Irish Tax Institute

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Irish Tax Institute

Response to OECD Discussion Draft:

Risk, Recharacterisation and Special Measures

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About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Our response

The Irish Tax Institute is writing in response to the Discussion Draft on the Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterisation, and Special Measures), which the OECD released on 19 December 2014. We prepared this submission with consideration and input from a number of our members.

Introduction

Actions 8, 9 and 10 of the OECD's Base Erosion and Profit Shifting (BEPS) project focuses on the alignment of transfer pricing outcomes with value creation. We believe that the Discussion Draft provides much clearer guidance, in particular the emphasis on aligning contractual terms with the parties' actual conduct. However, there are several recommendations in the Discussion Draft which we consider inconsistent with observed dealings between independent parties and do not address key issues underpinning the challenges of designing workable outcomes from the BEPS project.

The Irish Tax Institute recognises the importance for legislators and tax authorities to identify and prevent transactions structured to inappropriately abuse tax rules. It is critical that BEPS solutions to prevent abusive transactions do not disproportionately disadvantage the majority of transactions which are supported by adequate substance. A lack of balance in the BEPS solutions will greatly increase tax disputes and double tax cases, and result in overburdened tax authorities and taxpayers.

Our key concerns in the Discussion Draft are two-fold. Firstly, the Discussion Draft diverts a primary goal of the OECD Model Tax Convention on Income and Capital, which is to "*clarify, standardise, and confirm the fiscal situation of the taxpayers*". The direction taken is largely creating uncertainty for taxpayers. Second, the Discussion Draft ignores the economic importance of assets and capital that is required by independent parties to perform their functions and to assume contractually obligated risks.

Part I of the Discussion draft contains new guidance to Chapter I of the OECD Transfer Pricing Guidelines for Multinational Enterprises ("the OECD Guidelines"). The new guidance focuses on the relevance and allocation of risk as well as sets conditions where recharacterisation or non-recognition of transactions would be appropriate.

Part II of the Discussion Draft is a preliminary consultation on the applicability of five distinct measures to address BEPS issues with intangible assets, risk and over-capitalisation. This movement towards special measures for transfer pricing matters departs from the fundamental reliance on the arm's length principle and should be thoroughly considered before any recommendations are made.

A. Part I: Revision to Chapter I Section D of the OECD Guidelines

A core objective of the OECD Guidelines has been to set rules with reference to arm's length dealings in such a way that taxpayers can comprehend and comply, and that tax authorities can reasonably enforce. Another core objective is to provide sufficient guidance on applying the arm's length principle that enables transfer pricing disputes to be settled in a reasonable fashion. These disputes can occur between taxpayers and tax authorities as well as between tax authorities. Part I of the Discussion Draft significantly increases the complexity of the OECD Guidelines, and will likely result in greater disputes.

Our more specific commentary is as follows:

1 Actual conduct of the parties

The emphasis on actual conduct of the parties is viewed as a positive change, and consistent with other OECD developments in the transfer pricing area. The importance of substance and conduct is consistent with themes in Chapter IX of the OECD Guidelines which applies to business

restructurings. This Chapter directs the allocation of risk to follow the conduct of parties as well as economic principles governing the parties. As well, the OECD's ongoing work on intangibles places emphasis on each party's conduct to establish an appropriate allocation of risk, and value, from the creation of intangible assets.

2 Should focus on "when" not "who" in determining appropriate risk allocation

Tax authorities should not be able to exploit the benefit of hindsight and enforce adjustments on an *ex-post* basis. Part I appears to empower tax authorities to make retroactive adjustments to terms based on *ex-post* determination of the risk allocation in the original intercompany transaction.

It is recommended that the OECD Guidelines continue to advocate that tax authorities respect the contractual terms of the intercompany transaction where the parties have sufficiently demonstrated the arrangement was entered into under arm's length conditions at the time the contractual arrangement was entered into. Parties that assume risk may be rewarded with a successful outcome or suffer a loss for an unsuccessful outcome. Taxpayers have the ability to contemporaneously document and support their risk allocation at the time the transactions are entered into, relying on forecasts in connection with the transaction. Timely prepared and complete documentation should be adequate evidence to determine whether the transaction was and is in compliance with arm's length **expectations**. Once this is demonstrated, there should not be a requirement to monitor, thereafter, the allocation and management of risk between the parties.

