademark. Company S2 has no practical safeguards and is dependent on S1 to act appropriately to enhance and protect its asset through the marketing functions it undertakes, and S2 itself does not direct the way in which it can optimise returns on its asset. Compared to S1, Company S2 has less capability to manage and control the marketing which will affect the generation of expected income streams, and Company S2 has not enhanced or protected its commercial position but may have damaged it by not managing the risks in order to achieve a return on its investment in the asset. The alternative option of not entering into the transaction affords S1 greater opportunity to enhance or protect its commercial or financial position since it would retain the trademark key to its business.

92. The scenario set out in this example suggests that the transaction lacks the fundamental economic attributes of arrangements between unrelated parties; the arrangement does not enhance or protect the commercial or financial position of Company S1 nor of Company S2. It is also a relevant pointer that the Group benefit is limited to post-tax considerations since pre-tax the Group has incurred increased, duplicative costs and is worse-off on a pre-tax basis. The transaction should not be recognised with the result that the trademark is treated for transfer pricing purposes as continuing to be owned by Company S1.

D.4.3 Consequences of non-recognition

93. The structure that replaces the taxpayer's structure for transfer pricing purposes should be determined by the alternative transaction that affords the parties the opportunity to enhance or protect their commercial or financial position. The replacement structure should be guided by the fundamental economic attributes of arrangements between unrelated parties and comport as closely as possible with the commercial reality of independent parties in similar circumstances.

D.5. Specific considerations

D.5.1 Losses

94. [1.70-unchanged] When an associated enterprise consistently realises losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.

95. [1.71-unchanged] The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. For example, an MNE group may need to produce a full range of products and/or services in order to remain competitive and realize an overall profit, but some of the individual product lines may regularly lose revenue. One member of the MNE group might realize consistent losses because it produces all the loss-making products while other members produce the profit-making products. An independent enterprise would perform such a service only if it were compensated by an adequate service charge. Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.

96. [1.72-unchanged] A factor to consider in analysing losses is that business strategies may differ from MNE group to MNE group due to a variety of historic, economic, and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors. However, especially low prices should be expected for a limited period only, with the specific object of improving profits in the longer term. If the pricing strategy continues beyond a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises. Further, tax administrations should not accept especially low prices (*e.g.* pricing at marginal cost in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner.

D.5.2 The effect of government policies

97. [1.73-unchanged] There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.

98. [1.74-unchanged] One issue that arises is determining the stage at which a price control affects the price of a product or service. Often the direct impact will be on the final price to the consumer, but there may nonetheless be an impact on prices paid at prior stages in the supply of goods to the market. MNEs in practice may make no adjustment in their transfer prices to take account of such controls, leaving the final seller to suffer any limitation on profit that may occur, or they may charge prices that share the burden in some way between the final seller and the intermediate supplier. It should be considered whether or not an independent supplier would share in the costs of the price controls and whether an independent enterprise would seek alternative product lines and business opportunities. In this regard, it is unlikely that an independent enterprise would be prepared to produce, distribute, or otherwise provide products or services on terms that allowed it no profit. Nevertheless, it is quite obvious that a country with price controls must take into account that those price controls will affect the profits that can be realised by enterprises selling goods subject to those controls.

99. [1.75-unchanged] A special problem arises when a country prevents or “blocks” the payment of an amount which is owed by one associated enterprise to another or which in an arm’s length arrangement would be charged by one associated enterprise to another. For example, exchange controls may effectively prevent an associated enterprise from transferring interest payments abroad on a loan made by another associated enterprise located in a different country. This circumstance may be treated differently by the two countries involved: the country of the borrower may or may not regard the untransferred interest as having been paid, and the country of the lender may or may not treat the lender as having received the interest. As a general rule, where the government intervention applies equally to transactions between associated enterprises and transactions between independent enterprises (both in law and in fact), the approach to this problem where it occurs between associated enterprises should be the same for tax purposes as that adopted for transactions between independent enterprises. Where the government intervention applies only to transactions between associated enterprises, there is no simple solution to the problem. Perhaps one way to deal with the issue is to apply the arm’s length principle viewing the intervention as a condition affecting the terms of the transaction. Treaties may specifically address the approaches available to the treaty partners where such circumstances exist.

