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Via E-Mail
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OECD Discussion Draft: BEPS Actions 8, 9 and 10 - Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)

Dear Mr Hickman

The business federation SwissHoldings represents the interests of 61 Swiss based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the OECD Discussion Draft of the Proposed Modifications to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures; hereafter referred to as "the Draft").

SwissHoldings supports the objective to ensure that transfer pricing outcomes are in line with value creation. However, from the perspective of the taxpayer, the revised Draft should:

1. provide clear and, in particular, practical guidance (and not limit the discussion to new theoretical and complex concepts);
2. be completely in line with the arm's length principle in order to avoid controversy and double taxation, and
3. limit the additional compliance burden for taxpayers.

Unfortunately, the three key criteria and objectives above are not fulfilled. Therefore, we recommend substantial amendments to the Draft.

Moreover, besides clear rules, the key success factor is consistent application of the new principles by taxpayers and, more importantly, acceptance by all tax administrations.

Further comments on the Draft are provided below.

General Comments

1. We support that transfer pricing outcomes should be in line with value creation. However, instead of providing further guidance on how to improve the transfer pricing analysis and, in particular, the pricing of risk to ensure that transfer prices are in line with value creation, it seems the primary focus of the OECD was to create "BEPS Guidelines" and accept with the current Draft a substantial erosion of the arm's length principle. Our interpretation is that the new term "in line with value creation" is a synonym for "in line with the arm's length principle". A clarification would be welcomed.

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2. The Draft includes several new terms and concepts which are not clearly defined. Both aspects will most likely lead to controversy and double taxation for taxpayers.

3. Most of the new concepts (and tests) remain theoretical in nature (e.g., moral hazard, risk-return trade-off, commercial rationality test, etc.) without considering guidance and the ability to implement them in practice. One of the leading principles has been so far that transfer pricing (paragraph 3.55 of current Guidelines) is "*... not an exact science...*". Moreover, "*the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises…*". According to the Draft, these principles do not seem to be applicable anymore. It seems that the intention of the OECD is to make an exact science of the complex matter of transfer pricing. However, if taxpayers and tax administrations are not able to understand and apply the Guidelines and new theoretical concepts in practice, it will significantly increase the potential for controversy, double taxation and costs for taxpayers and tax administrations. A clarification that these leading principles are still applicable would be welcomed. Moreover, a simplification of the proposed rules and concepts are required.

4. There is a need to maintain a balance between a more detailed transfer pricing analysis (considering also risk) and the potential compliance burden for taxpayers. Hence, a reduction of complexity and limitation of the compliance burden for the taxpayers is required. In particular, the extensive new transfer pricing documentation requirements just communicated by the OECD should also be considered.

5. Given all the new definitions, concepts and tests to be performed with regard to risk, it would be helpful to clarify that risk is a "comparability factor". As for any comparability factor, transfer pricing adjustments should be performed, if required. This fundamental principle seems to be "hidden" in paragraph 75 of the Draft. Moreover, the Draft clarifies correctly in paragraph 74 that no separate compensation is required for (the not clearly defined term) "risk management", as this is included in the market prices for other transactions. The Draft also has a too isolated view on the risk analysis. Further clarifications would be helpful.

6. We also appreciate the ambition to provide guidance to identify risks. However, if risks are really difficult to identify, as assumed in paragraph 38, then the missing risk category cannot be material enough to be considered in the transfer pricing analysis. It would be helpful to clarify that the risk analysis should be limited to key or material risks and not applied to all (theoretical) risks.

Actual conduct, commercial rationality test and options available

7. We support that actual conduct and risk allocation is an important element in the transfer pricing analysis. However, the Draft goes unfortunately beyond mere "sharpening the focus" on conduct. In particular, it should be clarified that contractual obligations and rights between the parties are not only the starting point, but remain one of the main aspects for the transfer pricing analysis. We support that the contract should be supported by actual behaviour of the parties.

8. We also support the theoretical principles that options realistically available should be considered. However, the new "commercial rationally test" as described in section D.4.2 lacks clear practical guidelines. Moreover, it neglects that in most cases within a group, the options realistically available are limited if the - bargaining power - of the respective legal entities within a group is considered. If for instance the principal and IP owner (e.g., HQ) of a transaction decides to relocate certain activities (e.g., contract manufacturing, services, etc.) or risks (e.g., FX) from one (e.g., high cost) country to another to remain competitive, then there is no need to have a theoretical discussion around "options available" and/or whether it

would "offer each of the parties a reasonable expectation to enhance or protect their commercial or financial position on a risk adjusted basis." Rather, considering the bargaining power and respecting the actual (limited) options considered within a group the taxpayers and tax administration should focus on an arm's length remuneration for the transaction (transfer of assets or risks) under review. It would be helpful to clarify that theoretical and actually not relevant or considered options are not required to be evaluated and documented. Hence, the Draft should focus on more clear and practical guidance for proper pricing of transactions or risks. Due to the lack of divergence of interests is the behaviour per the definition different within a group compared to transactions with unrelated parties. Hence, the revised guidelines should focus to align the pricing and not artificially the behaviours within a group.

9. The examples and discussions about pre- and post-tax results are confusing, in particular if we consider that benchmarking is usually performed on an EBIT/operating income level. Hence, the new aspects should be dropped to reduce the potential for controversy and double taxation.

