



2121 41st Avenue
Suite 301
Capitola, CA 95010
PHONE 831.465.8204
FACSIMILE 831.465.9384

www.svtdg.org
info@svtdg.org

May 29, 2015

VIA E-MAIL

Andrew Hickman

OECD/CTPA

2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comments on *Public Discussion Draft—BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAs)*

Dear Mr. Hickman,

The Silicon Valley Tax Directors Group (“*SVTDG*”) hereby submits these comments on the above-referenced *Public Discussion Draft*, issued on April 29, 2015. SVTDG members are listed in Appendix A.

Sincerely,

A handwritten signature in blue ink, reading "Jeffrey K. Bergmann".

Jeffrey K. Bergmann

Co-Chair, Silicon Valley Tax Director’s Group

I. Introduction and summary

We thank Working Party No. 6 for preparing the *Public Discussion Draft—BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAs)* (“**Action 8 CCAs PDD**”) and for asking interested parties to give written comments. In this letter we comment on four aspects of the *Action 8 CCAs PDD*: (1) the requirement that CCA contributions must be assessed at their value rather than their cost; (2) risk bearing by CCA participants; (3) allocation keys for measuring CCA expected benefits; and (4) authority for disregarding part or all of the terms of a CCA.

The *Action 8 CCAs PDD* is wrong to assert that consistency with the arm’s length principle (“**ALP**”) requires contributions to a CCA be assessed based on their value rather than their cost. The assertion is contrary to the latitude permitted in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “**TPG**”), and to evidence of arm’s length behavior cited in the TPG, by the U.S. government, and in tax court case law. A typical R&D (development) CCA between associated enterprises will assess contributions of pre-existing intangibles based on value, but contributions of ongoing development based on cost. This is consistent with behavior of independent enterprise CCAs, and there are practical reasons for agreeing to this sort of sharing. The requirement that all CCA contributions must be assessed based on value is contrary to the ALP and should be removed.

The requirement in the *Action 8 CCAs PDD* that to qualify as a participant in a CCA an entity must have “the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA” is inconsistent with the ALP and should be removed. Risks the CCA as a whole bears must be distinguished from unique risks each participant may bear. At arm’s length it’s sufficient that at least one participant in a CCA be capable of controlling and/or

managing any risks borne by the arrangement (and the costs of this activity may be added to the pool of costs to be shared), but clearly not necessary that each participant have such capability. Lack of common capability to deal with risks the CCA as a whole faces can be expected to motivate independent enterprises to form CCAs. By contrast, each participant to an R&D CCA, for example, will face risks associated with successful commercial exploitation of intangibles assigned the participant under the arrangement; it's reasonable to require each participant to have the capability and authority to manage such specific risks. Thus requiring complete consistency with the general risk allocation principles in Chapter I of the TPG isn't appropriate for CCAs, which can be distinguished from typical associated enterprise transactions.

The list in the *Action 8 CCAs PDD* of explicit allocation keys for measuring expected benefit shares under a CCA should be expanded to include gross or operating profits. These keys are explicitly mentioned in the TPG, and are in many cases linked to additional income generated as a result of the CCA.

Article 9 and the TPG provide no grounds for disregarding part or all of the terms of a purported CCA. Local country law must be applied to determine the transaction—the “commercial or financial relation[]”—between associated enterprises necessary for application of Article 9. Such law may provide a basis—e.g., using equivalents of substance-over-form or economic substance doctrines—for recharacterizing or disregarding the terms of a purported CCA, but no such authority arises from Article 9 or the TPG. The *Action 8 CCAs PDD* should properly acknowledge this. Anti-abuse provisions under local law may in egregious circumstances justify total disregard of a CCA, and the TPG acknowledge this. But the *Action 8 CCAs PDD* removes the requirement that disregard potential be triggered only in abusive situations. This should be corrected.

II. Discussion of specific concerns

A. The *Action 8 CCAs PDD* improperly requires all contributions be assessed at value

1. Relevance of the ALP to CCAs

Paragraph 1.6 of the TPG provides that the authoritative statement of the ALP is found in Article 9 of the OECD MTC:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. [Emphasis added]

The ALP grounds application of the TPG, including treatment of CCAs. If any difference referenced in the opening clause exists, an allocation of profits among the associated enterprises is allowed by the second part of the sentence. In the phrase “those which would be made between independent enterprises,” “those” refers to conditions that would be made between independent enterprises. So the opening clause asks whether there’s a difference between (1) certain conditions that exist (“are made or imposed”) between associated enterprises; and (2) hypothetical conditions (“those which would be made”) between independent enterprises.

The existing conditions among associated enterprises must relate specifically to (actual) “commercial or financial relations” between such enterprises. The hypothetical nature of the conditions must relate to supposed (i.e., assumed) behavior of independent enterprises. Making the comparison between (1) and (2) is only meaningful if the hypothetical independent enterprises are assumed to be engaging in the same commercial or financial relation as that between the associated enterprises. The comparison in the first clause of the ALP is only meaningful if the clause is interpreted as “[where] conditions are made or imposed between the

two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises engaging in the same commercial or financial relations” . The ALP should operate to price associated enterprise transactions, not restrict—upon penalty of recharacterization—the set of transactions among such enterprises to those that independent enterprises would, under various assumptions, normally only engage in.¹

The mandate that an adjustment, if any, under the ALP be based on hypothetical conditions among independent enterprises has two corollaries, and they apply to CCAs just as to transactions among associated enterprises. The first is that application of the ALP in general doesn’t require evidence of actual independent enterprise behavior. Accordingly, if a CCA involving particular terms and conditions can’t be observed among independent enterprises, the ALP can nonetheless be used to determine transfer pricing. The second corollary is that if there exists evidence of actual behavior of independent enterprises engaging the same commercial or financial relations as those associated enterprises, such evidence controls application of the ALP in comparable circumstances. In this case, speculation is removed. This is important because there’s plenty of evidence of independent enterprises having engaged in CCAs that assess contributions at cost.

¹ We supported this conclusion in detail in our letter (submitted in conjunction with another trade association), dated February 6, 2015, on the OECD Public Discussion Draft *BEPS Actions 8, 9 and 10—Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures* (“**Comment Letter on BEPS Actions 8–10 PDD**”), a copy of which is attached as Appendix B to this comment letter. We reference our *Comment Letter on BEPS Actions 8–10 PDD* where relevant—e.g., in the discussion on recharacterization, below.

2. Evidence of independent enterprises engaging in CCAs

In 1986 the United States modified § 482 of the Internal Revenue Code (26 U.S.C.)—the basis for U.S. transfer pricing adjustments—to add “commensurate with income” language permitting in some situations *ex post* adjustments.² In adding this language, the U.S. Congress also directed the Internal Revenue Service (“*IRS*”) to conduct “a comprehensive study of intercompany [transfer] pricing rules.”³ Two years later the IRS and the U.S. Treasury Department produced the § 482 “*White Paper*,”⁴ which defined an R&D “cost sharing arrangement” (“*CSA*”) to be “an agreement between two or more persons to share the costs and risks of research and development as they are incurred in exchange for a specified interest in any property that is developed,”⁵ and stated that “[c]ost sharing arrangements have long existed at arm’s length between unrelated parties.”⁶ In *Xilinx, Inc. v. Commissioner*, 125 T.C. 37 (2005)⁷ the U.S. Tax Court held that petitioner domestic corporation and its foreign subsidiary—which were engaged in a CSA under § 482 regulations—didn’t in their CSA have to share “costs” associated with stock employee stock options because two unrelated parties (i.e., independent enterprises) in a cost sharing agreement wouldn’t share any such costs. The § 482 regulations defined a CSA as “an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from

² § 1231(e)(1) of the Tax Reform Act of 1986, 100 Stat. 20185 (1986) added the sentence: “In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”

³ H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986).

⁴ Notice 88-123, 1988-2 C.B. 458.

⁵ *White Paper*, 493 (emphasis added).

⁶ *Id.* (emphasis added).

⁷ *Aff’d*, 598 F.3d 1191 (9th Cir. 2010).

their individual exploitation of the interests in the intangibles assigned to them under the arrangement.”⁸ Xilinx at trial produced evidence of R&D cost sharing arrangements among independent enterprises.⁹

The 2010 TPG defines a CCA as “a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interest each participant in those assets, services, or rights.”¹⁰ It’s clear that an R&D CSA as defined under U.S. § 482 is a particular example of a CCA, so there’s evidence that R&D CCAs have long existed among independent enterprises. This is entirely consistent with the statement in the 2010 TPG that “[p]erhaps the most frequently encountered type of CCA is an arrangement for the joint development of intangible property, . . . ,”¹¹ but is more precise in that it points to evidence of parties at arm’s length sharing development contributions at cost. The 2010 TPG are thus relevant to associated enterprises choosing to adopt such arrangements.

3. Why the *Action 8 CCAs PDD* is wrong to require assessment of CCA contributions at value

The *Action 8 CCAs PDD* proposes a different definition of a CCA, as—

a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such

⁸ Former Treas. Reg. § 1.482-7(a)(1) (emphasis added).

⁹ “Petitioners also established that . . . companies (i.e., those who enter into cost-sharing arrangements relating to intangibles) do not take into account [employee stock option costs].” 125 T.C. at 59.

¹⁰ TPG, ¶ 8.3 (emphasis added).

¹¹ TPG, ¶ 8.6.

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intangibles, tangibles assets or services are expected to create direct benefits for the businesses of each of the participants.¹²

The proposed definition of a CCA is markedly different than that in 2010 TPG, and some important consequences follow. We'll call the proposed arrangement a "***Proposed CCA***" to distinguish it from the conventional CCA in the 2010 TPG.

The *Action 8 CCAs PDD* asserts that "[t]wo types of [Proposed] CCAs are commonly encountered: those established for the joint development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets ('development CCAs'); and those for obtaining services ('services CCAs')." ¹³ The *Action 8 CCAs PDD* makes this assertion without citing evidence. We think it doubtful that Proposed CCAs are "commonly encountered," so it's unsurprising no evidence was proffered. As discussed below, the requirement in the *Action 8 CCAs PDD* to value all contributions—i.e., whether contributions of resources, capabilities, or rights acquired by a participant outside the arrangement (e.g., pre-existing intangibles), or whether contributed within the arrangement (e.g., development activities)—makes a Proposed CCA much more complex to administer than a (conventional) CCA, which (in the case of intangible development) simply shares ongoing costs of co-developing intangibles. Moreover, while intangible joint development CCAs are common, much less common we think would be CCAs formed to carry out the other D-E-M-P-E activities.¹⁴ We think Proposed CCAs would be relatively rare.

¹² *Action 8 CCAs PDD*, ¶ 3 (emphasis added).

¹³ *Id.*, ¶ 8.

¹⁴ Development, enhancement, maintenance, and protection ("***D-E-M-P***") activities were the focus of the July 2013 *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, while the *Action 8: 2014 Deliverable—Guidance on Transfer Pricing Aspects of Intangibles* added "exploitation," rounding out "***D-E-M-P-E***."

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A fundamental error of the *Action 8 CCAs PDD* is the assertion that “to be consistent with the arm’s length principle,” “contributions must be assessed based on their value (rather than their cost)”¹⁵ This presumptive assertion of what independent enterprises would do is entirely contrary to the evidence, discussed above, of arm’s length CCAs in which participants assess contributions such as R&D and marketing activities at cost, not at value. The administrative superiority of forming such an arrangement over a Proposed CCA (requiring assessment at value) is obvious; it’s unsurprising evidence of such arm’s length cost-sharing CCAs is plentiful. In any case, even if some CCAs assess development contributions based on value, some (we believe most) assess them at cost, and there’s no principled basis for asserting compliance with the ALP requires assessment at value.