100. [1.76-unchanged] A difficulty with this analysis is that often independent enterprises simply would not enter into a transaction in which payments were blocked. An independent enterprise might find itself in such an arrangement from time to time, most likely because the government interventions were imposed subsequent to the time that the arrangement began. But it seems unlikely that an independent enterprise would willingly subject itself to a substantial risk of non-payment for products or services rendered by entering into an arrangement when severe government interventions already existed unless the profit projections or anticipated return from the independent enterprise’s proposed business strategy are sufficient to yield it an acceptable rate of return notwithstanding the existence of the government intervention that may affect payment.

101. [1.77-unchanged] Because independent enterprises might not engage in a transaction subject to government interventions, it is unclear how the arm’s length principle should apply. One possibility is to treat the payment as having been made between the associated enterprises, on the assumption that an independent enterprise in a similar circumstance would have insisted on payment by some other means. This approach would treat the party to whom the blocked payment is owed as performing a service for the MNE group. An alternative approach that may be available in some countries would be to defer both the income and the relevant expenses of the taxpayer. In other words, the party to whom this blocked payment was due would not be allowed to deduct expenses, such as additional financing costs, until the blocked payment was made. The concern of tax administrations in these situations is mainly their respective tax bases. If an associated enterprise claims a deduction in its tax computations for a blocked payment, then there should be corresponding income to the other party. In any case, a taxpayer should not be permitted to

treat blocked payments due from an associated enterprise differently from blocked payments due from an independent enterprise.

D.5.3 Use of customs valuations

102. [1.78-unchanged] The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes however may not be aligned with the OECD's recognised transfer pricing methods. That being said, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

103. [1.79-unchanged] Taxpayers may have competing incentives in setting values for customs and tax purposes. In general, a taxpayer importing goods may be interested in setting a low price for the transaction for customs purposes so that the customs duty imposed will be low. (There could be similar considerations arising with respect to value added taxes, sales taxes, and excise taxes.) For tax purposes, however, a higher price paid for those same goods would increase the deductible costs in the importing country (although this would also increase the sales revenue of the seller in the country of export). Cooperation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater cooperation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in countries that already have integrated administrations for income taxes and customs duties. Countries that have separate administrations may wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations.

Note

Sections D.6-8 reproduce the revised text relating to this Chapter contained in the Guidance on Transfer Pricing Aspects of Intangibles (2014), following a process of public consultation. The text is included here for convenience, but no comments are invited on these sections.

D.6. Location savings and other local market features [Section unchanged, except for paragraph numbering]

104. Paragraphs 1.27, 1.29 and 6.31 indicate that features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.

D.6.1. Location savings

105. Paragraphs 9.148 – 9.153 discuss the treatment of location savings in the context of a business restructuring. The principles described in those paragraphs apply generally to all situations where location savings are present, not just in the case of a business restructuring.

106. Pursuant to the guidance in paragraphs 9.148 – 9.153, in determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

107. Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

108. When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant associated enterprises, in the manner described in paragraphs 9.148 – 9.153.

D.6.2. Other local market features

109. Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified.

110. In assessing whether comparability adjustments for such local market features are required, the most reliable approach will be to refer to data regarding comparable uncontrolled transactions in that geographic market between independent enterprises performing similar functions, assuming similar risks, and using similar assets. Such transactions are carried out under the same market conditions as the controlled transaction, and, accordingly, where comparable transactions in the local market can be identified, specific adjustments for features of the local market should not be required.

111. In situations where reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should consider all of the relevant facts and circumstances. As with location savings, in each case where reliable local market comparables cannot be identified, it is necessary to consider (i) whether a market advantage or disadvantage exists, (ii) the amount of any increase or decrease in revenues, costs or profits, *vis-à-vis* those of identified comparables from other markets, that are attributable to the local market advantage or disadvantage, (iii) the degree to which benefits or burdens of local market features are passed on to independent customers or suppliers, and (iv) where benefits or burdens attributable to local market features exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such net benefits or burdens between them.

112. The need for comparability adjustments related to features of the local market in cases where reasonably reliable local market comparables cannot be identified may arise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm's length prices of goods transferred or services provided between associated enterprises.