10. The theoretical new "behaviour tests" limit the freedom for MNEs to operate. Any limitation is not in line with the arm's length principle. Moreover, it opens the door for unreasonable challenges by tax administrations considering ex-post information.

Moral Hazard

11. The concept of moral hazard is a complex theoretical concept and very difficult to assess and apply in practice. Independent of the complexity, we are of the opinion that this principle is not relevant in most cases for transactions between related parties and should therefore be completely dropped to mitigate confusion and potential for controversy and double taxation.

Risk-return trade-off

12. We fully support the theoretical concept around the new term "risk-return trade-off". However, we do not support the implications and unclear guidance provided in the Draft. Moreover, it is difficult, if not impossible, to implement in practice and partly not in line with the arm's length principle.

13. In particular, we are very concerned about the proposed limitations in doing business within a group. Why should a transaction not be recognised if the sole effect is to shift risks? MNEs are making permanently commercial and financial decisions about risks with unrelated parties, either in conjunction with a special transaction/activity or in isolation. This principle is applicable for all MNEs and not limited to the financial services sector. As such, it is unclear to us why the OECD wants to limit the freedom to operate for MNEs. Any limitations are not in line with the arm's length principle.

14. In transactions with unrelated parties risk is more likely to be assumed by the party which has the risk appetite and financial capacity to bear it as well as the required substance and not who "controls" or "manages" the risk. This is a fundamental difference in the proper understanding and application of the arm's length principle. Hence, instead of focusing too much on unclear and non-arm's length concepts, the Draft should focus more on clearer and practical guidance on how to determine accurate transfer prices, and where required, perform pricing adjustments (on a risk adjusted basis). As a general rule, there is no need to discuss and apply non-recognition or recharacterisation.

15. From an economic perspective, too much emphasis is on the behavioural aspects around risk, which is not in line with the arm's length principle. Although we acknowledge that actual conduct and control/risk management is an important element and needs to be properly considered in the transfer pricing analysis. But it is not the only aspect and in particular not the main one. Rather, bearing the financial/economic risk (funding) and capacity to do so (including having the required substance) remain the key elements at arm's length. This is another fundamental difference in the proper understanding and application of the arm's length principle. As stated above, MNEs are making decisions about risk (allocation) with unrelated parties and the risk management capabilities of the counter party is usually not a key factor. This is especially true if we consider the limited information available to both parties. With unrelated parties, the focus is primarily adjusting the (market) prices to reflect the adjusted risk allocation.

16. The newly introduced terms and concepts about "control" and "risk management" are not clearly defined and might result in controversy and double taxation. Alignment with the intangibles paper is required. A further clarification and reduction in complexity is welcomed.

Part II. Potential Special Measures

17. With clear and practical guidance to properly apply the arm's length principle, there is no need for further guidance on non-recognition, recharacterisation and in particular special measures.

18. Also, considering the extensive new transfer pricing documentation requirements, there is no need for further adjustments and new concepts as information asymmetry between taxpayers and tax administrations does not exist anymore or at least will be reduced significantly. Hence, before additional measures and concepts are implemented, which are not in line with the arm's length principle, we recommend to first assess the efficiency and impact of the existing activities.

19. If at all, it should be considered with the other actions (e.g., CFC rules) as all proposed measures have nothing to do with the arm's length principle and would lead to double taxation.

20. Considering also that transfer pricing is not an exact science, appropriate pricing adjustments always need to be used before any non-recognition and/or special measures are considered. Appropriate additional measures to avoid double taxation need to be implemented.

21. Moreover, as applicable for any guidance, clear definitions and practical guidance must be provided to ensure a consistent and efficient application.

Hard-to-value intangibles

22. The term Hard-to-value intangibles (HTVI) is not clearly defined. Without a clear definition, the implementation will fail and lead to controversy and finally double taxation. Sufficient guidance is provided in the revised Guidelines for Intangibles.

23. Moreover, with unrelated parties, the proposed price adjustment mechanism is the exception and not the rule, in particular long term. Hence, making the exception to the rule for MNEs is not arm's length and must therefore be dropped. However, as an alternative, if taxpayers are choosing this optionally and properly documenting the chosen set-up, then this must be respected by the tax administrations.

Inappropriate returns for providing capital

24. We are not clear about the example for “inappropriate returns for providing capital”. If it is obvious that the actual returns are not appropriate for the provided capital, then corresponding transfer pricing adjustments should be performed. Hence, there is no need to discuss at all special measures.

Minimal functional entity

25. The definition of a “minimal functional entity” is not clear. Is this a routine entity with a limited function and risk profile and typically benchmarked on a TNMM basis? If the transfer pricing analysis determines that the entity under review has “minimal functions”, then it should be able to determine an appropriate benchmark for such an entity. If required, additional transfer pricing adjustments should be performed.

26. The application of proposed functionality thresholds is not in line with the arm’s length principle and should be avoided. The same applies to the mandatory application of the profit split method based on pre-determined factors.

27. Instead, we would support the application of safe harbour rules as proposed in the draft guidelines for low-value adding services for “minimal functions” entities, respectively, routine entities.

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We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
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Chair Executive Committee

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cc - SwissHoldings Board
- Nicole Primmer, Senior Policy Manager, BIAC
- William Morris, Chair of the BIAC Tax Committee
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