Day 5, Session 1

Transfer Pricing in the OECD Area

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Agenda

I. BEPS Project and TPG Amendments under Actions 8-10:
   - Aligning substance with value creation
   - Chapter X Financial Transactions
   - Risk-free, risk adjusted returns

II. Transfer pricing and Covid-19

III. Two Pillar Solution: Addressing the tax challenges of the digitalisation of the economy
   - Amount B

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Base Erosion and Profit Shifting Project

- Actions 8-10: Align substance with value creation
  - Intangibles
  - Risks, capital (including financial transactions)
  - Transactions rarely undertaken between unrelated parties

- Start from contracts, but use analytical frameworks / proxies to help determine substance, e.g.
  - Intangibles → look to important functions such as DEMPE
  - Risk → look to control decisions and financial capacity
  - Financial instruments → look to features of the instrument, group policies

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BEPS Report on Actions 8-10

Two-Pillar Solution to Address Digitalisation

I	Delineation of the actual transaction, risk Recognition of the accurately delineated transaction Local market characteristics, assembled workforce, group synergies
II	Commodity pricing *Transactional profit split method (June 2018)*
IV	Annex: *Special considerations for baseline distribution (February 2024)*
V	TP Documentation, including CbC reporting
VI	Intangibles, including HTVI, *Implementation of HTVI (June 2018)*
VII	Low value-adding services
VIII	Cost Contribution Arrangements
IX	Conforming changes (e.g. Ch IX) (July 2017)
X	*Financial transactions (January 2020)*
	Attribution of profits to permanent establishments (March 2018)

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Section II

Financial transactions

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Institute for Austrian and International Tax Law . www.wu.ac.at/taxlaw

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OECD Model DTA – Commentary to Article 9

- Commentary (2017) states that Art 9 may be "*relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a* prima facie *loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital*"

- Public consultation on possible changes to commentary
- Interaction between the Art 9 and domestic rules on deductibility
  - Re-writing of accounts permitted where conditions between associates are not arm's length. Re-writing should be done in accordance with the ALP.
  - To determine if an interest payment is arm's length, States **may** examine the terms and conditions of the loan, including the rate and whether/to what extent a loan is in fact a loan (or something else, e.g. equity), based on domestic laws or TPG
  - Once profits allocated in accordance with ALP, how those profits are taxed (e.g. whether/ to what extent interest expense amounts are deductible) is a separate matter for domestic law

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Accurate delineation of a financial instrument

- Labels are only a starting point
- Consider the economically relevant characteristics of the instrument, e.g.:

- Fixed repayment date?
- Obligation to pay interest?
- Right to enforce payment of principal and interest?
- Status of funder compared to corporate creditors
- Financial covenants or security?
- Source of interest payments?
- Ability of recipient to obtain loans from unrelated lenders?
- Use of funds (eg for capital assets)
- Failure of recipient to repay on time?

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B.3 Economically relevant characteristics

- Contractual terms (verified by conduct)
- Functional analysis (lender's/ borrower's functions; control over risks)
- Characteristics of the instrument (seniority, tenor, purpose of loan, repayment schedule…)
- Economic circumstances (location, sector, timing…)
- Business strategies

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Functional analysis

- Lender’s perspective
  - Functional analysis, including analysis of risks
- Borrower’s perspective
  - Goals (have funding available, optimise WACC), options realistically available to achieve those goals
- Credit ratings as a measure/ proxy for creditworthiness
  - Impact of group membership
  - Use of group credit rating?
- Other economically relevant characteristics