The *Action 8 CCAs PDD* asserts that satisfaction of the ALP requires each participant’s proportionate share of the overall contributions to a CCA be consistent with the participant’s proportionate share of the overall expected benefits.¹⁶ Satisfaction of the ALP doesn’t, however, require blanket use of value to assess contributions. The ALP is satisfied, for example, if

¹⁵ *Action 8 CCAs PDD*, ¶ 22 (emphasis added). The *Action 8 CCAs PDD* repeatedly makes this incorrect assertion in slightly different ways—e.g., at ¶ 10 (“For . . . a [Proposed CCA] to satisfy the [ALP], the value of participants’ contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement.” (emphasis added)); ¶ 11 (“Independent enterprises would require that the value of each participant’s proportionate share of the actual overall contributions to the arrangement is consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement.” (emphasis added)); ¶ 20 (“For the purpose of determining whether a [Proposed CCA] satisfies the arm’s length principle . . . it is necessary to measure the value of each participant’s contributions to the arrangement.” (emphasis added)); and ¶ 27 (“A [Proposed CCA] will be considered consistent with the arm’s length principle where the value of each participant’s proportionate share of the overall contributions to the arrangement (taking into account any balancing payments already made) is consistent with the participant’s share of the overall expected benefits to be received under the arrangement.” (emphasis added)). We presume equivalence of a participant’s contribution (¶¶ 10 & 20) and the value of a participant’s proportionate share of the overall contributions (¶¶ 11 & 20).

¹⁶ *Id.*, ¶ 20.

participants assess contributions of pre-existing intangibles at value but contributions of the performance of R&D activities at cost, so long as each participant's proportionate share of each sort of contribution equals its proportionate share of overall expected benefits.¹⁷ A typical R&D (development) CCA involves participants sharing costs of ongoing R&D performed on pre-existing intangibles, often with subsequent injections of acquired intangibles upon which further R&D is performed. Assessing CCA contributions of intangibles at value makes sense because (1) information about the cost to develop the initial intangibles mightn't be available; and (2) acquired intangibles typically involve an outlay of value by a participant. Assessing CCA contributions of ongoing R&D activities at cost makes sense because (1) such costs are generally easier to determine than the value of the performance of the activities; and (2) a participant's overall costs (costs directly incurred and balancing payments) of participating in a CCA are typically lower than had assessment been at value.

The TPG recognizes that contributions to a CCA needn't be assessed at value. This isn't surprising, as the TPG define a CCA to be an arrangement for sharing certain costs and risks.¹⁸ The TPG asserts, for example, that in determining whether a CCA satisfies the ALP it's "necessary to measure the value or amount of each participant's contributions to the arrangement."¹⁹ The amount of a contribution could be gauged at cost. The TPG further

¹⁷ For example, a participant could bear 40 percent of the appropriate value of pre-existing intangibles contributed to a CCA, and 40 percent of the cost of ongoing R&D activities.

¹⁸ TPG, ¶ 8.3.

¹⁹ TPG, ¶ 8.13 (emphasis added).

explains that “[c]ountries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm’s length CCAs.”²⁰

The *Action 8 CCAs PDD* should accordingly be changed to remove the requirement that all contributions to a CCA be assessed at value. Such requirement is contrary to the ALP. Assessment at cost should be permitted.

B. Other concerns with the *Action 8 CCAs PDD*

1. Risk bearing by CCA participants

The *Action 8 CCAs PDD* discusses the risk bearing opportunity a CCA participant gets:

The general principles set out in Chapter I of these guidelines on the allocation of risks when delineating transactions apply to situations involving CCAs. Since a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I. In particular, this means that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA.²¹

Requiring complete consistency with the general risk allocation principles in Chapter I of the TPG isn’t appropriate for CCAs, which are in respects fundamentally different from controlled transactions.²² Considering for example an R&D (development) CCA, ignoring contributions of pre-existing intangibles, there’s no transfer of developed intangibles in a CCA among participants—rights in developed intangibles arise *ab initio* in the participants, who fund

²⁰ *Id.*, ¶ 8.15 (emphasis added).

²¹ *Action 8 CCAs PDD*, ¶ 13.

²² The TPG Glossary defines “controlled transactions” as transactions between two enterprises that are associated enterprises with respect to each other.

development. There's likewise no transfer among participants of risks associated with newly developed intangibles.

It's important to distinguish risks a CCA as a whole bears from unique risks each participant may bear. For example, an R&D CCA as a whole—thus the participants collectively—bears risk intangibles mightn't be successfully developed under the arrangement. This risk is mitigated through effective management and control of R&D activities. The costs of such management and control activities generally would be added to the pool of costs to be shared under the arrangement, but the ALP doesn't give a basis for asserting each participant must have “the capability and authority” to control such risk. Independent enterprises strike arrangements (e.g., joint ventures) in which one enterprise provides funding and another provides R&D capability: each enterprise needn't have the capability and authority to control risks associated with successful R&D—in fact this lack of common capability in each participant may be an important factor causing such enterprises to enter into such an arrangement, allowing them to pool and share aggregate functions and assets. At arm's length it's sufficient that a (i.e., at least one) participant in a CCA be capable of controlling and/or managing any risks borne by the arrangement, but clearly not necessary that each participant have such capability. It's thus contrary to the ALP to condition an entity's qualification as a CCA participant on the entity having the capability and authority to manage risks under CCA. The *Action 8 CCAs PDD* should be changed to comport with this.

For an R&D CCA, even if intangibles are successfully developed, each participant bears its own risks relating to commercialization and exploitation of developed intangibles. For example, a participant assigned rights in such intangibles in a particular geographic region risks

not being able to successfully exploit its assigned rights in that region. Such participant should have the capability and authority to manage such participant-specific risks.

2. The listed allocation keys for measuring expected benefits should be expanded

The TPG explain that shares of expected benefits under a CCA might be estimated based on anticipated additional income generated or costs saved by each participant as a result of the arrangement, and that in practice this is frequently done using “allocation keys,” including “sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth.”²³ The *Action 8 CCAs PDD* echoes this for Proposed CCAs, but inexplicably drops explicit mention of gross or operating profit as possible allocation keys (although one might argue they’re covered by the catch-all “and so forth”²⁴). This is puzzling. Because “additional income generated” is an obvious measure of benefit generated from a CCA, one would expect (in addition to sales) either gross or operating profit to be obvious candidates for allocation keys, as they’re linked to additional income generated. In a development CCA, one would expect gross or operating profit to reliably measure benefits to the extent such profits are largely attributable to exploitation of intangibles developed under the CCA, or if the portion of such profits attributable to such intangibles is anticipated to be similar for each participant. We accordingly recommend that “gross or operating profit” be explicitly included as examples of allocation keys.

3. Article 9 provides no grounds for disregarding part or all of the terms of a CCA

The *Action 8 CCAs PDD* in essence repeats language from the TPG:

²³ TPG, ¶ 8.19.

²⁴ But a negative inference of their exclusion might be intention to exclude such allocation keys.

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A tax administration may . . . disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA.²⁵

Paragraph 1.65 of the TPG describes two circumstances permitting a tax administration to disregard a controlled transaction, one of which arises if “the economic substance of a transaction differs from its form.” Application of Article 9 of the OECD Model Tax Convention (which embodies the ALP) requires local law determination of transactions (“commercial or financial relations”) among associated enterprises, and for this purpose a tax administration can use local tax law principles such as equivalents of the “economic substance” doctrine or “substance over form” doctrine common in many jurisdictions.²⁶ These doctrines, or related local law legal principles, may—depending on the facts and circumstances—justify the partial or total disregard of a CCA outlined in the cited passage. Neither Article 9 nor or the TPG, however, provide independent authority (i.e., provide no separate grounds) for a tax administration to disregard the terms of a transaction among associated enterprises.²⁷ By its terms the ALP applies—after the associated enterprise transaction has been delineated under

²⁵ *Action 8 CCAs PDD*, ¶ 32; TPG, ¶ 8.30 (the TPG uses the phrase “greater beneficial interest” rather than “greater interest”).

²⁶ This is discussed in greater detail in § II.A.3 of our *Comment Letter on BEPS Actions 8–10* (see Appendix B to this letter). In particular, the second circumstance described in ¶ 1.65 of the TPG permitting a tax administration to disregard a controlled transaction—if “arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price—is entirely without support from the ALP.

²⁷ *Id.*

local law tax principles—solely to determine (transfer) pricing of associated enterprise transactions.²⁸

Similarly, the TPG asserts that “[i]n circumstances [indicating] an attempt to abuse the rules governing CCAs, it may be appropriate for a tax administration to disregard the CCA in its entirety.”²⁹ Local country anti-abuse laws may—in egregious circumstances—justify total disregard of a CCA. The *Action 8 CCAs PDD* purports to give tax administrations even greater authority, removing any requirement that there be a taint of abuse: “In relevant circumstances it may be appropriate for a tax administration to disregard the CCA in its entirety in accordance with the principles for non-recognition of the delineated transaction set out in Chapter I.” To repeat, while local country legal principles may in some circumstances be applied to disregard all or parts of a CCA, neither Article 9 nor the TPG provide any independent ground for such action.

²⁸ *Id.*

²⁹ TPG, ¶ 8.30.

Appendix A—SVTDG members

SVTDG Member Companies

1. Adobe Systems, Inc
2. NetApp, Inc.
3. Accenture PLC
4. Acxiom Corporation
5. Advanced Micro Devices, Inc.
6. Agilent Technologies, Inc.
7. Altera Corporation
8. Amazon.com
9. Apple Inc.
10. Applied Materials, Inc.
11. Avago Technologies Ltd.
12. Aviat Networks, Inc.
13. Bio-Rad Laboratories, Inc.
14. BMC Software, Inc.
15. Broadcom Corporation
16. Brocade Communications Systems, Inc.
17. Cadence Design Systems, Inc.
18. Chegg, Inc.
19. Cisco Systems, Inc.
20. Cypress Semiconductor Corporation
21. Dolby Laboratories, Inc.
22. eBay, Inc.
23. Electronic Arts, Inc.
24. Etsy, Inc.
25. Evernote Corporation
26. Expedia, Inc.
27. Facebook, Inc.
28. FireEye, Inc.
29. Flextronics International Ltd.
30. Genentech, Inc.
31. Genesys Telecommunications Laboratories, Inc
32. Genomic Health, Inc.
33. Gilead Sciences, Inc.

Appendix A—SVTDG members

34. GLOBALFOUNDRIES, Inc.
35. Google, Inc.
36. Groupon, Inc.
37. Hewlett-Packard Company
38. Ingram Micro, Inc.
39. Intel Corporation
40. Intuit, Inc.
41. Intuitive Surgical, Inc.
42. KLA-Tencor Corporation
43. Lam Research Corporation
44. Marvell Semiconductor, Inc.
45. Maxim Integrated Products, Inc.
46. Mentor Graphics, Inc.
47. Microsoft Corporation
48. Netflix, Inc.
49. NVIDIA Corporation
50. Oracle Corporation
51. Palo Alto Networks, Inc.
52. Pandora Media, Inc.
53. Pivotal Software, Inc.
54. Plantronics, Inc.
55. Power Integrations, Inc.
56. Qualcomm, Inc.
57. Riverbed Technology, Inc.
58. Rovi Corporation
59. salesforce.com
60. SanDisk Corporation
61. SAP
62. Seagate Technology, PLC
63. ServiceNow, Inc.
64. Silicon Image, Inc.
65. Silver Spring Networks
66. SMART Modular Technologies Corp.
67. SunPower Corporation

Appendix A—SVTDG members

68. Symantec Corporation
69. Synopsys, Inc.
70. Tesla Motors, Inc.
71. The Walt Disney Company
72. Trimble Navigation Ltd.
73. Twitter, Inc.
74. Uber, Inc.
75. Visa, Inc.
76. VMware Corporation
77. Xilinx, Inc.
78. Yahoo! Inc.
79. Yelp Inc.

