

# Grant Thornton discussion draft response

BEPS Actions 8, 9 and 10: Revisions to 'Chapter 1' of the transfer pricing guidelines



Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled BEPS Actions 8, 9 and 10: Discussion draft on revisions to 'Chapter 1' of the transfer pricing guidelines (including risk, recharacterisation, and special measures), issued on 19 December 2014.





## **Proposed section D.1 - Identifying the commercial or financial relations**

We note that the current transfer pricing guidelines at Chapter 1 D1.2.3 1.53 provide that 'it is... important to examine whether the conduct of the parties conforms to the terms of the contract'. We would also observe that in practice most countries implementation of the guidelines, their own domestic substance-over-form or similar statutory interpretation principles are likely to take into account whether intra-group contractual documentation accurately reflects the reality of the conduct between the parties. As a general comment we therefore wonder whether the significant expansion of the discussion of conduct in the proposed amendments is intended to alter, or simply clarify, the existing guidelines and practice.

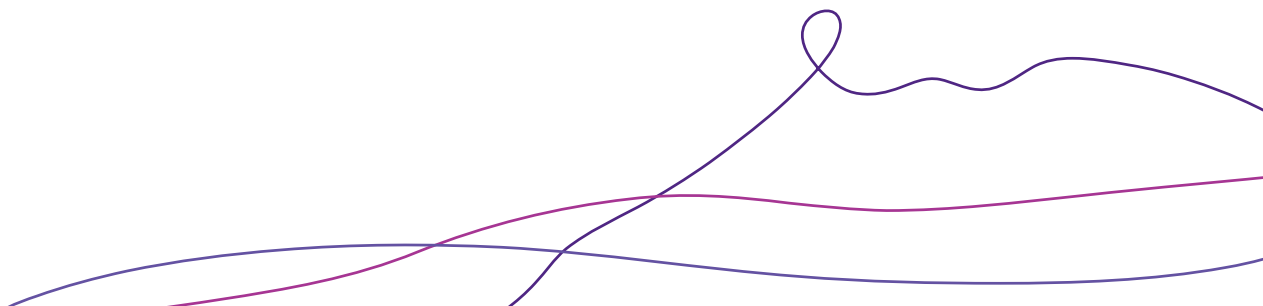
Because of these existing provisions in the guidelines and domestic law, we consider that in practice in the vast majority of cases multi-national enterprises are careful in conforming their intra-group contractual relationships to the conduct in practice (and vice versa). We would therefore welcome clarification that 'recharacterisation' of transactions from the contractual position by tax authorities should be applied exceptionally, and only where there is clear justification for rebutting an assumption that conduct and contracts align. We are concerned that otherwise tax authorities may interpret the revised guidelines as providing justification for a broad approach of looking at conduct first and foremost and generally disregarding the contractual position. This could give rise to a great deal of uncertainty and inconsistency between tax authorities, and a need for heavy reliance on the Mutual Agreement Procedures (MAPs) (we have previously commented on the need for improvements here, which are only partly addressed by the current BEPS Action 14 proposals).

## **Proposed section D.2 - Identifying risks in commercial or financial relations**

We welcome the focus on the identification of the allocation and management of risk as fundamental to arriving at the appropriate transfer pricing outcome. We consider that the management of risk is another example of the conduct of the parties which should be examined in accordance with section D.1 in order to determine whether the unusual step of recharacterisation by tax authorities from the contractual position is warranted.

We would welcome clarification that the consideration of risk allocation and management is indeed intended to be another dimension to the question of whether conduct conforms to the contractual arrangements. It is not entirely clear that this is the intention, or whether the proposed guidelines could be interpreted as allowing recharacterisation even where the conduct of risk management matches the contractual allocation of risk, in situations where a tax authority might argue that it was not in the interests of one party for risk management to be allocated in this way.