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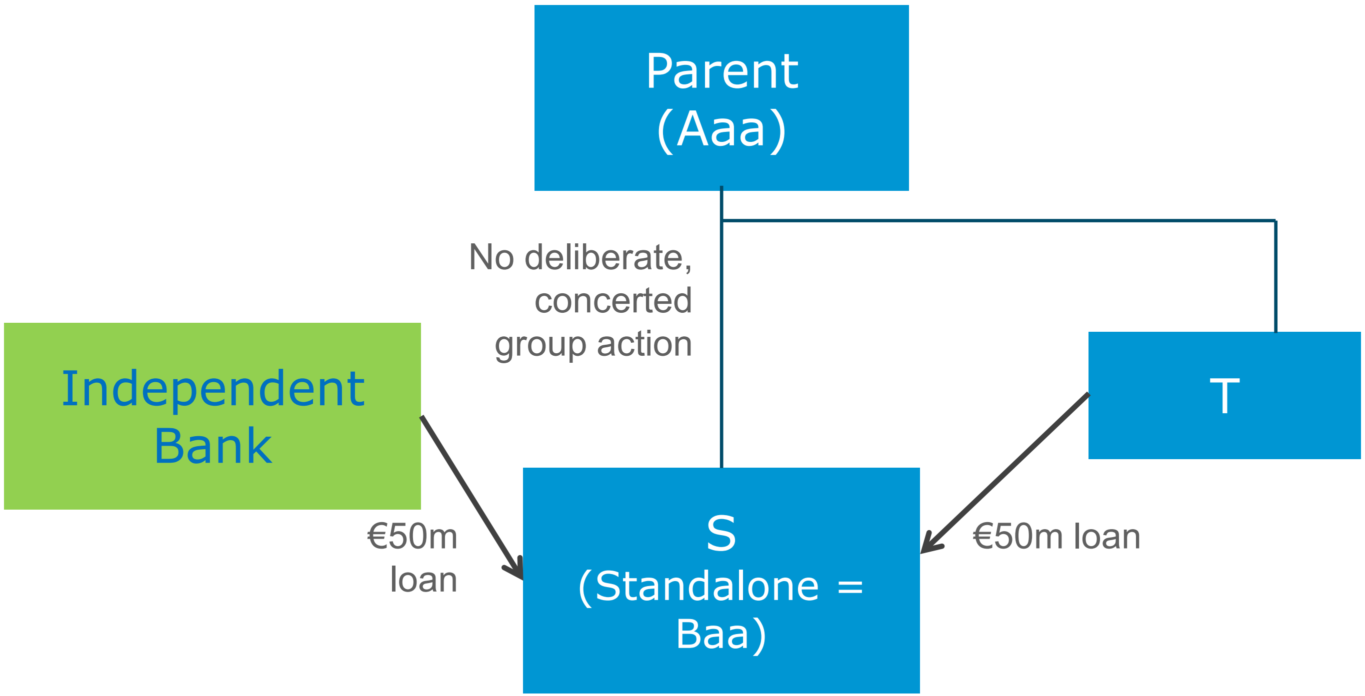
Chapter I: Group synergies example



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§D Guarantees

- Implicit support ←→ formal written guarantee
- Accurate delineation of guarantees
  - Economic benefit?
    - better terms/rate?
    - increased borrowing capacity?
- Pricing approaches
  - CUP?
  - Yield approach
  - Cost approach
  - Valuation of expected loss approach
  - Capital support method

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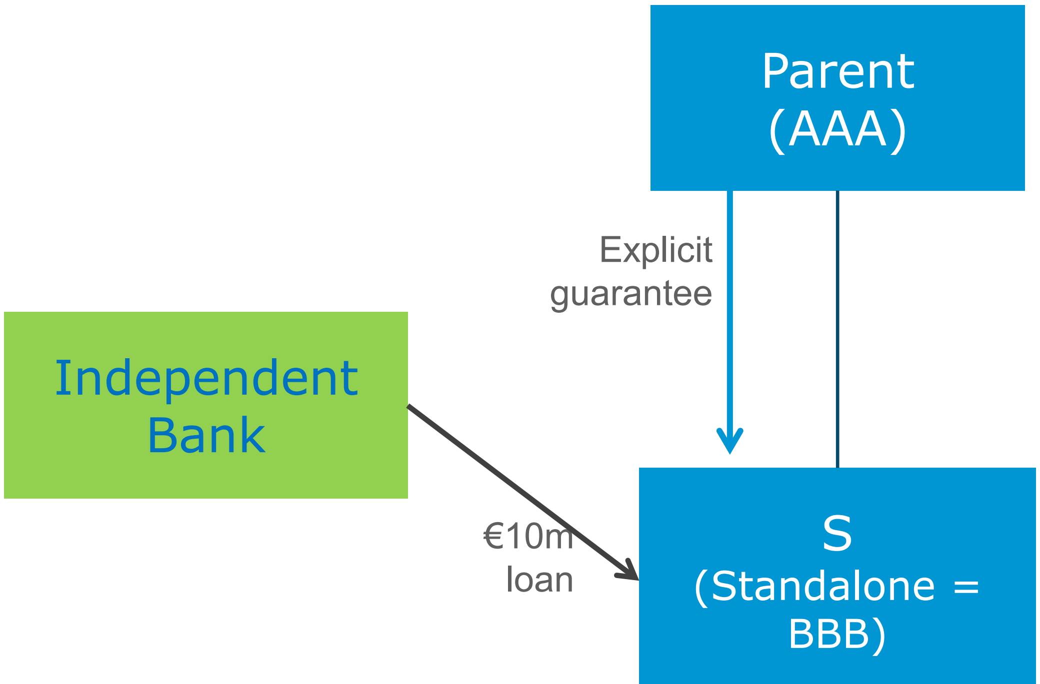
Example