February 6, 2015

VIA E-MAIL

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comment letter on the OECD Public Discussion Draft *BEPS Actions 8, 9 and 10—Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*

Dear Mr. Hickman,

These comments are submitted by the undersigned independent trade associations, described in Appendix A and B, which together include over 100 companies as members, in response to the invitation to submit comments on *BEPS Actions 8, 9 and 10—Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*, issued December 1, 2014.

Respectfully submitted,

Silicon Valley Tax Directors Group (SVTDG)
www.svtdg.org

TechNet
www.technet.org

I. Introduction and summary

We thank Working Party No. 6 (“**WP-6**”) for preparing the *Public Discussion Draft—BEPS ACTIONS 8, 9 AND 10: DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES* (“**Actions 8–10 PDD**”) and for asking interested parties to give written comments. In this letter we comment on three aspects of the *Actions 8–10 PDD*: (1) the proposed changes to § I.D.2 of the TPG—in particular, the additional points and questions relating to moral hazard risks and risk-return trade-offs; (2) the proposed changes to § I.D.4 of the TPG relating to non-recognition of associated enterprise transactions; and (3) the proposed special measures in Part II of *Actions 8–10 PDD*.

A. Summary of comments on Part I of the *Actions 8–10 PDD*, proposing changes to § I.D of the TPG

1. Summary of comments on § I.D.2 of the TPG—identifying risks

The questions in the *Actions 8–10 PDD* relating to moral hazard risk and risk-return trade-off can best be answered by reviewing how the arm’s length principle (“**ALP**”) in Article 9, ¶ 1 of the MTC works in the context of risk. The ALP is concerned with pricing associated enterprise transactions consistently with prescribed behavior of independent enterprises. When evaluating a particular associated enterprise commercial relation, the ALP first requires one to hypothesize that independent enterprises enter into the same commercial relationship, performing the same activities and having comparable assets. The associated enterprises in the commercial relation will generally be exposed to extrinsic risks, but they may not be exposed to moral hazard risks to the same extent as are independent enterprises. Applying the ALP further requires hypothesizing the independent enterprises being exposed to the same extrinsic risks as are the associated enterprises, and that the independent enterprises also choose the same contract

Appendix B—prior Comment Letter on BEPS Actions 8–10 PDD

terms (assuming the contract terms are consistent with the economic substance of the associated enterprise transaction) and allocation of extrinsic risks as chosen by the associated enterprises. The specific payment terms such independent enterprises would agree upon would reflect both any extrinsic risks imputed from the associated enterprise commercial relation and also any moral hazard risks arising from the imputed contract provisions and allocations of extrinsic risk. Under the ALP, the associated enterprises must price their commercial relation the same way—i.e., the payment terms incorporate compensation for both extrinsic risks they bear and also any moral hazard risks the associated enterprises mightn't actually bear (or bear only to a much smaller degree). This pricing of associated enterprise transactions can, under the ALP, come either through observations of independent enterprise behavior (comparables) or by determining pricing through methods not relying on comparables (including, e.g., TNMM, profit splits, etc.).

In response to the questions relating to moral hazard and risk-return trade-off: (1) arm's length payments between associated enterprises will generally reflect moral hazard risks arising among independent enterprises operating under the same commercial relationships under similar contractual provisions and comparable allocations of extrinsic risk, but this doesn't mean such moral hazard risks and the corresponding contractual incentives/penalties are being imputed to the associated enterprises; (2) the observation in ¶ 67 of the *Actions 8–10 PDD* that unrelated parties may be unwilling to share insights about core competencies for fear of losing IP or market opportunities is generally not accurate—agreements and behaviors between independent enterprises allow flows of proprietary information among such enterprises while preventing misuse of such information; (3) the assertion in the example in ¶¶ 90–91 that the conditions of sale of the trademark would create moral hazards so acute that such a sale wouldn't be economically rational if the transferor (S1) and transferee (S2) were independent enterprises isn't

justified; (4) pure risk shifting transactions among associated enterprises can arise among associated enterprises and—assuming the economic substance of such transactions mirrors the form—such transactions should be respected; and (5) the trademark transfer in the example in ¶¶ 90–91 likely reduces S1’s exposure, but increases S2’s exposure, to risks of the business in which the trademark is used, but S2 may for various reasons be better-positioned to bear such risk, in which case S2 would value the trademark more highly than would S1; and (6) the risk-return trade-off principle is consistent with the choices of both S2 (which assumes the risk of the trademark’s income (royalties) in exchange for an expected return that includes a risk-premium commensurate with the risks incorporated in the trademark’s expected income stream) and S1 (which accepts a lump sum by and gives up the risk-adjusted expected return on the trademark’s future income in exchange for not bearing the risks of the trademark).

2. Summary of comments on § I.D.4 of the TPG—recharacterization

If circumstances are such that the economic substance of a transaction among associated enterprises doesn’t mirror its form then for purposes of applying the ALP to find a transfer price the transaction must be recharacterized. Authority to recharacterize transactions for tax purposes exists in the tax laws of many jurisdictions, and its reach is broader than transfer pricing, but recharacterization in such circumstances is needed for proper application of the ALP, which can only work sensibly if hypothetical independent enterprises undertake what is in economic substance the nominal transaction at issue among associated enterprises.

No other grounds for recharacterization of associated enterprise transactions are needed for proper application of the ALP, and the ALP by its terms doesn’t permit recharacterization in any other circumstances. Proper application of the ALP requires determining a transfer price assuming independent enterprises undertake the same commercial arrangement (in economic

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substance) as that among associated enterprises, imputing the same extrinsic risks and taking into account moral hazard risks that arise. The pricing determination required under the ALP can sometimes be done by resort to observable behavior among independent enterprises (comparables), or failing that, other methods (such as TNMM, profit split methods, etc.) may be used. But there’s no indication in the ALP itself that the process should collapse if either observable comparable independent enterprise behavior can’t be found, or if in that event the determination is challenging. The TPG nonetheless introduced a second ground for recharacterization, based on whether “the arrangements made in relation to the transaction, viewed in their totality, [(1)] differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and [(2)] the actual structure practically impedes the tax administration from determining an appropriate transfer price.”³⁰ The *Actions 8–10 PDD* tries to give “greater definition” to this opaque test. This “greater definition” comes in essence from asserting requirement (2) to be redundant if requirement (1) is met, then recasting requirement (1) by asking whether the associated enterprise transaction exhibits “the fundamental economic attributes” of arrangements between unrelated parties, and then finally asserting that such an arrangement “would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted . . . basis, compared to other opportunities realistically available to them at the time the arrangement was entered into.”³¹ The *Actions 8–10 PDD* thereby in effect would allow recharacterization of any associated enterprise transaction that would be unlikely to be observed among independent enterprises. This is contrary to the ALP, which requires finding a transfer price for an associated

³⁰ TPG, ¶ 1.65.

³¹ *Actions 8–10 PDD*, ¶ 89.

enterprise transaction using either observable independent enterprise behavior in a comparable transaction or, if not observable, calculating a price based on hypothesized behavior. The ALP wasn't intended to restrict the transactional behavior of associated enterprises to that observed among independent enterprises. The *Actions 8–10 PDD* incorrectly equates lack of observable independent enterprise transactions with inability to solve a hypothetical economics problem. The tack taken by the *Actions 8–10 PDD* with respect to recharacterization arguably misinterprets the ALP in Article 9, ¶ 1 to give tax administrations authority to rewrite associated enterprise transactions unlikely to be observed among independent enterprises. Because it is not grounded in the ALP, the PDD's approach to recharacterization must be rejected.

The associated enterprise trademark transfer example in the *Actions 8–10 PDD* contrived to try to show application of the “fundamental economic attributes” test has questionable economic analysis in places and has confusing facts that under trademark law best practices and the law of several jurisdictions may invalidate trademark ownership. Correcting the analysis, aligning the facts consistent with trademark law best practices (i.e., the transferee must conduct core trademark functions), and assuming the economic substance of the arrangement between transferor and transferee mirrors its form, yields different results than those in the *Actions 8–10 PDD* (although the “fundamental economic attributes” test should in any event be rejected).

B. Summary of comments on Part II of the *Actions 8–10 PDD*, proposing special measures

The special measures in Options 1 (HTVI) and the primary rule in Option 5 (taxation of excess returns) warrant further consideration and could, if suitably modified, form practicable BEPS tools for WP-6 to endorse.

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Option 1 should be modified so as to be subject to the ALP: taxpayers could thus avoid *ex post* adjustments based on actual outcomes by proffering evidence of comparable independent enterprise transactions. Making the special measure subject to the ALP mitigates risks of double taxation. Conditioning application of the special measure on lack of contemporaneous documentation encourages taxpayers to create robust contemporaneous economic analysis in support of their transfer pricing.

The primary rule in Option 5 operates like a CFC rule, in which the ultimate parent can tax “excess returns” of a CFC if it’s subject to a three-year average effective tax rate lower than some threshold. The primary rule should apply after application of the normal transfer pricing rules (and after the impact of any local country taxes, withholding taxes, and any other gross income inclusion under a CFC regime with respect to that CFC, to determine effective tax rate), and will ensure a baseline level of taxation of most income currently subject to BEPS concerns. This work should be coordinated with that on Action 3 (strengthen CFC rules). The secondary rule in Option 5 should be rejected. It clearly is not consistent with the ALP. Only the ultimate parent jurisdiction, as location of the ultimate owner of a multinational group, has primacy of right in taxing “excess returns” of a CFC. The parent jurisdiction’s deferral of its sovereign right to tax deemed income inclusions to a resident parent company of a CFC with excess returns shouldn’t create a free-for-all allocating rights to tax such excess returns to “other jurisdictions”, whatever those jurisdictions might be. In the secondary rule, it’s unlikely that the unspecified “pre-determined rule” for allocating taxing jurisdiction over an arbitrary CFC’s excess returns would ever be the subject of agreement among jurisdictions. It’s equally unclear how double (or multiple) taxation could be avoided. The secondary rule special measure in Option 5 should accordingly be rejected.

The special measures in Options 2–4 should be rejected. Each such Option is arbitrary, impracticable, and/or subjective, and would lead to protracted disputes unlikely to be resolved. There is no generally agreed upon optimal level of capitalization, making Options 2 & 3 arbitrary. Option 4—dealing with minimal functional entities—is in effect an end-run around application of normal transfer pricing rules under the ALP (including revised TPG Chapter VI).