As is acknowledged in the document, all business is built on the concept of acceptance of risk for appropriate commercial return. Many businesses are subjected to countless commercial risks over which they do not have direct control, but they target returns which will compensate the owners of the business for the risk and inherent volatility which is accepted. Business may adopt at the same time or at different times a combination of high-risk/high target return and low risk/low target return strategies. Between independent enterprises negotiating commercial terms, pricing and risk allocation are necessarily considered together. We consider



that between associated enterprises there should be a presumption that risk allocation similarly should be seen first and foremost as a question to be taken into account in determining the appropriate arm's length price. Assuming that the conduct of risk management corresponds to the contractual position. We consider that the 'risk-return trade-off' question described in the discussion draft is necessarily linked to what is described as the issue of 'moral hazard' in that an enterprise will in third party situations accept a reduced level of control over certain risks, depending on its bargaining power and as long as it's appropriately compensated for doing so.

This of course assumes that an arm's length price is capable of being determined for the relevant transaction. The discussion draft at page 14 invites comment on the application of these concepts to the example in paragraphs 90 and 91. This is somewhat confusing as the context of that example is in the discussion of the question of possible non-recognition of a transaction on the basis that third parties would not have entered into the transaction at all, rather than the question of appropriately taking into account risk allocation in determining the arm's length price.

We consider that the example at paragraphs 90 and 91 is closely comparable in certain respects to the example in Chapter 9 of the existing transfer pricing guidelines at D3 9.193. On the assumption that the transaction is one that could have been entered into between third parties, we suggest that the risk transfer inherent in such a transaction should result in a requirement that the valuation of the intangible is high enough (or potentially that it may include deferred contingent consideration or an 'earn-out' or other commercially observable consideration arrangement) so as to fully compensate for the risks assumed by the transferor.

A further aspect of the allocation of risk is the financial resilience of the company to be able to withstand the commercial volatility which results. We consider that there is a link here with the question of capitalisation and explicit or implicit financial guarantees in a group situation.

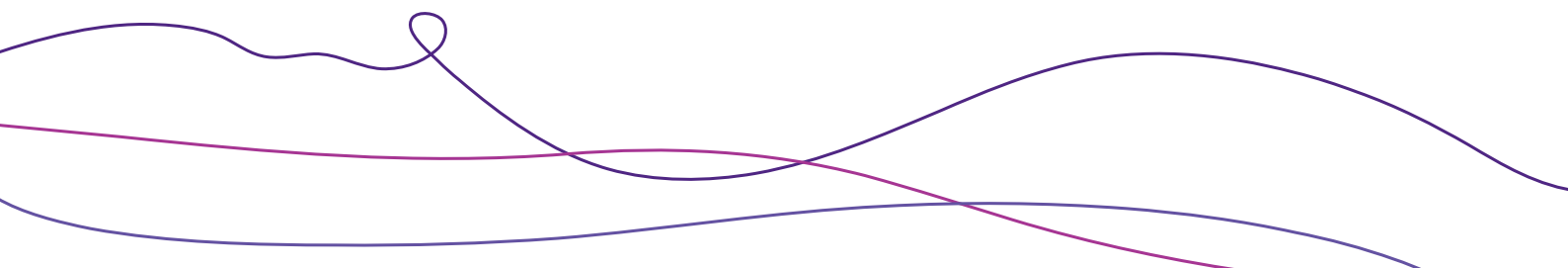
### **The financial services sector**

We agree that the financial services sector is a helpful area of consideration in that it often presents clear and transparent examples of how risk allocation impacts on the pricing of transactions. Often determining an arm's length price for the acceptance of risk is facilitated by transparent and liquid capital markets, eg for financial derivatives.

The sector also operates with a sophistication in linking the acceptance of risk with requirements as to the appropriate financing and capitalisation of a company, often governed by regulatory requirements.

In these respects we consider that the financial services sector should not require specific guidelines, but rather serves to illustrate and provide market evidence for the general proposition that arm's length pricing should correspond with the allocation and management of commercial risk.