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§E Captive insurance

- Accurate delineation
  - Genuine insurance?
    - Diversification of risk
      - Portfolio of risks insured
    - improved economic position for group
    - necessary FAR (incl expertise)
      - Assumption of risk by insurer; mitigation of policy-holder’s risk
      - Real possibility of loss for captive
    - insurable risk?
    - regulated entity?
  - Risk mitigation vs control over risk
  - Risk being insured vs risk in providing insurance
  - Pricing

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Section III

Risk-free, Risk adjusted returns

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Risk-free rate of return – Chapter I

- A funder that does not control the risks associated with its funding is entitled to no more than a risk free return on its funds
  - Consider funder's costs related to the funding
- Impossible to have a totally risk-free investment → need to consider available proxies
  - Interest rate on certain government-issued securities
  - To eliminate currency risk → use a security in the same currency as investor's cash flows
  - Use a security issued at the time, or with a similar maturity as the controlled transaction
  - Duration of the security should match the investment
  - Other examples: interbank rates, interest rate swap rates…

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Risk-adjusted rate of return

- A funder controls its financial risk, but does not control the underlying risk
  - Might be based on the return of a realistic alternative, comparable investment
  - Risk free rate + premium reflecting the financing risks
  - Could be based on cost of funds with a profit margin proportionate to the risk assumed by the lender

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Section IV

Transfer pricing and Covid-19

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Published Guidance December 2020 (not part of TPG)

Arm's length principle and interpretative guidance in TPG should continue to be relied upon

Published guidance focuses on how the arm's length principle applies to issues arising/ exacerbated as a result of the Covid-19 pandemic:

(i) Comparability analysis
(ii) Losses and the allocation of COVID-19 specific costs
(iii) Government assistance programmes
(iv) APAs

- Impact likely to vary by industry, country, timing, business model…

- Consider who assumes the risk under the accurate delineation

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Comparability analysis

- Where there has been a significant change in the economic environment, **timing issues** and use of historical data may become (more) problematic
  - Comparability adjustments?
  - Sources of contemporaneous information may include:
    - Sales volume trends
    - Capacity utilisation trends
    - Information on specific additional costs
    - Extent of government assistance
    - Macroeconomic information
  - Use of budgeted information?
  - Practical approaches

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Losses and allocation of Covid-specific costs

- **Not all MNEs have reduced profitability as a result of Covid**
- **Unexpected losses** due to falls in demand, supply chain disruptions, exceptional increases in non-recurring operating costs etc
- First consider allocation of risks; allocation of non-recurring costs

Limited risk entities

- TPG par 3.64: "simple / low risk functions… should not generate losses for a long period"

Modifying arrangements

- Evidence from independent parties?

Allocation of Covid-related operational/ exceptional costs

- Depends on risk assumption, nature of the expense

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Government assistance programmes

Eg: grants, subsidies; direct loans, loan guarantees, loan deferrals; tax relief; investment allowances…

- Is it economically relevant?
- Consider impact on taxpayer, comparables; extent to which economic benefits are passed on to suppliers, consumers
  - Does it materially affect the arm's length transfer price?
  - Consider the conditions of the assistance, assumption of relevant risks

- Sharing of government assistance with related party should be treated with caution unless supported by evidence it is arm's length

- Receipt of government assistance does not change risk assumption
- Local market comparables may be more important
- Ensure consistency of accounting treatment with comparables

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Advance pricing arrangements

- Existing APAs should generally be respected unless a condition for cancellation/revision has occurred, e.g. breach of critical assumption
- No blanket approach
  - Consider if there has been a breach of critical assumption, and if so, how material the disruption has been
  - If material, options include revision, cancellation, revocation
- Taxpayers should document possible breaches of critical assumptions and notify the tax administration asap