II. Specific concerns

A. Part I of *Actions 8–10 PDD*, proposing changes to § I.D of the TPG

1. Relevance of the ALP to risk and possible recharacterization

a. The ALP can be interpreted to require transfer pricing of all associated enterprise commercial relations

Paragraph 1.6 of the TPG provides that the authoritative statement of the ALP is found in Article 9 of the OECD MTC:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. [Emphasis added]

The ALP grounds application of the TPG—including analysis of risk and the possibility of recharacterization—so it’s important to review what this sentence says about those two topics. If the difference referenced in the opening clause of the sentence exists, an allocation of profits among the associated enterprises is allowed by the second part of the sentence. In the phrase “those which would be made between independent enterprises,” “those” refers to conditions that would be made between independent enterprises. So the opening clause asks whether there’s a difference between certain conditions that exist (“are made or imposed”) between associated enterprises and hypothetical conditions (“those which would be made”) between independent

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enterprises. But the ALP is more precise. The existing conditions among associated enterprises must relate specifically to “commercial or financial relations” between such enterprises. But to what must the hypothetical conditions among independent enterprises relate? Because the conditions are hypothetical, the ALP doesn’t require evidence of actual independent enterprise behavior. The hypothetical nature of the conditions must relate to supposed (i.e., assumed) behavior of independent enterprises—i.e., for purposes of seeking any difference in conditions in the first clause of the ALP—the independent enterprises must be supposed or assumed to be doing something to which the (hypothetical) conditions relate. A difference in conditions would generally be meaningless if the commercial relation between associated enterprises involved, say, an intangible transfer but that between independent enterprises involved the provision of services. Comparing conditions is only meaningful if the hypothetical independent enterprises are assumed to be engaging in the same commercial relation as that between the associated enterprises. That is, the comparison in the first clause of the ALP is only meaningful if the clause is interpreted as “[where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises engaging in the same commercial or financial relations.”

Various arguments might be raised against this interpretation, but they don’t withstand scrutiny under the ALP. One argument is that the emphasized phrase isn’t there and it shouldn’t be inferred. As pointed out above, however, inferring such a requirement allows an apples-to-apples comparison: assume hypothetical independent enterprises engage in the same commercial relation as that existing between associated enterprises, and only then compare the conditions made or imposed between the two sets of parties.

Another argument might be that one isn't—under the ALP—free to assume the hypothetical independent enterprises engage in the same commercial relations as that among associated enterprises. Rather, it might be argued, under the ALP one is restricted to commercial relations independent enterprises would engage in, in the sense that if as a matter of economics independent enterprises wouldn't normally engage in a commercial relation then one can't assume for purposes of the ALP comparison that they do engage in it. But the ALP by its plain terms seeks to compare actual conditions (between associated enterprises) with hypothetical conditions (between independent enterprises), and the hypothetical conditions (“those which would be made”) must relate to a hypothetical commercial relation—that which would be made between independent enterprises. Interpreting the ALP to prevent the hypothetical commercial relation among independent enterprises from being one not normally engaged in among independent enterprises would violate a canon of statutory construction: it would make the ALP inoperative in situations in which associated enterprises undertake transactions not normally engaged in, or not observable, among independent enterprises.³² This interpretation should accordingly be rejected. The more natural reading of the ALP—that the comparison of conditions in the ALP should be done assuming independent enterprises engage in the same commercial relation as that of associated enterprises—allows the ALP to function in all circumstances: (1) assume independent enterprises engage in the same commercial relation as that existing between associated enterprises; (2) find the conditions that would be made or imposed between such independent enterprises; (3) compare those conditions with those actually made or imposed between the associated enterprises; and (4) determine the “delta” in profits that

³² Critics of our interpretation might argue that this breakdown of application of ALP is precisely what permits recharacterization, but there's nothing in Article 9 (or the Commentary for that matter) suggesting such inapplicability of the ALP with consequent allowance of recharacterization.

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can be included in the income of the relevant associated enterprise and taxed accordingly. The purpose of the ALP must surely be not to force commercial relations among associated enterprises to mirror those among independent enterprises, but rather to suitably price associated enterprise relations.

A variant of the last argument is that by assuming in the ALP that hypothetical independent enterprises engage in the actual commercial relation undertaken by associated enterprises, it may not be possible as a matter of economics to determine (to solve for) the appropriate transfer price. This argument also can be refuted. It may be possible to find associated-enterprise transactions not normally observable among independent enterprises. But this doesn't mean that hypothetical independent enterprises assumed to have entered into such a transaction wouldn't arrive at a constellation of contract provisions, risk sharing, and pricing terms that optimizes their respective economic positions. This is discussed further below.

To summarize, finding the difference sought in the first clause of the ALP doesn't require one find evidence of independent enterprises in the same commercial or financial relation as that existing between associated enterprises. The use of “which would be made” means the conditions must be hypothetical, and the difference is only meaningful if one assumes the hypothetical independent enterprises engage in the same “commercial or financial relation[]” as that actually consummated by the associated enterprises. The ALP should operate to price associated enterprise transactions, not restrict—upon penalty of recharacterization—the set of transactions among such enterprises to those that independent enterprises would, under various assumptions, normally only engage in.

b. Associated enterprise commercial relations and risk

An important element of the conditions associated with a commercial or financial relation between associated enterprises is the set of risks borne by each enterprise under this relationship. As the *Actions 8–10 PDD* notes, these risks can arise from a variety of factors external or internal to these enterprises, such as the economic environment in relevant markets, the degree of competition they face in relevant markets, the reliability of the supply chain for raw materials, or uncertainties in employee capabilities.³³ These risks may be described as “extrinsic” to the associated enterprises in that they are substantially outside the control of these enterprises while being material to the outcome of their commercial relations. To find a transfer price under the ALP, a commercial or financial relation between independent enterprises must be imbued with the same extrinsic risks as the relations between associated enterprises to serve as a benchmark for arm’s length terms in the latter.

When independent enterprises are placed in a relationship with the same extrinsic risks as an associated enterprise relationship, however, additional risks could arise that may not occur between associated enterprises. These risks arise when an independent enterprise is unable fully to observe or regulate the conduct of the other independent enterprise within the relationship, and terms of the relationship incentivize one such enterprise to take actions that may not be in the best interests of the other. For example, if a firm engages an independent contract manufacturer to make its products and stipulates payment terms independent of the quality of the products, the manufacturer might have an incentive to reduce its quality control efforts to save costs. These risks arising from imperfect observability and control can be termed “moral hazard” risks.

³³ *Action 8–10 PDD*, § D.2.1. ¶ 42.

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Although it's possible for moral hazard to arise among associated enterprises, the likelihood and the scale of moral hazard is typically greater between independent enterprises.

Independent enterprises can adopt a variety of measures to curb moral hazard risks in their commercial or financial relations. First, moral hazard risk can be mitigated through provisions of a contract governing the relation. For example, the terms of their contract can allow one enterprise to monitor the actions of the other to the extent feasible (for example, through rights of periodic inspection) or to penalize misbehavior by the other if such misbehavior can be observed after the event. To the extent moral hazard cannot be eliminated through enforceable contract terms, it can be mitigated through the provision of incentives within the contract. For example, under certain conditions, the contract may, to align incentives of both enterprises to deal with extrinsic risks, stipulate a compensation structure that exposes both enterprises to extrinsic risks. Such risk-sharing contracts, however, may be inefficient in other settings where one enterprise is highly risk-averse or has limited capacity to manage risks to which it's being exposed. Finally, given the contractual provisions and the structure of extrinsic risk-sharing agreed upon by the parties, the specific payment terms chosen by independent enterprises will reflect any moral hazard that remain within their commercial or financial relations. Thus, if the nature of the moral hazard is that one enterprise may provide a sub-optimal level of effort in its stipulated tasks, the value of the payments the other enterprise will agree to make will likely be lower to reflect the anticipated value-loss arising from this moral hazard.

Given the different ways independent enterprises can deal with moral hazard, the conditions chosen by such enterprises for a particular commercial or financial relation may lie anywhere on a spectrum of possible outcomes, characterized by different combinations of

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contractual restrictions, incentive structures, and payment levels. Depending on the nature of the activity involved in this relationship, the degree of observability in the actions of the enterprise, or their degrees of risk aversion, we may find some enterprises choosing to impose significant contractual restrictions on behavior and limited risk-sharing, with a corresponding level of stipulated payments. Others might choose limited contractual restrictions on behavior but significant risk-sharing, with a different level of stipulated payments. Yet others might agree to few contractual restrictions or risk-sharing but with significant adjustments to the resulting stipulated payments.

Under these circumstances, with arm's length conditions for a particular commercial or financial relationship potentially falling anywhere within a set of possible combinations of conditions, how should the ALP be applied? In pursuing the ultimate objective of the ALP—the determination of the arm's length transfer price—one must ensure the conditions of commercial or financial relations between associated enterprises match those that would be observed among independent enterprises engaging in the same relations. The ALP thus requires the following analysis. When evaluating a certain relationship between associated enterprises, hypothesize that independent enterprises enter into the same relationship, entailing the same activities, undertaken with comparable assets, and exposed to the same extrinsic risks. Further, hypothesize that these independent enterprises also choose the same contractual terms and the same allocation of extrinsic risks that the associated enterprises have chosen. Now ask: what specific payment terms would the independent enterprises agree upon under these circumstances? Applying these payment terms to the transaction between associated enterprises will ensure their relationship is consistent with the ALP.

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As an illustration of how the ALP applies to determine a transfer price, consider an enterprise that licenses certain intangible property to an associated enterprise for commercial exploitation in certain markets. The two associated enterprises agree upon certain contractual restrictions on the licensee's use of this intangible property and agree further to share extrinsic risks by stipulating that royalty payments will be contingent on the actual revenues generated by products incorporating the licensed intangibles. To determine the arm's length royalty rate, we would examine any evidence of independent enterprises licensing comparable intangibles, with comparable commercial potential, facing comparable extrinsic risks, operating under comparable contractual restrictions, and structuring license payments as royalties contingent on sales. The royalty rates in such independent enterprise licensing agreements would serve as the arm's length royalty rates for the associated enterprise transaction. If, by contrast, the intangible property owner licensed the intangible with a stipulated lump-sum payment from the licensee to the licensor, so that the risks of extrinsic outcomes are borne entirely by the licensee, we would have to look for evidence on how independent enterprises would set a lump-sum payment when entering into a comparable commercial relationship now marked by focusing extrinsic risks on the licensee. If no such evidence was observable, other transfer pricing methods can yield an arm's length lump-sum price.

As discussed above, the payment terms observed among independent enterprises will reflect any moral hazards that arise in their commercial or financial relations, given the contractual provisions in these relations and the allocations of extrinsic risk undertaken. Therefore, the ALP requires that the payment terms between associated enterprises should reflect not only extrinsic risks but also the moral hazard that would arise between independent enterprises if they were to engage in the same relations on similar terms. The ALP thus requires

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associated enterprises to select payment terms that embed a compensation for moral hazard risks they may not actually bear, or bear only to a much smaller degree. The ALP thus properly interpreted has the advantage of allowing associated enterprises to draw on the significant body of market evidence on payment terms between independent enterprises to establish intercompany payments, without requiring adjustments for the absence of moral hazard risks.

The ALP, as articulated above, is consistent with transfer pricing methods that have had a well-established history both in the TPG and in U.S. transfer pricing regulations. The Comparable Uncontrolled Transaction (“*CUT*”) method identifies arm’s length payment terms with respect to payments between independent enterprises engaged in comparable commercial relations under comparable contractual terms and allocations of risk. To the extent moral hazard exists in comparable relations between independent enterprises, this moral hazard is already embedded in the payment terms of CUTs. Similarly, the profit margins of enterprises performing economic activities through market-mediated transactions with unrelated firms reflects the effect of moral hazard in these transactions, at least to the extent they’re sufficiently material to affect the pricing of these transactions. Transactional net margin methods—which determine intercompany prices in relation to the profit margins of independent enterprises performing comparable activities—thus also reflect moral hazard risks prevalent in the market-mediated transactions of such enterprises.