In addition, an unreasonable burden would be imposed on taxpayers to identify - for each transaction – potential risks, assumption of external risks, potential consequences and risk management measures in order to determine the appropriate pricing for the transaction.

3 Evidence of arm's length risk allocation

As noted above, contemporaneous evidence of the arm's length risk allocation should be sufficient to document the transaction or arrangement. However, it is recognised that arm's length evidence (i.e. comparables) for the same period are not ordinarily available at the time parties are agreeing to a risk allocation. When taxpayers prepare transfer pricing documentation for contemporaneous compliance, they employ a standard practice to use best available comparable data relevant for the period. Comparable data may include evidence of arm's length risk allocation, with reference to third party agreements.

As time progresses, more comparable data relevant to the period is often available for the benefit of tax authorities. The proposed revised OECD Guidelines appear to provide tax authorities with greater freedom to scrutinise risk allocations, and apply hindsight to the arm's length evidence of the risk allocation. If such freedoms are available, taxpayers will begin to question the purpose and value of preparing contemporaneous documentation. We strongly suggest the OECD provide thorough guidance on what is (and is not) acceptable evidence of arm's length risk allocation, from a technical and administrative perspective.

4 Increasing the profile of subjective measures

The focus on subjective measures is likely to increase disputes between taxpayers and tax authorities by increasing the reliance on subjective matters such as risk allocation and risk management. Risk is defined as "*the effect of uncertainty on the objectives of business*" in the proposed Discussion Draft, which is inherently subjective in nature.

There is also a likelihood of disagreement in both the possible interpretation and identification of key risks based on their evaluation of the facts at a different point in time.

5 ***Inconsistency with Chapter IX (control and financial capacity)***

The proposed new language in the Discussion Draft fails to recognise the importance of assets/capital that is required by the parties to perform their contractual functions and assume risk. Part I undermines rather than reinforces the framework under Chapter IX which purports that risks would follow capital or people functions.

6 ***Increased likelihood to non-recognition or recharacterisation***

The ability to set aside transactions ratified by both the tax authority and the taxpayer makes it difficult to deal with double taxation issues in the MAP process. If non-recognition or re-characterisation becomes more frequently applied by tax authorities, under the new Part I terms, taxpayers will face significant uncertainty on their ability to obtain relief from double tax. There should be significantly greater consideration of trickle down deterrent effect on taxpayers to enter into MAP arrangements.

It is suggested under the Discussion Draft that business arrangements can be disregarded so long as it is justifiable by an *ex-post* analysis of the risk allocation between the parties. The OECD Guidelines should again strongly caution against the use of hindsight to apply *ex-post* facts to re-evaluate the terms of the transaction. As mentioned earlier, if the taxpayer contemporaneously documents the transaction and risk allocation were arm's length at the time of entering the arrangement, then such terms should be respected throughout the life of the arrangement.

B. Part II: Potential Special Measures

Overview

When outlining the need for special measures, Part II of the Discussion Draft notes that the proposed changes in Part I may not be sufficient to re-align transfer pricing outcomes with value creation. Hence, the OECD has presented a consultation on five measures that go beyond the arm's length principle to limit the potential for perceived BEPS.

Only Option 1 of the special measures is related to transfer pricing - the pricing of transactions between related parties. All other measures reach beyond transfer pricing and into re-designing territorial tax systems. It is more reasonable that Option 1 remains a transfer pricing matter covered by BEPS Action 8, 9 and 10, while the other measures do not.

Many observers to the BEPS project will be aware that in certain jurisdictions there are taxation rules that are similar to some of the special measures. We understand that Action 3 of the BEPS project (Strengthen CFC Rules) is intended to address the non-taxation issues raised in Part II. A discussion draft under Action 3 is expected in April 2015. We recommend that the OECD defer further work or consultation on Options 2 to 5, and cede the work undertaken to those responsible for Action 3.