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Two-Pillar Solution

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Landmark Two-Pillar Solution

Pillar One	Pillar Two	Implementation

• Taxing rights over 25% of the residual profit of the largest and most profitable MNEs to be re-allocated to market jurisdictions (Amount A)
• Simplified/streamlined approach to the application of the arm's length principle (Amount B)
	• GloBE rules for a new global minimum corporate tax rate at 15% to apply to all MNEs with annual revenue over €750 million
	• Treaty-based Subject to Tax rule (STTR)
		• Pillar One
		  • Multilateral Convention (MLC) + Model domestic rules
		  • Amount B guidance in TPG
		• Pillar Two
		  • GloBE rules, guidance, GIR
		  • STTR Multilateral Instrument

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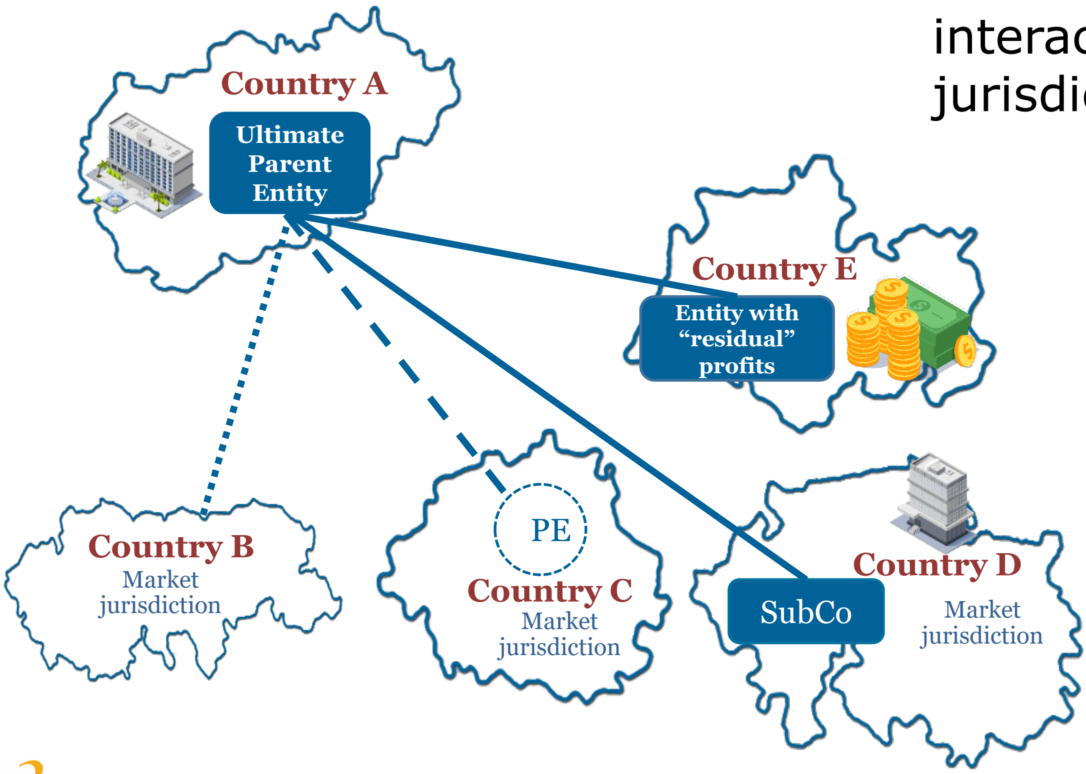
Pillar One

Pillar One deals with MNEs' interactions with market jurisdictions



Amount A: allocation of residual profits from market interactions

Amount B: simplification of ALP for routine returns from market interactions (i.e. by baseline marketer/distributors)

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Amount A

- Applies to largest, most profitable MNEs
- Reallocates 25% of residual profits (>10% Return on Sales) to market jurisdictions
- New special purpose nexus test – does not require physical presence
- Tax base uses financial accounting standards with limited adjustments
- Additional tax certainty measures
- Digital Services Taxes and other similar relevant measures to be removed (does not affect VAT/GST on e-commerce measures)

