Tel: +32 2 778 01 30
Fax: +32 2 778 01 43
@: bdo@bdointernational.com
www.bdointernational.com

BDO International Limited
Contact:
Boulevard de la Woluwe 60
B-1200 Brussels
Belgium

Ms Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
2 rue Andre Pascal
75775 Paris
France

6 February 2015

Dear Ms de Ruiter,

DISCUSSION DRAFT ON BEPS ACTIONS 8, 9 AND 10: REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERIZATION, AND SPECIAL MEASURES)

BDO welcomes the opportunity to comment on the OECD's Discussion Draft issued on December 1, 2014 on "BEPS Actions 8, 9 and 10: Revisions to Chapter 1 of the Transfer Pricing Guidelines (including risk, recharacterization and special measures)" (the "Discussion Draft").

We agree that there is a need to assure that transfer pricing outcomes are in line with value creation within all Multi-National Enterprises ("MNEs"). We concur with the general direction of the proposed Guidelines in the Discussion Draft and have kept the OECD's objectives in mind when drafting our comments and responses to the specific questions raised by the OECD.

We set out our comments, responses and suggestions below:

OVERALL

The Discussion Draft does not represent a significant departure from the historic intentions of the Guidelines, but rather reaffirms and emphasizes expectations. Overall, this should be helpful as it sets out clear expectations for both MNEs and tax authorities. However, by increasing emphasis on certain areas and by making the concept of non-recognition more explicit outside of the context of recharacterization in Chapter IX, there is a risk that this will increase the expectations for documentation and tax authority challenge across the board rather than simply focusing on the higher risk, hard to characterize or potentially inappropriate transactions which we understand are the OECD's main concern. The OECD might usefully consider increasing the level of practical guidance around how the new level of proposed scrutiny is implemented, placing this in the context of their Risk Assessment Handbook and their other recent moves towards simplification in certain areas.

On the same theme, it would be helpful for the OECD to clarify the similarities or otherwise between non-recognition in the Draft and recharacterization in Chapter IX. There is room for overlap between the concepts; however the different terminology could lead to uncertainty.

BDO International Limited is a UK company limited by guarantee. It is the governing entity of the international BDO network of independent member firms ('the BDO network'). Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.
Each of BDO International Limited, Brussels Worldwide Services BVBA and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA and/or the member firms of the BDO network.
BDO is the brand name for the BDO network and for each of the BDO member firms.

SPECIFIC COMMENTS

Section D.1

Paragraph 3

Acknowledging that communications other than formal intercompany agreements are acceptable is helpful and could reduce administrative requirements.

Paragraphs 4 and 5

Establishing the need to review the conduct of the parties over purely legal form or pricing policy is consistent with the arm's length standard. However it would be useful to provide guidance on how tax authorities might assess this. The overall requirement suggests a more in-depth review of the terms and delivery of transactions which may not be consistent with the process in the OECD's Risk Assessment Handbook, unless a very high-level approach, based on the data in a country by country report is to be used. When this is addressed elsewhere in the document, such as in paragraphs 16 and 37, the level of information required is consistent with full transfer pricing documentation at a minimum.

Paragraph 5

This paragraph alludes to the bargaining power of the parties to a transaction. Bargaining power can often be difficult to quantify and/or demonstrate. Guidance on what could form acceptable supporting evidence could alleviate uncertainty for MNEs preparing documentation and/or responding to an enquiry.

Paragraphs 9 and 10

The discussion of economically relevant characteristics is a good introduction. Explicit reference to the later sections on risk, and, in particular, the management of risk, would be helpful to ensure this is not interpreted in isolation. A consideration of that risk management in the context of concepts such as SPF and KERTs in the Attribution of Profit to PE work could be beneficial.

Paragraph 12

The implication is that the OECD is suggesting that consideration of ORA is required for every transaction. Meanwhile there is reference to some activities being essentially standard, such as distribution. In view of this there is a concern that some tax authorities may seek this additional level of analysis for all transactions, including those such as management services which carry lower risk. This could add significantly to documentation requirements and the requisite analysis. The OECD might be more specific about the existence of standard or routine transactions and suggest that this kind of analysis is expected in cases of higher risk, hard to value transactions or where there could be reasonable uncertainty of the arm's length nature of the transaction.

Paragraph 14

It would be helpful to clarify to OECD's expectation around the adjustment to comparable data, such as the use of working capital adjustments versus the analysis of an appropriate point in a range of comparable data. The OECD may want to comment on how its guidance in paragraph 14 is to be interpreted in conjunction with paragraph 26.

Paragraph 19

We are concerned that the OECD is recommending the recognition of "implicit support" provided to one company by other companies in the group, i.e., diversification that is implicit in the insurance premium charged by an independent insurer is already provided by the group companies. This appears to deviate from the arm's length principle, in that the OECD Guidelines have always been based on two related companies transacting at amounts, and on terms and conditions, which would exist between two unrelated companies. Recognizing any "benefit" from being part of a group of companies is a direct contradiction of the arm's length principle that is "the" foundation for the OECD Transfer Pricing Guidelines.

