The **BEPS** Monitoring Group

Comments on the Public Discussion Draft on

CONFORMING AMENDMENTS TO CHAPTER IX OF THE TRANSFER PRICING GUIDELINES

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with contributions and comments from Tommaso Faccio and Sol Picciotto.

SUMMARY

Chapter IX was introduced into the OECD Transfer Pricing Guidelines (TPGs) in 2010 to help deal with the consequences of the spread since the 1990s of corporate restructurings by multinational enterprises (MNEs) essentially aimed at tax avoidance, typically involving transfers of rights to intangibles, redesignation of the responsibilities or functions of affiliates, and notional reassignments of risk-bearing. This draft rewrites the chapter to bring it into line with the other changes to the TPGs resulting from the BEPS project.

Our comments suggest ways in which the draft should be revised to make its purpose clearer, with additional coverage of restructurings that are only contractual in nature or that involve insubstantial movements of assets, people, and risks. It should state that the burden of proof is on the taxpayer to establish the validity and substantive nature of any stated business reasons behind any business restructuring, and should bring out more clearly the applicability of the profit split method.

General Remarks

1. One-sided feeling

Since the late 1990s tax consultancy firms have offered advice on corporate restructuring aimed at producing tax savings.[1] These often entail few substantive changes to the actual organisation of the main business activities of a multinational enterprise (MNE). They should be distinguished from restructurings driven by considerations of the business itself, involving significant transfers of real activities, plant closures, etc. Instead, tax-motivated restructurings typically involve transfers of rights to intangibles, redesignation of the responsibilities or functions of affiliates, and notional reassignments of risk-bearing. Such restructurings result from decisions of the central management of the MNE, although they are generally given legal form by changes in the contractual arrangements between the MNE's various entities in different countries.

As a partial response to the increase in such tax-driven restructurings, the OECD introduced a new chapter IX in its Transfer Pricing Guidelines (TPGs) in 2010. This Discussion Draft (DD) provides a rewritten version of that chapter, to bring it into conformity with the other changes in the TPGs resulting from the BEPS project. Perhaps as a result of the need to achieve consensus between a large number of countries, many of the changes have lacked clarity, and have left the Guidelines confusing and contradictory, as we and other commentators have pointed out. Our comments on this DD are limited to suggestions on how this particular chapter could be made clearer and more effective, in the context of the other changes already agreed by the OECD.

Reading this draft of Chapter IX feels to some extent like it has been written for the benefit of taxpayer MNEs rather than for the benefit of tax administrations, or even for the equal benefit of both. Chapter IX would be much more helpful to both taxpayers and tax administrations if it were more balanced, including additional coverage of restructurings that are only contractual in nature or that involve insubstantial movements of assets, people, and risks.

The draft chapter does include some statements that acknowledge the nature of many of the tax-driven notional reorganisations by MNEs which create illegitimate tax savings. Notably, para. 9.35 points out:

> Business restructurings often lead MNE groups to implement global business models that are hardly if ever found between independent enterprises, taking advantage of the very fact that they are MNE groups and that they can work in an integrated fashion. For instance, MNE groups may implement global supply chains or centralised functions that may not be found between independent enterprises.

This understanding is reflected in the example in para 9.46 and the restructuring described in para 9.123. With these notable exceptions, the examples and situations included in the discussion assume 'real' restructurings where assets, people, and functions move from one group member to another. This even results in the absurdity of

[1] Notably PWC's Global Tax Optimization Program, which offered "a coordinated, tailored approach to achieving [a company's] lowest sustainable tax rate" (US Senate, Permanent Subcommittee on Investigations, "Caterpillar's Offshore Tax Strategy" (2014), p.42).

accepting that MNE restructurings may comply with the arm's length principle even if no comparables can be found between unrelated firms. For example:

> It should be noted that the mere fact that an arrangement is not seen between independent enterprises does not in itself mean that it is not arm's length nor commercially irrational. (Para. 9.109).
>
> … There are also cases where comparables data are not found, for instance where the restructuring has led to fragmentation of integrated functions across several group companies in a way that is not found between unrelated parties. This does not necessarily mean that the conditions of the controlled transaction as accurately delineated are not arm's length. (Para. 9.113).

We suggest that the draft should be rewritten to bring out much more clearly the nature of tax-driven restructurings by MNEs which involve merely notional changes in the ownership of rights in intangibles and allocation of risks. They should stress the need for tax authorities to understand the facts and circumstances, and should place squarely on taxpayers the burden of proof to establish the bona fides of their actions.