In certain situations, the commercial or financial relations between associated enterprises are not directly comparable to relations observed between independent enterprises. As the OECD Guidelines repeatedly recognize, however, the absence of a directly comparable transaction between independent enterprises doesn’t mean a transaction between associated

enterprises isn't arm's length.³⁴ One can use methods described in the TPG and U.S. Treasury Regulations for determining payment terms independent enterprises would negotiate under the conditions applying to the transaction between associated enterprises. The requisite economic analysis might consist of determining an appropriate adjustment to the terms of market transactions that are substantially similar to the associated enterprise transaction except for particular contractual terms or extrinsic risk allocations. Alternatively, where appropriate, this analysis might entail a fundamental analysis of how independent enterprises might split the aggregate profits from the subject transactions within a profit split method. Considerations of moral hazard risks may require economists to analyze the effects of information and incentives in finer detail within their models but this doesn't impugn applicability of such non-transactional methods in determining arm's length payment terms.

2. Proposed changes to § D.2 of the TPG—moral hazard and risk-return trade-off

The *Actions 8–10 PDD* invites comments on several issues relating to moral hazard, the risk-return trade-off and their implications for the ALP.

Question 1. Under the arm's length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?

The ALP requires payment terms between associated enterprises to be determined with reference to payment terms that would be observed among independent enterprises engaged in the same commercial or financial relation under comparable contractual provisions and comparable allocations of extrinsic risk. As discussed in § II.A.1.b above, payment terms

³⁴ TPG, ¶ 1.11.

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negotiated between independent enterprises under such conditions will reflect any moral hazard risk remaining between these enterprises under these conditions. Arm's length payments between associated enterprises will thus generally reflect moral hazard risks arising among independent enterprises operating under the same commercial relationships under similar contractual provisions and comparable allocations of extrinsic risk.

The fact that arm's length payment terms reflect the moral hazard operating between independent enterprises doesn't mean that moral hazard risks and the corresponding contractual incentives between such enterprises are being imputed to associated enterprises. As discussed above, the existence of common control between associated enterprises may reduce moral hazard between such enterprises. To impute all independent enterprise moral hazard risks to such associated enterprises would be to imbue the associated enterprises with risks they may not actually face. Arm's length payments reflect moral hazards faced by independent enterprises because: (a) market prices, the best source of information on the pricing of economic transactions between independent enterprises, reflect moral hazards faced by such enterprises in their dealings with each other; (b) there's little market-based evidence to adjust these prices for the absence of moral hazard, precisely because moral hazard typically arises in market-mediated transactions; and (c) the use of such market prices has the virtue of being consistent with long-established and widely adopted methods of transfer pricing analyses, which are based on direct evidence or economic modeling of the terms on which independent enterprises would transact.

Question 2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

The observation is correct only in the limited sense that such lack-of-sharing behavior “may” be observed, but it’s incorrect as a general matter. In many technology-intensive industries, such as semiconductors, networking or computer hardware, technologies that have to be integrated within a final product used by consumers are developed by independent enterprises. These enterprises have developed effective contractual mechanisms to share vital information about their proprietary technologies with other firms in the value chain to facilitate a mutually advantageous cohesion in their technology development efforts.³⁵

The prevalence of such agreements within the information economy indicates that it’s possible to design a set of contractual provisions that enable proprietary information to be transmitted through market-mediated relationships to facilitate certain transactions while preventing its leakage into unintended uses. If a transaction among associated enterprises would involve the transmission of valuable intellectual property or core competencies from one enterprise to another, the arm’s length conditions for this transaction can thus be determined as follows: (i) first, hypothesize a transaction between independent enterprises involving the same functions and requiring the same flow of proprietary information from one such enterprise to the other; (ii) identify contractual provisions that would effectively constrain each such enterprise from using the other’s proprietary information in unintended ways; (iii) conduct an economic

³⁵ Many examples can be offered for such mutually advantageous flows of information. One such example arises in the world of enterprise software, where the developers of operating systems for enterprise computing systems share proprietary information about their software code with independent developers of tools that enhance the productivity of these operating systems for consumers. A variety of contractual, relational, and compensation mechanisms have emerged to curb moral hazard and information risks among independent enterprises, thereby helping companies develop and exploit knowledge-based assets within such relationships.

analysis to identify the additional costs and risks (if any) borne by each such independent enterprise as a result of the constraints to which it's subjected under these contractual provisions, offset by the anticipated economic benefits they stand to realize by complying with these provisions; and (iv) in light of these economic benefits, costs, and risks, determine the payments to be made by the independent enterprises to each other under the transaction. Such an analysis may be economically complex, but it's not qualitatively different from the analyses required to quantify other complex sources of economic benefits, costs, and risks.

Question 3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm's length principle?

In this example,³⁶ the *Actions 8–10 PDD* asserts that a potential moral hazard could arise because Company S2, which will own the trademark after the sale transaction, doesn't perform the extensive marketing functions needed to maintain and enhance the trademark. These functions will continue to be performed by the seller of the trademark, Company S1, under the monitoring and supervision of S2. However, S1 will now be performing these marketing functions for the benefit of a trademark it doesn't own or fully control. Under these conditions, ¶¶ 90–91 asserts that the proposed sale of the trademark would create moral hazards so acute as to render the sale economically infeasible if S1 and S2 were independent enterprises.³⁷

This conclusion is unjustified by the facts in ¶¶ 90–91. We're told that as part of the agreement under which S1's trademark is sold to S2, S1 gets a license from S2 to use the trademark in exchange for an annual royalty payment. The example is silent on whether this

³⁶ We raise other concerns with this example below, in § II.A.3, below, where we discuss how the *Actions 8–10 PDD* addresses recharacterization under the ALP.

³⁷ This assertion relates to the “fundamental economic attributes” test the *Actions 8–10 PDD* fashions to permit recharacterization of associated enterprise transactions. We address this test in § II.A.3, below.

license is exclusive in S1’s territory. If the license is exclusive, it’s readily seen that S1 will have a strong incentive to maintain and enhance the trademark as effectively as possible, because S1 will get any incremental revenues that arise from the enhanced value of the trademark. Provided the royalty rate for the license is set efficiently to leave some benefit of these incremental revenues with S1, S1’s incentives to maximize the value of the trademark will be strong. Knowing this, S2 will be prepared to purchase the trademark from S1 for a lump-sum that reflects the present value of the anticipated future royalty stream from licensing the trademark back to S1. This lump-sum amount also should fully compensate S1 for the anticipated income foregone by selling the trademark.

Paragraph 91 expresses the concern that “Company S2 has no practical safeguards and is dependent on S1 to act appropriately . . . and S2 itself does not direct the way in which it can optimize returns on its asset.” But this concern is moot in light of the strong alignment of incentives between S1 and S2 regarding the value of the trademark. Equally moot is the concern that “Company S1 is theoretically subject to the constraints of the terms agreed with S2 on ongoing activity related to the maintenance and enhancement of the trademark.” Given their shared interest in maximizing the value of the trademark, S1 isn’t constrained by contract terms that require it to conduct marketing activities for the trademark because S1 has a direct economic incentive to do so even in the absence of such terms.

There remains the question of how S1 “enhances or protects its commercial or financial position” through such a transaction. Even if the lump-sum compensates S1 for the income foregone by selling the trademark, why should S1 not just hold on to the trademark and realize this stream of anticipated trademark income in the future rather than converting this income into a lump-sum amount up-front through the sale of the trademark? Again, ¶¶ 90–91 are silent on

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the facts necessary to evaluate this question, but one can envisage circumstances under which the sale of the trademark would be beneficial to S1 and S2. If S1 is specialized in the business associated with the trademark, its risks are concentrated in this business. Considered as an independent enterprise, S1 may have an interest in diversifying its business risks. Selling the trademark for a lump-sum and then investing this lump-sum in an uncorrelated activity or financial instrument allows S1 to achieve this diversification. Depending on its circumstances, S2 may be in a better position to bear the risks associated with the trademark than S1. This could happen if S2 holds other intangible property rights that aren't highly correlated with the trademark (e.g., if S2 owns a broad portfolio of intangible property rights). If S2 can bear the risks of the trademark better than S1 can, the trademark would be more valuable in S2's hands than S1's. If so, this would be an added rationale for the transaction.

As an alternative to incentives, S2 may consider contractual provisions as the solution to S1's potential moral hazard. Paragraph 90 notes that S2 has several employees with capability to “assess, monitor and direct the use of the trademark by S1.” These capabilities may ensure that S2 can assess the marketing activities needed to enhance the value of the trademark, direct the efforts of S1 in performing these activities and monitor whether S1 is performing the specified tasks. These capabilities are sufficient to support contract provisions stipulating actions S1 should take, identify any failures by S1 to perform these tasks, and impose penalties in this eventuality. Thus, as an alternative to incentives, contract provisions can also serve to effectively bind S1 into acting in the interests of the trademark.

We've so far assumed that after the sale of the trademark, S2 will license the trademark back to S1 on an exclusive basis. This assumption isn't necessary for the overall transaction between S1 and S2 to be viable. If S2 licenses the trademark back to S1 only on a non-exclusive

basis, S1 will have to consider the possibility that its marketing efforts aimed at maintaining and enhancing the trademark will benefit not only its own future sales but also sales of potential rival manufacturers who may license the same trademark. S2 can still maintain S1's incentive to provide such marketing efforts for the trademark by making S1's compensation for these efforts contingent in some form on aggregate sales of all products sold under the trademark (not just S1's sales). Now, after S1 initially sells the trademark to S2 for a lump-sum amount, S1 will still have an incentive to enhance the overall value of the trademark through its marketing efforts because it retains a financial interest in this overall value through its compensation for these marketing efforts.

As a non-exclusive licensee and producer of goods sold under the trademark, S1 may lose some market share after the transaction if S2 licenses the trademark to other enterprises. However, S1 can recover the value of these lost profits up-front through the lump-sum price it charges S2 for the trademark. If this price is properly calibrated, S2 should be in a position to pay this price because it gets the incremental profits earned by the trademark from licenses to enterprises other than S1. Of course, careful economic analysis will be necessary to establish the economically efficient set of lump-sum values and royalty rates.

Question 4. Under the arm's length principle, should transactions between associated enterprises be recognized where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognized, how should they be treated?

Independent enterprises transacting at arm's length often enter into transactions whose sole economic effect is to shift risk. A classic example is the purchase of insurance. When a firm enters into a contract with an insurance provider to insure against the risk of an adverse business outcome (for example, the firm buys business casualty insurance), the firm is shifting

the risk of this outcome to the insurance provider. In exchange, the firm pays the insurance provider a series of stipulated payments (or insurance premiums) to bear this risk.

Between associated enterprises, an example of pure risk-shifting arises when a parent company implicitly or explicitly guarantees the debt of its subsidiary. Without such a guarantee, the subsidiary would have to pay its creditors an interest rate that included not only a benchmark borrowing rate such as the prime rate but also a spread above this rate for the default risk associated with its borrowing. If the parent company is regarded as more credit-worthy than the subsidiary, the parent's guarantee will ensure the subsidiary will have to pay its creditors only the lower interest rate associated with the parent company. At arm's length, the subsidiary will have to compensate the parent for providing this guarantee. Drawing on well-established models for pricing credit risk, it's possible to determine the lump-sum payments or the stream of annual premiums that would give the parent company an actuarially fair return on its anticipated payment obligations under the guarantee.