One other observation about the financial services sector would be the existence within multi-national entity (MNE) groups of central risk management functions. These typically provide intra-group services to subsidiaries as an outsourcing of the operational aspects of risk management. The financial services sector also includes independent service providers who provide risk management services, against which intra-group risk management service fees can be benchmarked. This evidences that



aspects of risk management can itself be a service capable of being priced. This may mean that where one company has outsourced aspects of risk management to another company, comparison with arm's length situations would imply that this should not necessarily mean it's appropriate for the entire return in relation to the relevant assets to be transferred to the entity managing the risk.

Even outside of financial services we would note that an MNE may have central risk management functions, for example a group internal audit function, where it would be appropriate for an arm's length service fee to be determined for that service alone without disturbing profit allocation more broadly.

An example in the discussion draft at pages 22-23 is the position of a group treasury company. Despite the comments above, we do not consider that just because a group treasury function is hedging the risk borne by a subsidiary, that it could be considered as providing a service to that subsidiary. If the subsidiary is consciously taking risk, is appropriately rewarded for taking that risk, and is appropriately capitalised in order to withstand the resulting volatility, then the assumption should be that the reward to the company is appropriate. A shareholder will naturally review its entire portfolio of investments and determine (taking into account correlations and natural hedges) what its overall economic risk position is. The shareholder may then take an independent decision to hedge some of its resulting aggregate or net economic risks for its own account.

Further, the factoring example in paragraph 71 appears rather over-simplistic. See for example the wording: 'Neither party will expect to be worse off...'. An independent company with a low tolerance for risk may well factor its debts expecting that its own profits will fall, in exchange for the removal of the risk of substantial loss (or just to even out its cash flow).

## **Proposed section D.4 – Non-recognition**

Whilst this proposed section is substantially new, we note that the existing transfer pricing guidelines do include provisions regarding the potential for non-recognition of transactions, including Chapter 1 D2 and Chapter 9 Part IV C. Again it would be helpful if it could be confirmed whether the proposed new section is intended to alter, or simply clarify the existing guidelines and practice.

Also we note in proposed paragraph 83 that 'the term non-recognition' is intended to convey the same meaning to what is understood to be conveyed by the term 'recharacterisation'. Clarification of this would be welcome. The connotation of the document is that 'recharacterisation' implies that a tax authority can argue that a different transaction is entered into from that purported by the contractual documentation. Whereas it would appear that 'non-recognition' is intended to apply in situations where a tax authority can disregard a transaction entirely and treat it as if it had not happened at all. We do not think that these concepts are the same, and we would appreciate clarification.

The wording in paragraph 89, suggesting that an examination of all potential alternative arrangements for each party, and the use of language such as 'would not be recognised' (emphasis added) will, we consider, cause difficulties in practice.

We agree with the position in the current guidelines (D2 1.64) that whilst non-recognition may in some instances be warranted. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise, the inequity of which could be compounded by double taxation. We would welcome confirmation that non-recognition is still viewed as exceptional

and fundamentally problematic, especially given the potential need for MAPs to be invoked to ensure consistency between tax authorities and avoid double taxation.

The potential difficulties if more 'non recognition' occurs are not addressed by the short paragraph under proposed D.4.3. How is the money that has been paid out by S2, for example, to be treated, as a loan?

### **Potential special measures**

As a general observation we would note that the special measures outlined could benefit from greater detail in describing the circumstances in which they would apply, and exactly how they would operate. Another general observation would be that the proposed revisions to the transfer pricing guidelines discussed above appear to be intended to deal with many of the circumstances described through their focus on risk allocation and management and conduct. If the revised transfer pricing guidelines were to succeed in these objectives, there would appear to us to be little need for special measures standing outside the overall framework of, and challenging the internal consistency and integrity of, the guidelines as revised. Introducing special measures in addition to the transfer pricing guidelines would create further areas of potential inconsistency in application between taxing jurisdictions. It could also be seen to provide justification for the departure from the guidelines more frequently, jeopardising the international consensus of their application.

We have the following comments on the specific options for special measures outlined:

#### **1. Hard To Value Intangibles (HTVI)**

We would suggest that the issue could be dealt with within the framework of the proposed revised guidelines.