113. In other circumstances, a business restructuring or the transfer of intangibles between associated enterprises may make it possible for one party to the transaction to gain the benefit of local market advantages or require that party to assume the burden of local market disadvantages in a manner that would not have been possible in the absence of the business restructuring or transfer of the intangibles. In such circumstances, the anticipated existence of local market advantages and disadvantages may affect the arm's length price paid in connection with the business restructuring or intangible transfer.

114. In conducting a transfer pricing analysis it is important to distinguish between features of the local market, which are not intangibles, and any contractual rights, government licences, or know-how necessary to exploit that market, which may be intangibles. Depending on the circumstances, these types of intangibles may have substantial value that should be taken into account in a transfer pricing analysis in the manner described in Chapter VI, including the guidance on rewarding entities for functions, assets and risks associated with the development of intangibles contained in Section VI. B. In some circumstances, contractual rights and government licences may limit access of competitors to a particular market and may therefore affect the manner in which the economic consequences of local market features are shared between parties to a particular transaction. In other circumstances, contractual rights or government licences to access a market may be available to many or all potential market entrants with little restriction.

115. For example, a country may require a regulatory licence to be issued as a pre-condition for conducting an investment management business in the country and may restrict the number of foreign-owned firms to which such licences are granted. The comparability and functional analysis may indicate that qualifying for such a licence requires demonstrating to appropriate government authorities that the service provider has appropriate levels of experience and capital to conduct such a business in a reputable fashion. The market to which such a licence relates may also be one with unique features. It may, for example be a market where the structure of pension and insurance arrangements gives rise to large cash pools, a need to diversify investments internationally, and a resulting high demand for quality investment management services and knowledge of foreign financial markets that can make the provision of such services highly lucrative. The comparability analysis may further suggest that those features of the local market may affect the price that can be charged for certain types of investment management services and the profit margins that may be earned from providing such services. Under these circumstances, the intangible in question (*i.e.* the regulatory licence to provide investment management services) may allow the party or parties holding the licence to extract a greater share of the benefits of operating in the local market, including the benefits provided by unique features of that market, than would be the case in the absence of the licensing requirement. However, in assessing the impact of the regulatory licence, it may be

important in a particular case to consider the contributions of both the local group member in the local market and other group members outside the local market in supplying the capabilities necessary to obtain the licence, as described in Chapter VI. B.

116. In a different circumstance, the comparability and functional analysis may suggest that a government issued business licence is necessary as a pre-condition for providing a particular service in a geographic market. However, it may be the case that such licences are readily available to any qualified applicant and do not have the effect of restricting the number of competitors in the market. Under such circumstances, the licence requirement may not present a material barrier to entry, and possession of such a licence may not have any discernible impact on the manner in which the benefits of operating in the local market are shared between independent enterprises.

D.7. Assembled workforce [Section unchanged except for paragraph numbering]

117. Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce *vis-à-vis* the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services.

118. In some business restructuring and similar transactions, it may be the case that an assembled workforce is transferred from one associated enterprise to another as part of the transaction. In such circumstances, it may well be that the transfer of the assembled workforce along with other transferred assets of the business will save the transferee the time and expense of hiring and training a new workforce. Depending on the transfer pricing methods used to evaluate the overall transaction, it may be appropriate in such cases to reflect such time and expense savings in the form of comparability adjustments to the arm's length price otherwise charged with respect to the transferred assets. In other situations, the transfer of the assembled workforce may result in limitations on the transferee's flexibility in structuring business operations and create potential liabilities if workers are terminated. In such cases it may be appropriate for the compensation paid in connection with the restructuring to reflect the potential future liabilities and limitations.

119. The foregoing paragraph is not intended to suggest that transfers or secondments of individual employees between members of an MNE group should be separately compensated as a general matter. In many instances the transfer of individual employees between associated enterprises will not give rise to a need for compensation. Where employees are seconded (*i.e.* they remain on the transferor's payroll but work for the transferee), in many cases the appropriate arm's length compensation for the services of the seconded employees in question will be the only payment required.

120. It should be noted, however, that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how or other intangibles from one associated enterprise to another. For example, an employee of Company A seconded to Company B may have knowledge of a secret formula owned by Company A and may make that secret formula available to Company B for use in its commercial operations. Similarly, employees of Company A seconded to Company B to assist with a factory start-up may make Company A manufacturing know-how available to Company B for use in its commercial operations. Where such a provision of know-how or other intangibles results from the transfer or secondment of employees, it should

be separately analysed under the provisions of Chapter VI and an appropriate price should be paid for the right to use the intangibles.