So pure risk-shifting transactions occur regularly between independent enterprises, and they can also arise between associated enterprises. They should therefore be recognized as valid transactions³⁸ and priced according to well-established analytical models for the pricing of risk.

Question 5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm's length principle?

As discussed above in response to Question 3, the sale of the trademark by S1 to S2 will likely reduce S1's exposure to the aggregate risks of the business in which this trademark is

³⁸ This assumes that the economic substance of such transactions is consistent with their form (see discussion below in § II.A.3.a.i).

used. In exchange for the risky stream of incremental income associated with this trademark, S1 gets a fixed lump-sum amount, which can be invested in other income-generating assets whose risks are different from those of the trademark's line of business.

By contrast, the same transaction increases S2's exposure to the risks of the trademark's line of business. However, the lump-sum paid by S2 to S1 would fairly compensate S2 for holding this risk. Specifically, under economic principles for the pricing of risky cash flows, the trademark should be valued by first identifying the risk-adjusted return S2 should expect to get for being exposed to the trademark's overall risks. The lump-sum value of the trademark should be the present value of the incremental expected future income from the trademark, discounted at this risk-adjusted rate of return. At this value, S2 will earn the risk-adjusted expected return on the amount spent to buy the trademark.

If S2 is better positioned to bear the risks of the trademark than S1 (for example, because S2 has alternative assets or investments, that provide better diversification for the trademark's income stream, than has S1, which is specialized in the business associated with the trademark), the risk-adjusted expected return S2 requires to hold the trademark is lower than the corresponding expected return S1 requires. Therefore, S2 would value the trademark more highly than S1.³⁹ If so, both enterprises can stand to gain from the transfer of the trademark from S1 to S2.

³⁹ The discount rate used by S2 to determine the present value of the trademark's expected income would be lower than that used by S1. Therefore, the present value of the trademark's expected income will be higher for S2 than for S1.

Question 6. In the example at paragraphs 90 and 91, how should the risk-return tradeoff implications be taken into account under the arm's length principle?

The answers to the previous questions also indicate the answer to this question. As the *Actions 8–10 PDD* notes, the risk-return tradeoff principle supports the notion that it's economically rational to take on (or lay off) risk in return for higher (or lower) anticipated nominal income.⁴⁰ The example in ¶¶ 90–91 illustrates the application of this principle both for S1 and S2. First, S2 takes on risks associated with the income from using the trademark. S2 gets royalty payments by licensing the trademark to S1, but S2 also has to pay S1 a lump-sum amount to buy the trademark from S1. These two streams of payments are connected; the lump-sum value paid by S2 to S1 should equal the present value of S2's anticipated income from licensing the trademark, computed at a discount rate that reflects the risks associated with the trademark's royalty stream. The higher this risk-adjusted discount rate, the lower is the value S2 should pay as a lump-sum in exchange for the royalties anticipated from S1. The net effect of the sale and subsequent license is that by paying up-front the discounted value of the anticipated future income stream from the trademark license, S2 is in the position to realize an expected return equal to the risk-adjusted discount rate from purchasing the trademark. Thus, in summary, S2 takes on the higher risk of the trademark's income in exchange for an expected return that includes a risk-premium commensurate with the risks incorporated in the trademark's expected income stream.⁴¹

⁴⁰ *Actions 8–10 PDD*, p. 14.

⁴¹ If S2 gives S1 not an exclusive but rather a non-exclusive license to the trademark, and licenses the trademark to other firms, as discussed above S2's risk profile changes but the overall conclusion remains the same.

As the counter-party to both legs of this transaction, S1 is in the reverse of S2's position. Specifically, S1—by getting the lump-sum but giving up the future income stream—is giving up the risk-adjusted expected return on the trademark's future income in exchange for not bearing the risks of the trademark. Therefore, the choices of both S1 and S2 are consistent with *Actions 8–10 PDD*'s risk-return trade-off principle.

Question 7. Under the arm's length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

- a) **Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?**
- b) **Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm's length principle, or falling outside the arm's length principle?**

Yes, the risk-return trade-off does, under the ALP, apply in general to transactions involving as part of their aspect the shifting of risk (see the answer to question 6). Question 7a) is unclear, but seems directed at putative “opportunistic” behavior of taxpayers. The discussion in this letter regarding risk-return trade-off presumes proper application of the ALP, accurate assessment of risks, and justifiable use of corresponding discount rates. Question 7b) is excessively open-ended. We believe BEPS concerns are adequately addressed within the ALP (including perhaps a special measure allowing, in narrow circumstances and subject to the ALP, *ex post* adjustments to be made to associated enterprise transfer prices) and perhaps by the implementation of adequately-tailored CFC regimes. The response to question 5 shows, consistent with the risk-return trade-off principle, that associated enterprise transactions can—depending in part on the risk profiles—enhance the economic positions of both enterprises and may be observable among independent enterprises. The function of the ALP, however, is to

price associated enterprise transactions based on hypothetical behavior of independent enterprises.

3. Proposed changes to § D.4 of the TPG—non-recognition

a. General comments

- i. The ALP doesn't justify recharacterization of an associated enterprise transaction unless the economic substance of such transaction doesn't mirror its form*

Section D.4 of the TPG involves fundamental attributes of associated enterprise transactions, and it's critical to keep in mind some basic tax principles.

The first concerns “economic substance.” The tax laws of many countries have—either in common law or in statute—a version of the economic substance doctrine allowing a tax authority to disregard the form of a transaction as structured by a taxpayer and recharacterize it (i.e., treat it for tax purposes) according to its perceived “economic substance.” This is most often, but not exclusively, applied to transactions involving associated enterprises. A tax authority may, for example, assert that a transaction structured by associated enterprises as a sale is in economic substance a structured financing arrangement, and tax it accordingly.

The ability to disregard the form of an associated-party transaction and recharacterize it according to its economic substance must be a fundamental part of the ALP. Obviously one must, when applying the ALP, know the substance of the “commercial relations” between associated enterprises because under the ALP this commercial relation is imputed to the independent enterprises so an arm's length transfer price can be found. If a transaction among associated enterprises lacking economic substance is imputed to independent enterprises, the wrong transfer price will result. This application of economic substance principles looks to what

in substance the associated enterprises are doing, and ignores considerations of whether independent enterprises would do this. If the form of an associated enterprise transaction has economic substance—if, for example, a transaction whose form is a license is in economic substance also a license—the transaction should be respected for transfer pricing purposes.⁴²

A similar use of economic substance characterization of a transaction comes when one performs a comparability analysis. Obviously one must, for comparability of contracts with independent enterprise transactions, use what is in economic substance the associated enterprise transaction.⁴³

Consistent with this discussion of recharacterization that must be allowed under the ALP, ¶ 1.65 of the TPG allows a tax administration—if the economic substance of a transaction differs from its form—to “disregard the parties’ characterisation of the transaction and re-characterise it in accordance with its substance.”

The TPG assert in ¶ 1.65 that for transfer pricing purposes, being able to recharacterize a transaction consistent with its economic substance isn’t enough—tax administrations need a further recharacterization tool. To justify this additional recharacterization authority, the TPG discusses an example of—

a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research

⁴² See, e.g., U.S. Treasury Regulation § 1.482-1(f)(2)(ii)(A) “The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance.”

⁴³ See, e.g., U.S. Treasury Regulation § 1.482-1(d)(3)(ii)(B)(i) “The contractual terms, including the consequential allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions.”

for the term of the contract (as indicated in paragraph 1.11). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.⁴⁴

The example posits enterprise X selling to associated enterprise Y for a lump sum payment “unlimited entitlement to the intellectual property rights arising as a result of future research.”

The example doesn’t say so, but presumably the research is done on some underlying set of intangible property;⁴⁵ the example also doesn’t say which enterprise owns the underlying intangibles, but from the conclusion we can suppose it’s Y. That is, what’s happening in the example is X nominally selling Y, for a lump sum “unlimited entitlement to the intellectual property rights arising as a result of future research” done on intangible property owned by Y. But if X doesn’t own the underlying intangible property it has nothing to sell Y—X is merely providing services to Y: this is the economic substance of the arrangement. Tax case law is used to addressing these situations by gleaning the substance of a transaction.⁴⁶ No new recharacterization tool is needed, merely proper application of the existing economic-substance-over-form recharacterization tool.⁴⁷ Thus the proffered example justifying the need for another recharacterization tool doesn’t support the need for it.

⁴⁴ TPG, ¶ 1.65.

⁴⁵ Reference to “continuing research” supports this presumption, but the presumption isn’t necessary—the same conclusion obtains if X purports to “sell” Y any fruits of future “blue sky” research not based on existing intangibles.

⁴⁶ See, e.g., *Boulez v. Commissioner*, 83 T.C. 584 (1984).

⁴⁷ If in fact the example intended X to own the underlying intangibles then X could sell “unlimited entitlement to the intellectual property rights arising as a result of future research” done on the underlying intangibles X owned, and if so X wouldn’t be performing R&D services for Y.

As explained above, the ALP by its terms doesn't require or condone recharacterization of a transaction assuming the economic substance of the transaction mirrors the form. With this assumption, the ALP posits that independent enterprises engage in the same commercial relation (transaction and extrinsic risks) as that between associated enterprises, and then determines the appropriate transfer price based both on the imputed extrinsic risks and any moral hazard risks arising. There's a distinction between recharacterizing or disregarding a transaction between associated enterprises and recharacterizing or disregarding a particular term or terms of such a transaction—in particular, pricing terms. In the case of transactions involving hard-to-value intangibles one might argue that in some circumstances a form of *ex post* pricing is warranted. To emphasize, this would respect the overall transaction but simply recast the amount and form of the pricing to be based on actual outcomes. This is precisely the approach of special measure Option 1 in the *Actions 8–10 PDD*, dealing with hard-to-value intangibles (discussed below). Taxpayers should not be subject to this modification to the pricing terms of their associated enterprise arrangements if they can demonstrate conformity with the ALP—i.e., the authority to make *ex post* adjustments to the amount and form of pricing terms in the case of hard-to-value intangibles should always be subject to the ALP.

ii. The “fundamental economic attributes” test for recharacterization in the Actions 8–10 PDD rests on flawed reasoning

As just explained, the ALP strictly doesn't condone disregard or recharacterization of a structure adopted by associated enterprises in entering into a controlled transaction unless the economic substance of the transaction differs from its form. The example in ¶ 1.65 of the TPG allegedly justifying an alternative tool for recharacterizing associated enterprise transactions can be readily dealt with using economic-substance principles, and doesn't justify a second ground

for recharacterizing associated enterprise transactions. The second recharacterization tool is set out as follows:

The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.⁴⁸

This ground for recharacterization is difficult to understand, but in any event it's not justified under the ALP, nor is it needed to apply the ALP to get an arm's length price. The *Actions 8–10 PDD*, however, to give “greater definition”⁴⁹ to this alternate test for recharacterization, recasts the alternate test and ends up with a “fundamental economic attributes” test for disregarding associated enterprise transactions.