General concerns with special measures

Part II of the Discussion Draft suggests circumstances which may warrant a special measure to avoid inappropriate profit distribution, but, as noted earlier, Part II offers no details on how this work is connected to other BEPS actions.

Part II of the Discussion Draft has created unease for multinationals because it fails to provide adequate guidance on how recommendations will be drafted to enact any of the special measures. Both tax authorities and taxpayers seek and benefit from certainty and predictability in their tax environment. To provide certainty, there is an urgent need for consistency between the recommendations that may result from this Discussion Draft and existing rules, and to minimise the double tax consequences that can easily result from special measures.

It will be critically important that during this consultation of special measures, the OECD commits to "*clarify, standardise, and confirm the fiscal situation of the taxpayers*". With these special measures, it is foreseeable that multinationals may not receive fair or consistent application of new rules by tax authorities, and as a result, lead to substantial levels of double taxation.

Finally, to avoid the creation of double taxation, a two-sided mechanism must be addressed in future Discussion Drafts so that any *ex-post* adjustment by one tax authority is required to be recognised by the tax authority of the counterparty jurisdiction, as long as there is a tax treaty available to avail of double tax relief. The work on Action 14 (Making dispute resolution more effective) focuses on issues currently faced by taxpayers and tax authorities. It is critical that Action 14 also considers and addresses the future double tax scenarios that are likely to result from this and other Actions.

Option 1: Hard-to-value intangibles

The proposed special measure involves a presumption of a price adjustment rule where the price of a transaction is fixed, either as a lump sum or a royalty rate. This measure allows the benefit of hindsight to re-price transactions. The OECD Guidelines cautions against the use of hindsight when third party contracts would not grant such rights to the parties.

As noted earlier, we suggest the OECD Guidelines strongly caution the use of hindsight except in abusive situations. It should be strongly phrased in the Guidelines that if a taxpayer has demonstrated compliance with arm's length expectations, through complete contemporaneous documentation, it

should be prohibitive for tax authorities to retro-actively adjust prices of certain transactions if risks materialised different from expectations.

Rules similar to the proposed measures that allow a retro-active price adjustment already exist in the United States transfer pricing rules. The Commensurate with Income rules (CWI) in the US transfer pricing regulation allow for a variance from the projections used to set the price in connection with the transfer of an intangible asset. CWI also limits the retro-active period to a finite amount. While we are not in agreement with such measures, we recommend any future development of this special measure ensures consistency in principle with existing transfer pricing or tax regulations.

In particular, the Discussion Draft lacks a requirement to restrict the number of years tax authorities may "look back" to review a transaction. The current wording provides leeway to tax authorities to review these transactions without limitation.

Hallmarks of CFC regimes

Options 2 through 5 are intended to address inappropriate returns for providing capital. These options introduce new rules that appear like the foundation of CFC regimes. It is our view that a well-crafted CFC regime should at least have these four characteristics:

1. rules that define a CFC;
2. clear definitions of what constitutes *bad* CFC income versus *good* CFC income;
3. consistent and clear thresholds for substance (e.g. number of employees, materiality of third party revenue, etc.); and
4. specific rules stating when the CFC income (good or bad) will be subject to tax in the parent company's jurisdiction, if at all.

Option 2: Independent investor

This special measure is intended to address inappropriate returns to capital-rich, asset-owning entities that are dependent on other group companies to generate returns on those assets. The proposed measure is to attribute the return associated with the capital-rich, asset-owning company to the parent company, as if the parent company made a direct investment in the asset.

The description of this measure is light and requires greater detail on how the re-allocation of income would occur in practice. Any inappropriate allocation of income to such an entity is generally addressed in well-crafted CFC regimes. We strongly recommend that any special measure that is similar to a CFC measure should be addressed in Action 3.

Option 3: Thick capitalisation

The thick capitalisation special measure involves deeming interest on the capital amount that is considered excessive capital allocated to a capital-rich, asset owning company. The measure would deem interest expense on this company and interest income on the company providing the excess capital. The Discussion Draft suggests that fixed ratios of thick capitalisation could be referred from capital adequacy of a regulated financial services business.