121. Moreover, it should also be noted that access to an assembled workforce with particular skills and experience may, in some circumstances, enhance the value of transferred intangibles or other assets, even where the employees making up the workforce are not transferred. Example 24 in the Annex to Chapter VI illustrates one fact pattern where the interaction between intangibles and access to an assembled workforce may be important in a transfer pricing analysis.

D.8. MNE group synergies [Section unchanged except for paragraph numbering]

122. Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group.

123. Paragraph 7.13 of these Guidelines suggests that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant. Consistent with this general view of benefits incidental to group membership, when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.

124. In some circumstances, however, synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.¹

¹ In light of differences in local law, some countries consider a deliberate concerted action to always constitute a transaction, while others do not. However, the consensus view is that, in either scenario, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required. See, *e.g.* Example 5.

125. For example, if a group takes affirmative steps to centralise purchasing in a single group company to take advantage of volume discounts, and that group company resells the items it purchases to other group members, a deliberate concerted group action occurs to take advantage of group purchasing power. Similarly, if a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group wide discount with a supplier on the condition of achieving minimum group wide purchasing levels, and group members then purchase from that supplier and obtain the discount, deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members. Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred.

126. Where corporate synergies arising from deliberate concerted group actions do provide a member of an MNE group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.

127. If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party co-ordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes.

128. Comparability adjustments may be warranted to account for group synergies.

Example 1

129. P is the parent company of an MNE group engaging in a financial services business. The strength of the group's consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, *i.e.* a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

130. Assume that S borrows Euro 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows Euro 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender, (*i.e.* an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S's other borrowings including the simultaneous loan to S from T.

131. Under these circumstances the interest rate charged on the loan by T to S is an arm's length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent enterprises at an interest rate lower than it could

were it not a member of the group because the synergistic benefit of being able to borrow arises from S's group membership alone and not from any deliberate concerted action of members of the MNE group.

Example 2²

132. The facts relating to S's credit standing and borrowing power are identical to those in the preceding example. S borrows Euro 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA. The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

Example 3

133. Assume that Company A is assigned the role of central purchasing manager on behalf of the entire group. It purchases from independent suppliers and resells to associated enterprises. Company A, based solely on the negotiating leverage provided by the purchasing power of the entire group is able to negotiate with a supplier to reduce the price of widgets from \$200 to \$110. Under these circumstances, the arm's length price for the resale of widgets by Company A to other members of the group would not be at or near \$200. Instead, the arm's length price would remunerate Company A for its services of coordinating purchasing activity. If the comparability and functional analysis suggests in this case that in comparable uncontrolled transactions involving a comparable volume of purchases, comparable coordination services resulted in a service fee based on Company A's costs incurred plus a mark-up equating to a total service fee of \$6 per widget, then the intercompany price for the resale of the widgets by Company A would be approximately \$116. Under these circumstances, each member of the group would derive benefits attributable to the group purchasing power of approximately \$84 per widget. In addition, Company A would earn \$6 per widget purchased by members of the group for its service functions.

Example 4

134. Assume facts similar to those in Example 3, except that instead of actually purchasing and reselling the widgets, Company A negotiates the discount on behalf of the group and group members subsequently purchase the widgets directly from the independent supplier. Under these circumstances, assume that the comparability analysis suggests that Company A would be entitled to a service fee of \$5 per widget for the coordinating services that it performed on behalf of other group members. (The lower assumed service fee in Example 4 as compared to Example 3 may reflect a lower level of risk in the service provider following from the fact that it does not take title to the widgets or hold any inventory.) Group members purchasing widgets would retain the benefit of the group purchasing discount attributable to their individual purchases after payment of the service fee.

² Action 4 of the BEPS Action Plan calls for additional work on transfer pricing aspects of financial transactions. Example 2 should not be viewed as providing comprehensive transfer pricing guidance on guarantee fees. Additional consideration will be given in the course of the BEPS project to the determination of arm's length conditions for guarantees and particularly to situations where guarantees between associated enterprises can give rise to BEPS.