The plain meaning of this alternate test is that two requirements must each be met for recharacterization to be permitted: (i) commercial arrangements made in relation to an associated enterprise transaction “differ from those which would have been adopted by independent enterprises behaving in a commercially rationale manner;” and (ii) “the actual structure practically impedes the tax administration from determining an appropriate transfer price.” The *Actions 8–10 PDD* calls this the “two legs” test. The plain meaning of this test is that if either requirement (i) or (ii) isn't met, recharacterization isn't permitted. But the *Actions 8–10 PDD* states that the “two legs can lead to the assertion that if you can find a price, the arrangement is not commercially irrational.” This assertion would be unfounded—the legs are independent, so

⁴⁸ TPG, ¶ 1.65.

⁴⁹ *Actions 8–10 PDD*, ¶ 88.

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failing requirement (ii) generally says nothing about whether requirement (i) is met or fails. The assertion doesn't comport with a plain reading of the two legs test.

But the *Actions 8–10 PDD* makes this assertion apparently to cast doubt on the two legs interpretation, which it contrasts with “interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality.” With this, the *Actions 8–10 PDD* recasts the two legs test—which nominally says a tax administration can recharacterize if both requirements (i) and (ii) are met—into something different: it asserts that if requirement (i) is met (i.e., commercial irrationality) then requirement (ii) will be met (i.e., impedance of appropriate transfer price). Thus according to the *Actions 8–10 PDD*, requirement (ii) is redundant: “commercially irrational” arrangements—whatever that might mean—would automatically impede appropriate transfer pricing. The focus then, according to the *Actions 8–10 PDD*—shifts from determining an appropriate transfer price (which is the base function of the ALP) to commercial rationality (which is arguably indeterminate).

The *Actions 8–10 PDD* asks “whether it is appropriate in the first place to try to find a price for something which lacks the fundamental economic attributes of arrangements between unrelated parties.” With this, the *Actions 8–10 PDD* has replaced requirements (i) & (ii) of the two leg test for recharacterization (which isn't in the first place justified under the ALP) with just requirement (i) (because, the *Actions 8–10 PDD* asserts, requirement (ii) is automatically met if requirement (i) is), and then replaced requirement (i) by a “fundamental economic attributes” requirement.

As a final step, the *Actions 8–10 PDD* explains the “fundamental economic attributes” requirement—

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An arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis, compared to other opportunities realistically available to them at the time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them, then the transaction would not be recognised for transfer pricing purposes.⁵⁰

The *Actions 8–10 PDD* in essence asserts that if a transaction didn't offer two independent enterprises “a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted . . . basis, compared to other opportunities realistically available to them at the time the arrangement was entered into,” the transaction likely wouldn't be observed among independent enterprises. What the “fundamental economic attributes” test thus does is allow a tax authority to recharacterize any associated enterprise transaction that likely wouldn't be observed at arm's length.

What the *Actions 8–10 PDD* has done in ¶¶ 88–89 is take a test for recharacterization of associated enterprise transactions that isn't justified under the ALP, and in any case is hard to understand,⁵¹ and—purporting to give “greater definition” to the test—replaced it with the “fundamental economic attributes” test, which in essence would allow recharacterization of any associated enterprise transaction that isn't observed among independent enterprises. This isn't justified. The original two step test for recharacterization arguably had no basis in the ALP. Particular associated enterprise transactions may not always be observable among independent enterprises because of moral hazard risks that might arise among independent enterprises, but

⁵⁰ *Actions 8–10 PDD*, ¶ 89 (emphasis added).

⁵¹ “That [commercial rationality] test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done.” *Actions 8–10 PDD*.

this doesn't mean that (a) such associated enterprise transaction doesn't make sense economically intra-group; (b) a transfer price can't be found (see the discussion above); or (c) the associated enterprise transaction must be recharacterized. The ALP by its terms, and normatively, applies to find a transfer price using the hypothetical behavior of independent enterprises assumed to be engaged in the same commercial relation as associated enterprises, taking into account the same extrinsic risks and any moral hazard risks that arise. Recharacterization of the related party transaction—other than to ensure economic substance mirrors form—is neither permitted nor needed under the ALP.

b. Comments on the example in ¶¶ 90–91 of *Actions 8–10 PDD*

The example in ¶¶ 90–91 of the *Actions 8–10 PDD* tries to show application of the “fundamental economics attributes” test, which as explained above is based on flawed reasoning and is in any case not required for proper application of the ALP. The *Actions 8–10 PDD* ignores the relevant question: what's the transfer price in this case under the ALP? We make four interrelated points. First, the analysis in the example is in several places flawed. These failures were described in § II.A.2 above, where we addressed the example under questions 3, 5, and 6 posed in the *Actions 8–10 PDD* relating to moral hazard and risk-return trade-off. Second, the example posits that “extensive marketing functions with regard to the maintenance and enhancement of the trademark will be undertaken and managed by Company S1,” but also that “Company S2 has several employees with capability to assess, monitor, and direct the use of the trademark.”⁵² It's unclear why Company S2's direction of the use of the trademark wouldn't overlap or even trump Company S1's management of the maintenance and enhancement of the trademark. Third, trademark law best practices would have Company S2 conducting core

⁵² *Actions 8–10 PDD*, ¶ 90.

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trademark control functions —e.g., making decisions on what products to brand, their quality, etc. If Company S2 failed to conduct those functions, it may be subject to challenge that its trademark is invalid, and its trademark rights could be cancelled. Fourth, assuming Company S2 performs such core trademark control functions, the substance of the arrangements mirrors its form, and properly analysing the underlying economics, yields different results, as shown in the table below.

<i>Actions 8–10 PDD assertion</i>		comments (assume S2 performs core TM mgmt & control)
S1	likely to have lost commercial value because it no longer owns the trademark key in generating its income	<ul style="list-style-type: none"> ◊ S1 received \$400m—if price is arm’s length, commercial value of S1 shouldn’t drop ◊ it’s wrong to assert that a sale for arm’s length price subject to license-back results in loss of commercial value for S1
	subject to additional risk it’s reliant on S2 (treated as independent under ALP) being willing to license TM and not to take actions that might enhance TM value for S2 but detract from S1	<ul style="list-style-type: none"> ◊ sale of TM can be made <u>subject to</u> license back (a common commercial arrangement)—i.e., little risk (a common extrinsic risk) ◊ situation of S2 taking actions that enhance TM value for S2 but detract value for S1 is extreme in a way not normal—generally one could expect enhancement in value of TM to benefit S1, too
	“theoretically” subject to constraints of contract with S2 on ongoing activity relating to maintenance and enhancement of TM	<ul style="list-style-type: none"> ◊ if substance mirrors form, S1 <u>is</u> subject to constraints of services contract with S2 ◊ <u>if</u> S2 employees make core branding & other decisions relating to TM (i.e., properly manage TM) ⇒ benefit to S1 from performing functions directed by S2 employees
S2	has no practical safeguards and is dependent on S1 to act appropriately to enhance & protect its asset (TM) through marketing functions S1 undertakes	<ul style="list-style-type: none"> ◊ S2 control substance mirrors contractual form ◊ S2 makes core decisions re maintenance, enhancement, & protection of TM ◊ S2 would contractually bind S1 to take no action adverse to TM (trademark law practice)
	doesn’t direct way in which it can optimize returns on its asset (TM)	<ul style="list-style-type: none"> ◊ S2 makes core decisions relevant to optimizing returns on its asset
	has less capability than S1 to manage & control marketing that will affect generation of income streams;	<ul style="list-style-type: none"> ◊ S2 has full capability to manage & control marketing
	hasn’t enhanced or protected its commercial position but may have damaged it by not managing risks to achieve a return on its investment in the asset.	<ul style="list-style-type: none"> ◊ S2 has enhanced or protected its commercial position by managing risks

The point of the exercise is to show that varying the facts to parallel those in arrangements considered sound from a trademark law perspective, and assuming the substance of the arrangement mirrors its form, can yield a different result under the “fundamental economic attributes” test⁵³—but as explained above this test in any event should be rejected under the ALP.

B. Part II of *Actions 8–10 PDD*, proposing five special measures

The special measures in Option 1 and the primary rule in Option 5 warrant further consideration and could, if modified, form practicable BEPS tools for WP-6 to endorse. The special measures in Options 2–4 and the secondary rule in Option 5 should be rejected, however. Below we expand on these recommendations.

1. The special measures in Option 1 & the primary rule in Option 5 could, if modified, form practicable BEPS tools

a. Option 1—HTVI

i. General comments

The special measure in Option 1 shares features with “commensurate with income” adjustments permitted under § 482 of the U.S. Internal Revenue Code of 1986, as modified, and implemented under the “periodic adjustments” rule in § 1.482-4(f)(2) of the associated U.S. Treasury Regulations. Option 1 could, if suitably modified, be appropriate for dealing with hard-to-value intangibles.

By its terms, the special measure could be invoked if two requirements are met:

⁵³ As pointed out in § II.A.2 above, in the responses to questions 3, 5, and 6, the economic analysis in ¶ 91 supporting the conclusion in the *Actions 8–10 PDD* is flawed.

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- [1] a taxpayer fixes a transfer price for an intangibles transaction either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and
- [2] the taxpayer doesn't contemporaneously document those projections and make them available to the tax administration.

Thus the special measure wouldn't operate in a situation in which a taxpayer adopts a lump sum or fixed royalty, but contemporaneously documents projections and makes them available to the tax administration. If the special measure is invoked, a tax administration could presume a price adjustment mechanism would have been adopted and would be permitted to “rebase the calculations based on the actual outcome, imputing a contingent payment mechanism.”⁵⁴ Option 1 presents conditions under which the presumption would be rebuttable.

We recommend Option 1 be modified to make clear that any adjustments made under an HTVI special measure should be subject to the ALP and the TPG. Accordingly, the special measure wouldn't operate in circumstances in which a taxpayer produced evidence of the same intangibles being the subject of transactions with independent enterprises under substantially the same circumstances as those of the associated-enterprise transaction. Any HTVI special measure should acknowledge the difficulty of making projections over multi-year periods and accordingly be inoperable if a taxpayer has, say, five post-transaction years in which no adjustments were warranted under the special measure.

⁵⁴ *Actions 8–10 PDD*, p. 41. We assume the contingent payment mechanism would be such that any adjustments would be based on actual income.

ii. Answers to framework questions for Option 1

- [1] **Efficacy**—The modifications to Option 1 outlined above would improve it. The goal of getting closer alignment between transfer pricing outcomes and value creation may—in the absence of comparable transactions and absent a robust contemporaneous transfer pricing analysis—be furthered by a special measure, subject to the ALP, allowing a tax administration to make the rebuttable presumption outlined in the special measure, as modified.
- [2] **Advantages/disadvantages**—Option 1 as modified would ensure the special measure operates within the framework of the ALP, which has long served as the yardstick for pricing associated-enterprise transactions. This would minimize risk of double taxation inasmuch as adjustments made under the special measure (as modified) would be covered by Article 9, ¶¶ 1 & 2 of the OECD MTC.
- [3] **Likely effect**—Option 1 as modified likely wouldn't encourage behavioral changes, other than to encourage robust and contemporaneous transfer pricing documentation.
- [4] **Adaptation of TP rules**—Option 1 as modified would be subject to the ALP and TPG.
- [5] **Targeting**—Option 1 as modified targets situations involving hard-to-value intangibles using bright lines rules that increase the likelihood of tax administrations agreeing a case meets the criteria for application of the measure and on the resulting measurement.
- [6] **Tax advantage**—the special measure makes no reference to tax attributes; the measure as modified shouldn't include criteria limiting it to circumstances where the arrangement results in a tax advantage to the group.

