

PRESENTED BY:

The 2015 OECD International Tax Conference

June 10-11, 2015
Four Seasons Hotel
Washington D.C.



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IV. Transfer Pricing

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Panelists

- Bill Sample – Microsoft
- Ian Brimicombe – Astra Zeneca
- Rocco Femia – Miller & Chevalier
- Philippe Penelle – Deloitte
- Michael McDonald – US Treasury
- Joe Andrus - OECD

BEPS TP Work Program

- Chapter VI – Intangibles
- Documentation / CbC Reporting Implementation
- Chapter I – Delineation / Risk / Recharacterization
- Low Value Added Services
- Commodity Transactions
- Cost Contribution Arrangements
- Profit Split Methods
- Financial Transactions

Today's Agenda

- Hour One – Aligning Value Creation and Income
 - Contracts and Delineation of Transactions
 - Allocation of Risk
 - Re-characterisation of Transactions
- Hour Two - Intangibles
 - CCAs
 - Finalizing Chapter VI
 - Hard to Value Intangibles

Contracts and Conduct

- Contracts the starting point for transfer pricing analysis
- Role of conduct of parties
 - Contracts incomplete
 - Contracts ambiguous
 - Conduct inconsistent with contracts

Example

- P licenses intangibles to S, ostensibly to be used by S as entrepreneur in its business
- P continues to negotiate with customers, often jointly contracts with S, P provides all technical support, S functions limited to support services to the business, lacks and is not developing capability to assume entrepreneurial responsibility
- Delineation step would characterise P as the principal and S as a service provider, characterization of S as a licensee / entrepreneur as per the contract would not be proper

Allocation of Risk

- Identify commercially significant risks
- Identify contractual allocation of such risks
- Identify operations of parties related to risk, including control and risk mitigation functions and relevant risk related costs borne and risk premiums earned
- After gathering facts in first three steps, consider whether conduct is consistent with contractual risk allocation
- Consider whether the party allocated risk also controls risk
- Reallocate risk if necessary to align control and risk bearing
- Price the transaction

Questions Regarding Risk

- What does it mean to control risk?
- What if more than one associated enterprise is involved in control of a particular risk or in mitigation of that risk?
- Is the assertion that control over risk and risk bearing should be aligned consistent with the arm's length principle?
- Does alignment of risk with control over risk constitute “delineation” or “recharacterization”? Does it matter?
- What role does financial capacity to bear risk play?
- What role, if any, does moral hazard play in the analysis?

Example

- P manufacturer is assigned product liability and recall risk under contract with S, its country X distributor. Sales of products by P to S are priced accordingly. See Chapter VI, Example 8.
- When problems arise, S bears recall related expenses and defends against product liability claims notwithstanding the contractual provision.
- How does the approach to respect for contracts, consideration of conduct, and control over risk play out in this circumstance?

Delineation of the “Real Deal”

- Determined based on analysis of contracts, conduct, allocation of risks
 - Do contractual terms affect the ‘real deal’
 - If not, what is the ‘real deal’
- Pricing of ‘real deal’
- Is delineation of the ‘real deal’ the same thing as ‘re-characterization’ under the economic substance leg of current 1.65? If not, how is it different?

Recharacterization / Non-recognition

- Current 1.65: Transaction that is commercially irrational and inhibits identification of an arm's length price
- December 2014 DD: Lacking the fundamental economic attributes of arrangements that would be agreed between unrelated parties
- Exceptional?
- Is a recharacterization remedy necessary if transactions are properly delineated and risks are allocated in a manner consistent with control over risk?

Capital and the Cash Box “Problem”

- Governments have concern over the possibility that an “overcapitalized” entity with low functionality and a low tax rate could be allocated substantial profit because of its capital or assets used.
- Do the foregoing provisions fully address that problem
- What is the correct rate of return for a low – function, low – tax, high - capital entity?
- If such an entity is limited to a “risk free” funding return, is that consistent with the ALP?
- If not, should a “special – measure” be designed?

CCAs

- Discussion draft issued on April 29, 2015
- Distinguishes between development CCAs and other cost sharing arrangements
- Requires all contributions to be valued at market rather than cost
 - “Buy in” payments for pre-existing assets
 - Ongoing current contributions
- Requires the same sort of alignment between functions, risks and income attribution as do revised Chapters I and VI
 - Implication is that a low – function, high – capital, CCA may not be allowed to participate in CCA or may be allowed very little anticipated return

Chapter VI Open Issues

- Allocation of ex – post returns / losses from unanticipated events
- Same issues as discussed above on remuneration of limited function provider of capital – See Example 7 and compare it to a pure cash-box entity
- Separation of functions / assets from risk / control over risk – analysis of Examples 17 and 18
- Further revision of guidance on profit splits likely to be deferred slightly
- Other

Hard to Value Intangibles

- Discussion draft issued in early June – public consultation in July
- Focus is on information asymmetry
- Fairly broad application of price adjustment mechanisms that consider post-transaction performance in assessing the reliability of the information on which ex-ante prices are based
 - Lack of comparables
 - Lack of reliable projections
 - Highly uncertain valuation assumptions
- Subject to right of taxpayer to challenge on proof of:
 - provision of adequate information
 - careful valuation at time of the transaction
 - Differences between projections and outcomes attributable to unexpected events