Example 5

135. Assume a multinational group based in Country A, has manufacturing subsidiaries in Country B and Country C. Country B has a tax rate of 30 percent and Country C has a tax rate of 10 percent. The group also maintains a shared services centre in Country D. Assume that the manufacturing subsidiaries in Country B and Country C each have need of 5 000 widgets produced by an independent supplier as an input to their manufacturing processes. Assume further that the Country D shared services company is consistently compensated for its aggregate activities by other group members, including the Country B and Country C manufacturing affiliates, on a cost plus basis, which, for purposes of this example, is assumed to be arm's length compensation for the level and nature of services it provides.

136. The independent supplier sells widgets for \$10 apiece and follows a policy of providing a 5 percent price discount for bulk purchases of widgets in excess of 7 500 units. A purchasing employee in the Country D shared services centre approaches the independent supplier and confirms that if the Country B and Country C manufacturing affiliates simultaneously purchase 5 000 widgets each, a total group purchase of 10 000 widgets, the purchase discount will be available with respect to all of the group purchases. The independent supplier confirms that it will sell an aggregate of 10 000 widgets to the MNE group at a total price of \$95 000, a discount of 5 percent from the price at which either of the two manufacturing affiliates could purchase independently from the supplier.

137. The purchasing employee at the shared services centre then places orders for the required widgets and requests that the supplier invoice the Country B manufacturing affiliate for 5 000 widgets at a total price of \$50 000 and invoice the Country C manufacturing affiliate for 5 000 widgets at a total price of \$45 000. The supplier complies with this request as it will result in the supplier being paid the agreed price of \$95 000 for the total of the 10 000 widgets supplied.

138. Under these circumstances, Country B would be entitled to make a transfer pricing adjustment reducing the expenses of the Country B manufacturing affiliate by \$2 500. The transfer pricing adjustment is appropriate because the pricing arrangements misallocate the benefit of the group synergy associated with volume purchasing of the widgets. The adjustment is appropriate notwithstanding the fact that the Country B manufacturing affiliate acting alone could not purchase widgets for a price less than the \$50 000 it paid. The deliberate concerted group action in arranging the purchase discount provides a basis for the allocation of part of the discount to the Country B manufacturing affiliate notwithstanding the fact that there is no explicit transaction between the Country B and Country C manufacturing affiliates.

PART II

POTENTIAL SPECIAL MEASURES

1. As the BEPS Action Plan indicates, the main aim of the Transfer Pricing Actions (8-10) is to assure that transfer pricing outcomes are in line with value creation. The BEPS Action Plan also indicates that in order to achieve this aim “special measures, either within or beyond the arm’s length principle, may be required with regard to intangible assets, risk and over-capitalisation.”

2. The proposed revisions set out in Part I of this discussion draft to the guidance contained in Section D of Chapter I of the Transfer Pricing Guidelines are intended to make significant contributions to achieving this aim of the BEPS Project. In particular features including (i) the accurate delineation of the actual transaction based on both the contractual arrangements and the conduct of the parties, (ii) the specification of associated risks and allocation of risk to risk management, and (iii) the non-recognition of transactions which lack the fundamental attributes of arrangements between unrelated parties, will go far in aligning where profits are reported and where value is created.

3. However, in preparing the revised guidance in response to the mandate of the BEPS Action Plan, it has been recognised that even if these changes to the transfer pricing guidance are introduced, certain BEPS risks may remain. These residual risks mainly relate to information asymmetries between taxpayers and tax administrations and the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs. Therefore, special measures have been considered to address these risks.

4. This second part of the discussion draft outlines the options for potential special measures, and invites comments on them. These special measures have been broadly outlined at this stage, and significant design work will need to be undertaken as the measures are further considered.

5. Some of the special measures are narrowly targeted, whereas others are broad. There are similarities and overlaps between some of the special measures, and so there is interest in comparing the advantages and disadvantages of each. Respondents should provide comments on the features of the options on a stand-alone basis, but also, where appropriate, on a comparative basis. In addition, it is recognised that the situations addressed in this section have a close interaction with other actions under the BEPS Action Plan, including Action 3 on strengthening CFC rules and Action 4 on interest deductions. Some of the measures included in this section have a close relationship with or can be seen as CFC rules.³ The intention of including these measures in this discussion draft is to invite comments on these measures in advance of the public consultation on CFC rules foreseen in April 2015. With that, the public comments received will feed into the work on this area and will acknowledge the necessity to take account of the close interactions between the actions.