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- [7] **Ordering**—Option 1 as modified would be subject to the ALP and TPG, and thus become part of the “normal” transfer pricing rules.
- [8] **Eliminating double taxation**—the special measure as modified would be subject to the ALP, so that adjustments made under the measure would be consistent with Article 9, ¶ 1, thereby under Article 9, ¶ 2 minimizing the risk of double taxation.
- [9] **Excluding sectors**—no sectors should be excluded from application of the measure.

b. Option 5—excess returns

i. General comments

The primary rule special measure in Option 5, if applied to tax CFC income at the CFC's ultimate parent jurisdiction and if suitably crafted, could address any residual BEPS concerns, after application of the ALP and TPG, about non-taxation of CFC income. A CFC approach at the ultimate parent jurisdiction level has long existed as a mechanism to deem income to the ultimate parent, and tax that income, based on income earned by the CFC.⁵⁵ Significantly, the primary rule would have to operate after application of normal transfer pricing rules and after the impact of any local country taxes, withholding taxes, and any other gross income inclusion under a CFC regime⁵⁶ with respect to that CFC to determine the effective tax rate on the CFC's income. The transfer pricing ordering rule, the comprehensive approach mentioned above to determine the CFC's effective tax rate, and any foreign tax credit mechanism in the parent jurisdiction, would minimize risks of double taxation. Accordingly, we endorse a suitably adjusted primary rule in Option 5 as a viable special measure. This special measure should—as referenced in the *Actions 8–10 PDD*⁵⁷—be coordinated with that on Action 3 (strengthen CFC rules).

The secondary rule special measure in Option 5 should be rejected, for several reasons. The primary rule would only be justified if modified as described above, and then only if applied in the jurisdiction of the ultimate parent of a CFC, but not in the jurisdiction of any other direct or indirect owner of the CFC. The parent jurisdiction, as location of the ultimate owner of a

⁵⁵ See, e.g., U.S. Subpart F rules in 26 U.S.C. §§ 951 - 965.

⁵⁶ E.g., other provisions of U.S. Subpart F.

⁵⁷ *BEPS Actions 8–10 PDD*, p. 38.

multinational group, has primacy of right in taxing “excess returns” of a CFC. Such parent jurisdiction may choose at any time to exercise its sovereign right to tax deemed income inclusions to a resident parent company of a CFC with excess returns, but it might also choose to defer taxation for a period of time (e.g., by only selectively deeming certain income of the CFC to be income of the ultimate parent). The parent jurisdiction’s deferral of taxation for a period of time shouldn’t create a free-for-all allocating rights to tax such excess returns to “other jurisdictions.” The secondary rule in Option 5 doesn’t specify what these “other jurisdictions” are, perhaps because it’s unclear what legal authority would justify an arbitrary “other jurisdiction” asserting authority to tax income earned by an arbitrary CFC. Certainly the arm’s length standard would not justify such allocation. Compounding this uncertainty is the unspecified “pre-determined rule” for allocating taxing jurisdiction over an arbitrary CFC’s excess returns. The ALP provides a principled way for jurisdictions of enterprises associated with the CFC for asserting taxing authority over returns properly earned at arm’s length by such associated enterprises, but what the secondary rule proposes is clearly different. Given the lack of specificity of the “pre-determined rule”—in effect, formulary apportionment—it’s unclear whether consensus could ever be reached among jurisdictions on what rule to choose. It’s equally unclear how double (or multiple) taxation could be avoided. The secondary rule special measure in Option 5 should accordingly be rejected.

ii. Answers to framework questions for primary rule in Option 5

[1] **Efficacy**—normal transfer pricing rules, which would operate before application of the primary rule, and the effective tax rate test (which would have to be determined after the impact of any local country taxes, withholding taxes, and any other gross income

inclusion under a CFC regime with respect to that CFC), would ensure alignment of transfer pricing outcomes and value creation.

- [2] **Advantages/disadvantages**—Option 5 recognizes the primacy of a CFC’s home jurisdiction to tax income earned by the CFC. It’s based on a bright-line rule that can be further tailored to encourage or discourage CFC behavior.⁵⁸ It directly addresses a primary BEPS concern of double non-taxation of income by ensuring a minimal level of taxation of CFC income.
- [3] **Likely effect**—the primary rule would likely encourage behavioral changes, depending on the criteria used to trigger income inclusion (and taxation) in the parent jurisdiction. The primary rule as proposed would, for example, encourage operations in CFCs in jurisdictions such that the effective tax rates exceed the specified threshold.
- [4] **Adaptation of TP rules**—as the primary rule would operate after application of the normal transfer pricing rules, no adaptation of such rules is needed.
- [5] **Targeting**—Option 5 targets a primary BEPS concern of double non-taxation of CFC income. The measure provides a bright line rule for its application, based on effective tax rates, using a well-established approach. Agreement among tax administrations is unnecessary; only the tax administration in the ultimate parent’s jurisdiction is concerned with criteria for application—the tax administration in the CFC jurisdiction is unaffected.

⁵⁸ See, e.g., proposed CFC rules in Prop. § 954(f) in H.R. 1, *Tax Reform Act of 2014*, 113th Cong., 2d. Sess.

- [6] **Tax advantage**—the measure makes no reference to tax attributes; criteria shouldn't be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group.
- [7] **Ordering**—the measure should be applied after application of the normal transfer pricing rules.
- [8] **Eliminating double taxation**—double taxation is unlikely to arise because (1) normal transfer pricing rules apply first (with a relatively low risk of resulting in double taxation); (2) the comprehensive approach mentioned above to determine the CFC's effective tax rate; and (3) the tax credit mechanism in the parent jurisdiction should mitigate double taxation.
- [9] **Excluding sectors**—no sectors should be excluded from application of the measure.

2. The special measures in Options 2–4 should be rejected

a. Options 2 & 3, targeting capitalization of subsidiaries

Some comments are warranted relating to the preamble to Options 2 & 3. The BEPS Action Plan called for “transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has . . . provided capital.”⁵⁹ The BEPS Action Plan thus signaled concerns about returns accruing to an entity that neither assumed risks nor performed functions relating to intangible property. By contrast, the *Actions 8–10 PDD* asserts, that “[t]he BEPS Project . . . sets out the need to consider the potential for inappropriate returns for providing capital.”⁶⁰ The *Actions 8–10 PDD* thus inexplicably broadens the scope of

⁵⁹ BEPS Action Plan, Action 9 (emphasis added).

⁶⁰ *Actions 8–10 PDD*, p. 42.

Appendix B—prior Comment Letter on BEPS Actions 8–10 PDD

the BEPS Action Plan special measure relating to capitalization, suggesting use of such a special measure even if an entity bears risks and performs functions relating to intangible property. The *Actions 8–10 PDD* asserts that application of [presumably, normal] transfer pricing rules “may determine that little or no return is due to [a] capital-rich, asset-owning company,” but that “[i]n other circumstances, however, the application of the arm’s length principle may be difficult and may not address the allocation of excess or unanticipated returns to the capital-rich, asset-owning company.”⁶¹ The thrust of this seems to be that the called-for special measure can be used by tax administrations to get tax revenue if normal transfer pricing rules fail to get it. It’s unclear what “excess” returns are—do they relate to residual returns earned by a capital-rich, asset-owning company after applying normal transfer pricing rules, or perhaps even to returns earned by such a company if the arm’s length principle is “difficult” to apply? “Unanticipated” returns presumably relate to hard-to-value intangibles, so can be dealt with using a suitably crafted variation of Option 1, as discussed above.

Options 2 & 3 should be rejected. Neither Option could be justified under the ALP.

Option 2 targets “circumstances where [a] capital-rich, asset-owning company depends on another group company to generate a return from the asset.” It proposes using as its touchstone an “independent investor” who considers which of the two companies offers a better investment opportunity, “taking into account expertise in conducting risk managed activities to generate a return on the investments and the level of risk and potential return.” It’s unclear how this constraint would apply in any fact pattern. How are the investment opportunities precisely to be determined? If the special measure is triggered, how much capital is deemed contributed to

⁶¹ *Id.* (Emphasis added).

the company providing the more rational investment opportunity? Is the capital-rich company entitled to keep any capital, and if so, doesn't the same difficulty in choosing an "acceptable level" of capitalization arise? In a situation involving an asset-rich company owning many assets, how would its capital to be apportioned among its assets?

In any event, Option 2 seems designed to skew the result to yield an outcome favoring investment in companies performing functions rather than owning assets and bearing risks associated with those assets. There's certainly no economic policy justification for an independent investor ignoring assets, and the bearing of risks associated with those assets, in favor of the performance of activities relating to the exploitation of any of those assets. An unconstrained investor might well choose to invest in a capital-rich, asset-owning company rather than a company used to generate returns from the assets on the grounds that the functions performed by the latter company—e.g., manufacturing and sales—generate only routine returns.

Aside from the lack of clarity and questionable policy underpinnings of Option 2, it suffers from lack of practicability. It focuses on an asset-by-asset approach. The determination of the deemed capital contributions would be exceedingly difficult in any situation in which many group companies perform activities relating to generating returns from a broad portfolio of intangibles. This would be the case with most large multinational enterprises.

Option 3 hinges on determining a level of "thick capitalisation." But there's no generally agreed-upon level of capitalization of a company, nor how one would choose criteria to determine the level to use. Option 3 is also opaque on which company would be treated as providing the excess income—is it the immediate, or ultimate, parent?

b. Option 4, targeting minimal functional entities

Option 4 proposes a special measure focusing on a threshold level of functionality in an entity that, where lacking, would cause the profits of that entity to be reallocated. This special measure should be rejected.

The TPG would allocate profits among associated enterprises in part according to the risks they bear and the functions they perform; in particular, functions relating to the development, enhancement, maintenance, protection, or enhancement of intangible property. Option 4 asserts that if one of the associated enterprises is a “minimal functional entity” then “[i]t may prove simpler and more effective” to adopt the special measure. Does this mean the special measure would be applied instead of normal transfer pricing rules in the TPG? If so, it amounts to a type of profit-split / formulary apportionment depending entirely on functions performed—such an approach was rejected in the TPG “in theory, implementation, [and] practice.”⁶² If the special measure was intended to be applied following application of the normal transfer pricing rules, it would amount to an excessive weighting placed on functions for allocating profits, to the detriment of risks and assets.

The proffered thresholds are problematic. The qualitative threshold mirrors a situation in readily addressed under the normal transfer pricing rules of the TPG, so it’s unclear that this approach is “simpler and more effective” than the TPG. A desire for simplicity does not justify departing from analyzing the facts and circumstances under the ALP. The quantitative thresholds are equally troublesome. An entity performing mainly routine functions with a small number of employees would likewise be unlikely to earn much profit based on those functions

⁶² TPG, ¶¶ 1.15–1.32.

under normal transfer pricing rules. The fact that “[a] substantial part of the company’s income is from arrangements with group companies” says nothing about functionality within the entity, even assuming that’s a valid criteria on which to solely special measure (it’s not). Likewise, looking at the ratio of a company’s assets to income, or its capitalization, says nothing about functionality.

Regarding reallocation of profits if the threshold wasn’t met, it’s unlikely that a “pre-determined factor” could be agreed upon for purposes of the “mandatory profit split” variant for allocating profits. The same concerns voiced in the TPG’s rejection of formulary apportionment are relevant here.⁶³

⁶³ E.g., “Even if some countries were willing to accept global formulary apportionment, there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximise that country’s own revenue.” TPG, ¶ 1.23.