In our view, there is a fundamental mismatch in the purpose of the proposed thick capitalisation ratio and capital standards for regulatory reasons. Any **maximum** capital threshold suggested in this special measure would be counter-intuitive to the **minimum** capital levels required by a financial regulatory regime. Further, there is a lack of guidance on how to determine the pre-determined capital ratio which makes practical application difficult and arbitrary.

The application of transfer pricing principles must adhere to how arm's length parties conduct business. It is often the case that independent companies, both small and large are fully capitalised by

equity and carry no interest-bearing debt. Hence, we suggest that any special measure deeming debt on an entity solely because of its capitalisation contradicts the basis of the arm's length principle and Article 9 of the Model Tax Convention.

It is important to recognise the connection between this measure and Action 4 (Interest Deductions and Other Financial Payments), which is advocating rules limiting intercompany interest deductions through thin capitalisation and other methods. Multinationals generally borrow externally such to reduce the overall financial cost to the business. This might be at the parent company level. Amounts are then lent within the organisation in compliance with transfer pricing and other taxation rules.

Thin capitalisation threshold in certain countries are a fixed formula, and are indifferent to external borrowings of the organisation. It appears contradictory on one hand to support measures that deny deductions for interest that based on external costs, while on the other hand not permitting the capitalisation of an entity without debt. We suggest that both sides of the capitalisation spectrum are treated equally.

Option 4: Minimal function entity

The special measure addressing minimal function entities (MFE) re-allocates the profits of the MFE to companies providing the relevant functional capacity that create the profits of the MFE. Both qualitative and quantitative thresholds are suggested to determine whether a company qualifies as an MFE. Qualitative attributes address functional capacity, whereas quantitative attributes measure employees, source of income, and value of the assets.

A key concern is the qualitative attributes suggested in the Discussion Draft are subjective, providing for disputes between taxpayers and tax authorities, and between tax authorities. Further, it would be challenging to derive reliable and consistent quantitative measures that would apply across jurisdictions and across industries.

Since this special measure suggests the profit split as a way to re-allocate the profits of an MFE, we strongly recommend there is a clear nexus with Action 10 on the application of the profit splits to global value chains. Because the draft suggest that profits of an MFE may re-allocated to multiple parties performing the functions, this option creates the possibility of multiple tax authorities seeking to tax the same income of an entity deemed an MFE. There is already disagreement amongst tax authorities in applying the arm's length principle. Triple taxation, or worse, is a foreseeable outcome of this option and should be avoided where possible.

Option 5: Ensuring appropriate taxation of excess returns (CFC rule)

The fifth special measure involves the application of a primary or secondary rule, akin to a CFC regime, aimed at preventing non-taxation. This measure would apply to CFCs earning excess returns in low tax jurisdictions.

We are extremely concerned with the '*effective tax rate*' approach outlined in the primary rule. A CFC approach specifically targeting effective tax rates has a high likelihood of collateral damage beyond the intended non-taxation in tax havens. Concerns over harmful tax practices are being addressed in Action 5 and encourage the outcome of Action 5 to distinguish between inappropriately reduced effective tax rates from appropriately reduced effective tax rates.

There are a number of reasons why effective tax rate is not a suitable benchmark. For instance, effective tax ignores the impact of losses carried forward. The Discussion Draft suggests a three-year period to evaluate effective tax rates. Lifecycles of a business, whether it supplies good or services, can easily extend beyond three years. Losses incurred in the development stages may reduce taxes on future profits for many years to come. Such business realities must be considered in developing any new rules.

There is also a high risk of different thresholds being adopted by local law leading to increased disputes and triggers a need for constant re-evaluation of the threshold. Some countries may wish to specify a fixed percentage (as suggested in the Discussion Draft). Others may set the threshold relative to their own corporate tax rates, e.g. Swedish CFC law applies to income subject to taxation at a rate less than 55 percent of the Swedish rate.

We see this measure will be very difficult to implement into law so that it achieves a consistent approach to allocate excess income across multiple jurisdictions. There is a significant amount of work required to attain the buy-ins from tax authorities from multiple jurisdictions which could be hard to achieve.

Overall, we strongly suggest the OECD stops any further work on Option 5 pending the outcomes on both Action 3 and Action 5.