SPECIFIC REMARKS

1. Expanding mention of the profit-split method

One outcome of the entire BEPS process is that there is recognition that the transactional profit-split method will have increased importance in the future. With this in mind, whether through footnotes or addition explanation, the possible applicability of this method in connection with Chapter IX matters would be useful to taxpayers and tax administrations alike. Presently, this method is only mentioned at the very end of the document in paragraph 9.131. There are other locations where it might usefully be mentioned as well. One excellent example is para 9.113.

2. Burden of proof concerning business reasons

Paragraph 9.4 comments on reasons reported by business for restructuring. There are of course many potential commercial and non-tax legal reasons for conducting business restructuring. Too often, though, stated business reasons for corporate structure changes are only facades for what is primarily a tax motivation. We strongly suggest that Chapter IX make clear that tax administrations should view purported business reasons with a healthy degree of scepticism. Further, Chapter IX should state that the burden of proof is on the taxpayer to establish the validity and substantive nature of any stated business reasons behind any business restructuring.

3. Financial capacity

This Chapter IX draft refers some number of times to the "financial capacity" of a party. (This term is defined in para 1.64 of the Guidelines.) While we do not suggest that this concept can never be important and relevant, in this Chapter on business restructuring, there must be some additional explanation given to alert tax administrations that the relevance of financial capacity must be carefully considered in each situation.

Often, and especially in any business restructuring where an MNE is shuffling the assets, activities, and risks of its group member to accomplish one or more business and/or tax goals, the actual financial capacity of any particular group member is totally at the discretion of the MNE. The MNE has full control to capitalize a group member, loan it funds, etc. As such, whether a particular group member does or does not have sufficient financial capacity to conduct certain activities, own certain assets, or take on certain risks is meaningless from the standpoint of analysing the actual conduct of the parties.

We recommend that explanation concerning this be either added in appropriate places via footnote or through additional explanation. Several examples of paragraphs requiring such guidance are paras 9.20, 9.21, 9.43, 9.51, 9.90, and 9.108.

4. Taxability of full-fledged distributor profits irrespective of limited-risk distributor status—Existence of DAPE

The example in para 9.46 provides an excellent illustration of how a distributor might be in varying risk/reward situations such that it would be more or less inclined to change the economic basis on which it operates. While we of course approve of the point being illustrated, the example seemingly implies, through silence, that only contractual changes are being made and that no significant people functions are moving out of the full-fledged distributor. Thus, as a distributor, it will continue in the future to make sales locally and to make normal distributor decisions regarding local marketing, promotion and advertising, which potential customers to approach, to whom and how much credit to extend, etc.

As we understand the example, with this formerly full-fledged distributor retaining all its functions, the only relevant trade-off is the relative level of commercial risk being undertaken and reward being earned, i.e., the risk of a distributor that will primarily either make money or lose money based on volume of goods sold as against a cost-plus or similar pricing model that will protect the distributor from any loss, no matter how low the level of sales might be.

In such a limited risk situation with this sort of pricing where the purchase and resale of the principal's products by the 'distributor' is in legal form only, the real effect is that the foreign principal has a dependent agent permanent establishment (DAPE). The Action 7 Final Report deals with 'commissionnaire arrangements and similar strategies'. Paragraph 5 of that Final Report defines such an arrangement as:

> … an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products. …

Whether through only a footnote or through more extensive discussion, this example must inform taxpayers and tax administrations alike that this type of arrangement will create a DAPE of the foreign principal. This will put both taxpayers and tax administrations on notice that where these full distributor functions are being conducted locally that the full distributor profits will be taxable in the local country either in the hands of the full-fledged distributor or in the combined hands of the limited-risk distributor and the DAPE of the foreign principal. All concerned must recognize this factor in their overall review of the effects of the business restructuring.

Consideration should be given as well for similar disclosure in the new business model that is described in para 9.51 and in the example provided in para 9.102.

Along this same line, we note with approval the inclusion of the following in para 9.108:

> … The analysis should go beyond the label assigned to the restructured entity, as an entity that is labelled as a "commissionnaire" or "limited risk distributor" can sometimes be found to own valuable local intangibles and to continue to assume significant market risks...

This point is further emphasized in para 9.112 and found as well in para 9.121. Again, whether through a footnote or other explanation, para 9.108 and para 9.121 are good places to put taxpayers and tax administrations on notice that certain functions conducted by a limited risk distributor will cause a DAPE with appropriate profit being earned in the host country under the rules of Article 7.