³ It should not be assumed that the work on strengthening CFC rules will be limited by the options outlined in this discussion draft.

6. The BEPS Action Plan refers to special measures that are “either within or beyond the arm’s length principle.” Some of these measures could be seen as within the arm’s length principle and others beyond. At this stage, it is not critical to determine whether a potential measure is on one side or the other of the boundary, but the aim is to consider the effectiveness of the measure. It should also not be assumed that, if special measures are introduced that go beyond the arm’s length principle, double taxation may result. The main aim of these special measures is to create transfer pricing outcomes in line with value creation and to limit BEPS risks for governments. It is recognised that consideration needs to be given to the way in which these special measures will be part of the global transfer pricing standards and the way in which double taxation will be prevented. In addition, nothing should be read into the order in which the options are presented in this discussion draft; there is no priority implied.

7. The measures give rise to an overarching standard set of questions around the advantages and disadvantages of the measure, how the thresholds for application of the measure should be set, the effect of the measure, its administrability, and how relevant it might be in achieving the aims of the BEPS Project. The framework for questions is set out in the following box, but respondents should feel able to elaborate their answers in the specific context of each option.

Framework for questions on all options

1. How well does the measure achieve the policy goal of ensuring a closer alignment between transfer pricing outcomes and value creation? What other alternatives might be available to achieve the goal? What design options for the particular measure would improve the achievement of this goal?
2. What are the advantages and disadvantages of the measure, and relative to other measures?
3. What is the likely effect of the measure? Will it operate mainly as a deterrent and encourage behavioural changes, or will it require compliance and reporting? What issues are likely to arise in complying with and in administering the measure?
4. Given the targeted circumstances in which the measure would apply, in what ways can transfer pricing rules and guidance or other rules be further adapted to target such circumstances in parallel to or as an alternative to this measure?
5. How well does the measure target the focus of its application? What criteria for application of the measure, and other thresholds, should be considered to improve clarity of application? In particular what design features of the options will secure the likelihood that tax administrations, when considering the facts of a given case in the context of audit or competent authority proceedings, will agree the case meets the criteria for application of the measure and on the resulting adjustment?
6. Where the measure makes no reference to tax attributes, should criteria be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group?
7. In what order should the measures apply? Does the measure come into consideration following the application of normal transfer pricing rules, or should it be applied instead of transfer pricing rules?
8. Should mechanisms be available for eliminating double taxation, even if the rules are considered to be anti-abuse measures, and how should any such mechanisms be framed?

9. Should certain sectors be excluded from the application of the measures? In particular, how should measures focussing on capital distinguish financial services activities where capital adequacy rules apply and where the amount of capital affects the amount of business that can be carried on?
10. What other measures would respondents wish to have considered, taking into account the policy goal of the BEPS Project, and what would the outline of such measures involve?

Option 1: Hard-to-value intangibles ('HTVI')

Action 8 of the BEPS Project requires the development of transfer pricing rules or special measures for transfers of hard-to-value intangibles. The need for a measure arises because of the potential for systematic mispricing in circumstances where no reliable comparables exist, where assumptions used in valuation are speculative, and where information asymmetries between taxpayers and tax administrations are acute. The most significant issues can arise where it is difficult to verify the assumptions on which a fixed price is agreed sometimes several years before the intangible generates income.

The measure could target 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 effect of 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 presumption may be rebuttable under certain conditions. Those condition could be designed to include situations where:

- the taxpayer can demonstrate the robustness of its *ex ante* projections used in determining the fixed price, its experience of making such projections reliably in similar circumstances, and the comprehensiveness of its consideration of reasonably foreseeable events and other risks.
- the outcome does not differ from projections used *ex ante* to calculate the fixed price by more than [xx]% or the actual profitability of the transferee does not differ from anticipated profitability by more than [xx].