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Amount B – Mandate

*The application of the arm's length principle to **in-country baseline marketing and distribution** activities will be **simplified and streamlined**, with a particular **focus on the needs of low capacity countries***

- AIM: Reduce and prevent disputes on pricing of common marketing and distribution arrangements

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AMOUNT B – Overview of the Framework

Scope: applies to wholesale distributors	Priced using a pricing matrix	Implementation options
• Including buy/sell entities, commissionaires, sales agents • Should not own unique and valuable intangibles nor assume economically significant risks • Segmentation and *de minimis* retail sales permitted • Excludes distribution of services, digital goods and commodities	• Taking account of industry, operating asset and expense intensity • Includes a geographic adjustment mechanism to address specific country risk differences • Pricing is adapted in cases of very low & high functionality	• Amount B has been incorporated into OECD TPG (Annex to Ch IV) • Amount B will be available as an optional approach to any jurisdiction • Non-binding on the counter-party jurisdiction except in the case of Low capacity jurisdictions

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AMOUNT B – Scope

Applies to wholesale distributors including, buy/sell, commissionaires and sales agents

- No unique and valuable intangibles
- No assumption of economically significant risks
- No distribution of commodities or services
- No retail above de minimis (20%)
- No non-distribution activities unless segmentable
- No below-baseline activities, measured quantitatively as OpEx/sales < 3%
- Quantitative filter of 20% - 30% maximum OpEx/Sales – set by adopting administration

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AMOUNT B – Pricing

Common search criteria	Profit drivers	Features to address geographic differences	Adapted to address low & high functionality	Publication of pricing matrix
Application of **common benchmarking searching criteria** to identify a global dataset	Use of **operating assets**, **operating expenses** and **industry** as factors influencing profitability	**Features to account** for evidence based **geographic differences** in certain cases	Pricing is adjusted to **avoid potential overcompensation** of entities with low functionality profiles **and potential under-compensation** of entities with high functionality	**Publication of a pricing matrix** that includes arm's length ranges Established **prospectively** and **periodically updated**

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AMOUNT B – Pricing

Simplified and streamlined approach to pricing

- Supersedes other TP methods - only internal CUPs can supersede Amount B pricing
- Application of common benchmarking search criteria and use of global data to inform the determination of arm's length ranges
- Design of a pricing matrix which takes account of operating asset, operating expense and industry as relevant profit driving factors
- Use of return on sales as the applicable net profit indicator
- Country risk adjustments for higher risk markets
- Periodic updates and publishing of relevant data

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AMOUNT B – Pricing

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Table 5.1. Pricing Matrix (return on sales %) derived from the global dataset

Industry Grouping Factor Intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
(A) OAS 45% or more, any level of OES	3.50%	5.00%	5.50%
(B) OAS 30% to 44.99%, any level of OES	3.00%	3.75%	4.50%
(C) OAS 15% to 29.99%, any level of OES	2.50%	3.00%	4.50%
(D) OAS less than 15%, OES 10% or more	1.75%	2.00%	3.00%
(E) OAS less than 15%, OES less than 10%	1.50%	1.75%	2.25%

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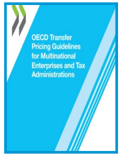
AMOUNT B – Implementation



Incorporated into the OECD TPG as an optional approach available to any jurisdiction (and may be implemented as a safe harbour or rule by an adopting jurisdiction)

Amount B will be non-binding on counter-party jurisdictions; specific measures / guidance included to address tax certainty and double taxation considerations

The IF has made a political commitment to respect the application of Amount B in the case of **low-capacity jurisdictions** to be defined in the coming weeks.

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AMOUNT B – further work

Future work on Amount B may consider the feasibility of moving beyond an optional framework

Regular reviews and updates of data underpinning Amount B

Training materials, capacity building and implementation guidance planned

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Pillar Two

Subject to Tax Rule ("STTR")	GloBE Rules (IIR & UTPR)
• Treaty rule targeting specific base eroding payments between connected persons which are subject to low rates of taxation in the residence jurisdiction. • Nominal tax rate test • Tax levied under STTR taken into account in calculating GloBE ETR.	• Domestic rule that ensures large MNEs pay a minimum level of tax on income arising in each jurisdiction where they operate. • Effective tax rate test • Co-ordination mechanism (rule order) to avoid double taxation of same income under laws of different jurisdictions • Substance based carve-out • Complementary QDMTT

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