For example it may be the case that in a third party situation it would be difficult to agree a fixed price for a HTVI. However other third party contractual paradigms may be available and an intra-group transaction could potentially be recharacterised to fit these paradigms. For example, deferred contingent consideration, or 'earn outs'. In exceptional cases, as is contemplated in the existing and proposed revised transfer pricing guidelines, it may be appropriate for non-recognition to apply to a purported intra-group transfer of a HTVI.

We do not support a 'commensurate with income' approach or test, and we are concerned with the implication of hindsight under the potential rebuttable presumption.

#### **2. Independent investor and 3. Thick capitalisation**

This appears to be a question about appropriate capitalisation within a group of companies which accept a volatile position. Again it would appear to us that focusing on a functional analysis based on conduct including risk management should be capable of addressing concerns. The presence of documented or implied intra-group guarantees should also be considered in this context.

We would be very concerned about the potential for arbitrary and inconsistent reallocations of capital by tax authorities under option 2 and about the imposition of 'blunt instrument' ratios under option 3. Further, as in many real life cases where tax authorities challenge what taxpayers have done, there appears to be an underlying presumption that we will always be discussing attribution of profits, and not losses. Indeed, we suggest the document as a whole could be enhanced by additional commentary about the risks of loss.



#### **4. Minimal functional entity**

The transfer pricing guidelines as amended should be apt to deal with concerns here through a possible recharacterisation of transactions where there are minimal functions performed in an entity in extreme cases. In other cases, it should be able to be dealt with through fundamental principles of arm's length pricing of transactions where minimal functions are performed. Further, the proposed qualitative and 'quantitative' thresholds, as well as the discussion on the effect of failing the test, all seem highly subjective.

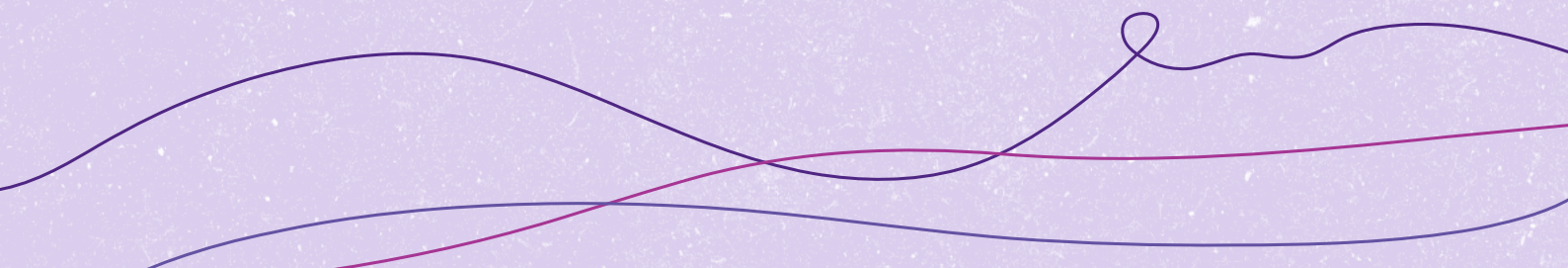
#### **5. Ensuring appropriate taxation of excess returns**

We consider that transfer pricing rules should as a fundamental point of principle be capable of being operated on a consistent global basis without regard to the tax rates in any jurisdiction.

#### **Summary**

Grant Thornton International Ltd welcomes the OECD's proposal to maintain the position of the transfer pricing guidelines as, in the context of the BEPS project, continuing to have a central role in the international tax framework for the appropriate allocation of profit and avoidance of double taxation, and hopes that the comments set out above assist the OECD in this.

If you would like to discuss any of these points in more detail then please contact Wendy Nicholls, Partner, Grant Thornton UK LLP at [Wendy.Nicholls@uk.gt.com](mailto:Wendy.Nicholls@uk.gt.com) or Richard Milnes, Partner, Grant Thornton UK LLP at [Richard.Milnes@uk.gt.com](mailto:Richard.Milnes@uk.gt.com).





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