Inappropriate returns for providing capital

The BEPS Project requires an alignment between profits and value creation, and sets out the need to consider the potential for inappropriate returns for providing capital. The potential measures seek to address issues arising from the freedom MNE groups have (except in certain regulated sectors) to control their structures, including the creation and capitalisation of companies. The capital can be used to acquire assets and those assets then feature in intra-group transactions. Transfer pricing rules, including the guidance in Part I of this discussion draft, focus on the functions actually performed in relation to those assets, including the management of risks, and may determine that little or no return is due to the capital-rich, asset-owning company, and in some circumstances may determine that the resulting intra-group transactions relating to that company's assets should not be recognised. In other circumstances, however, the application of the arm's length principle may be difficult and may not address the allocation of excess or unanticipated returns to the capital-rich, asset-owning company.

Option 2: Independent investor

The target for this option is circumstances where the capital-rich, asset-owning company depends on another group company 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. An investment in the company which has no or little capability to generate a return from the asset might be considered by an independent investor to carry higher risk with lower returns than an investment in a company with such capability.

In such circumstances the capital would be deemed to have been contributed to the company providing the more rational investment opportunity to an independent investor, and that company would be deemed to have used the capital to acquire the asset, with the result that no return would be attributed to the capital-rich, asset-owning company.

The approach for deeming the capital to have been provided to the alternative company maintains the structure of indirect investment. Another possibility is to consider whether the indirect investment in a subsidiary having little capability is a better investment than making an investment in the asset directly. Under this variation, any income attributable to the capital-rich, asset-owning company would be reallocated to the parent company which would be treated as having made a direct investment in the asset.

Option 3: Thick capitalisation

This option depends on determining and applying a thick capitalisation 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.

A crucial feature for this option is to determine the level of thick capitalisation. Options might include adopting a group ratio or a fixed ratio, including consideration of a fixed ratio which may be set by reference to capital adequacy requirements as if the company were a regulated financial services business.

Option 4: Minimal functional entity

It may be the case in transactions between associated enterprises, especially transactions transferring key business risks or intangibles, that one of the parties to the transaction has minimal functions. Minimal functions may also be the root cause of an arrangement lacking the fundamental economic attributes that normally underpin arrangements between unrelated parties. It may prove simpler and more effective, therefore, in dealing with such cases to adopt a targeted special measure that focuses on a level of functionality that, where lacking, would cause the profits of that entity to be reallocated.

The option would determine thresholds of functionality. Such thresholds could involve:

- Qualitative attributes
 - The entity lacks the functional capacity to create value through exploiting its assets and managing its risks, and is mainly reliant on a framework of arrangements with other group companies in order to exploit its assets and manage its risks.
- Quantitative attributes
 - The company in substance performs mainly routine functions, and has a small number of employees;
 - A substantial part of the company's income is from arrangements with group companies
 - The value of the company's assets is greater than or significant in proportion to its income, or an attribute based on a thick capitalisation ratio.

The effect of falling beneath the thresholds would require the entity's profits to be reallocated. There are various options that could be considered for doing so:

- A mandatory profit split could be used based on a pre-determined factor. The profits of the minimal functional entity would be combined with the profits of the company or companies providing the relevant functional capacity to exploit the company's assets and manage its risk, and the mandatory profit split applied.
- The profits could be re-allocated to the immediate parent, and if that immediate parent is also a minimal functional entity, iteratively up the chain until the parent is not a minimal functional entity.
- The profits could be re-allocated to the company providing functional capacity, and if more than one such company, shared between them in proportion to the respective contributions.

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 trigger for applying this option could be a low rate of tax, recognising that the BEPS project is fundamentally motivated by the shifting of income intra-group to locations where it is taxed at a low rate or not taxed at all.

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%). Where the primary rule applies, excess returns would be subject to tax in the parent jurisdiction at that rate of x%, less any foreign taxes paid.

Excess returns would need to be defined in accordance with design considerations but could target returns associated with intangibles and risk and equal all of the CFC's income, less:

- An allowance for corporate equity, which may provide an exemption for normal returns on capital invested in real activities within a jurisdiction
- Local income from sales or services to unrelated persons for ultimate use or consumption in the CFC's country of tax residence

In addition, a secondary rule would apply if none of the parent jurisdictions of a CFC have applied the primary rule. This would allocate taxing jurisdiction over the CFC's excess returns, where the effective tax rate is below x%, to other jurisdictions based on a pre-determined rule.