Section D.2

The overall discussion in this section could be interpreted as movement towards a world of transfer pricing using the Profit Split Method. The OECD may want to make more reference to its guidance on comparability and testing in this context to show that, for example, the Cost Plus Method or the Resale Price Method can be consistent with the proposals in the draft.

Paragraph 46

It should be emphasized that management may be a core operational function that is not always co-located with execution of an activity.

Paragraphs 49 to 53

In the discussion of respective risks, the OECD may usefully expand on how to treat the concept of exclusivity as this is a more common feature in associated entities than third parties. This has a bearing on risk, but for both sides.

Also around this point there is discussion of moral hazard. This is a good area to dwell on, but how does it compare to the ultimate entrepreneurial and financial risks?

Paragraph 92

Where a tax benefit is identified, this should not necessarily be a red flag. Costs may need to be reviewed on a multiyear basis to gain a full picture of a (new) arrangement as any tax benefit may be recognized more quickly than any commercial or financial benefits.

Paragraph 93

Can the OECD clarify the impact of non-recognition? Is this always non-recognition of the whole transaction or, where that transaction is made up of identifiable component parts, could "line-item non-recognition" that alters the nature of one of those component parts be an acceptable option for a taxing authority?

OECD QUESTIONS

Moral Hazard

As stated in the Discussion Paper, Moral Hazard "refers to the lack of incentive to guard against risk where one is protected from its consequences" and it "is used ... 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." Moral Hazard "extends to the safeguards or incentives that unrelated parties may incorporate into contracts between then in order that interests are better aligned and moral hazard is reduced or avoided."

1. In our experience, contracts between unrelated parties deal with moral hazard largely through the use of termination clauses combined with clearly delineated clauses dealing with the obligations of both parties and the responsibilities of both parties. Such contracts also state clearly those acts/actions that are considered unacceptable (again, usually in the termination clauses). The same types of clauses are evident in contracts between related parties, with the added safeguard of the oversight of the contractual arrangement by the Parent Company in the group. As a result the role of imputed moral hazard and contractual incentives is minimal in respect of determining the allocation of risks and other conditions between associated enterprises.

2. In our experience, the fact that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities has minimal impact on the analysis of transactions between associated enterprises. Unrelated parties will share what is required to complete the work required under a contract. Related parties will likewise share what is required to complete the work required under a contract. In most cases, related parties are unwilling to share insights into core competencies or market opportunities.

3. The terms and conditions of the contract between S1 and S2 would be such that S2 would be required to obtain the "substance" required to promote and protect the trademark for which it is collecting a royalty from S1. The example at paragraphs 90 and 91 illustrate, to our mind, the need for the substance of a transaction between related parties to mirror the substance inherent in the terms and conditions required in a similar transaction between unrelated parties.

4. In any transaction between unrelated parties there is agreement on which party bears which risk. The return attributable to each party to the contract is determined, in part, on the performance of specific functions and, in part, on bearing certain specific risks. If a risk is shifted between two parties to a transaction, whether related or unrelated, then the return needs to be shifted in a manner that accurately reflects the true quantum of risk being transferred.

5. In the example at paragraphs 90 and 91, the asset transfer alters the risks assumed by the two parties because the risk of ownership, maintenance and defence of the trademark should rest with the owner of the trademark. In other words, S2 should now bear the risk associated with the trademark, such as defending the trademark against infringement.

6. As noted in our previous responses, S2 requires the substance to own, maintain and defend the trademark to justify charging a royalty for it to S1.

7. Yes, the risk-return trade-off does apply generally to transactions involving, in part, the shifting of risk. Further:

    a) There are limits to the extent the risk-return trade-off should be applied, in that the shifting of risk must be bona-fide, and the determination of appropriate returns must be made to correlate with the true economic impact of an entity bearing that risk.

    b) This may require analyses and documentation of the historical costs incurred by the entity bearing the risk before that risk gets shifted within the MNE.

8. In the financial services sector the same concepts apply, in that the party bearing the financial risks must have the ability to effectively deal with the risks, mitigate the costs associated with those risks, and bear the costs associated with the risks. In our experience, there is already an increased emphasis on risks in the financial services sector, with those risks being very specific and linked with the capital of a company as presented in the Financial Statements.

For clarification of any aspects of this response sent on behalf of the BDO transfer pricing network, please contact:

Paul Daly
Partner, BDO UK
paul.daly@bdo.co.uk
+44 11 8925 8512

Dan McGeown
National Practice Leader Transfer Pricing, BDO Canada
dmcgeown@bdo.ca
+1 416 369 3127

Anton Hume
Partner, BDO UK
anton.hume@bdo.co.uk
+44 207 893 3920

Duncan Nott
Director, BDO UK
duncan.nott@bdo.co.uk
+44 20 7893 3389