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OECD Centre for Tax Policy and Administration
Attn. Mr. Andrew Hickman
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By email: TransferPricing@oecd.org

Re: RSM International comments on the Discussion Draft 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)

Dear Mr. Hickman,

We appreciate everything that Working Party No. 6 (WP6) has achieved on all its transfer pricing endeavours. On behalf of RSM International Limited, we respectfully submit for your consideration, general observations, and specific responses to comments requested on the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures).

Our comments are as follows:

Part I, Chapter I, Section D of the Transfer Pricing Guidelines

Overall, we agree with the proposed changes to Chapter I, Section D of the Transfer Pricing Guidelines. We believe that most of it is a logical and inevitable extension to the work done in the field of intangibles. In this regard, we refer especially to the comments included in Section D2 regarding control over risk and moral hazard. We generally agree with the notion that between unrelated parties risks tend to be allocated to the parties that have relatively more control over such risks. In this regard, we recommend allowing for exceptions where taxpayers or tax administrations are allowed to demonstrate that in specific situations, third parties are willing to absorb a relatively large portion of risk, despite exercising little control over such risks.

D.1 Identifying the commercial or financial relations, paragraph 12

The discussion in paragraph 12 could benefit by referencing business strategies pursued by an enterprise (mentioned in paragraph 10). For example, it is common for an enterprise to sell products to an independent third party at a lower price even when other potential customers are willing to pay more under similar conditions, or are willing to pay the same price under more beneficial terms and trade conditions, as a strategy to gain a new customer/distributor in an important sector or territory. In addition to the comparability considerations discussed therein, we suggest an explicit mention in this paragraph about the considerations for market penetration strategies or other long term business objectives in evaluating the terms of a potential transaction.

D.1.4 Business Strategies, paragraph 35

We agree that tax administrations may wish, rather should, consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued, in determining what period of time an independent enterprise would accept to conclusively determine their outcome. However, various “rules-of-thumb” for establishing periods of time are seen in practice, e.g., three-years, etc. We welcome the OECDs comments on said practices.

D.4 Non-Recognition, paragraphs 83-84

We agree with the OECD’s caveats on non-recognition, and encourage the OECD to expand on this section to include unambiguous parameters and examples as to when this approach can be invoked.

Questions Raised

In response to questions 4-7 (pp.14-15), it is our view that transactions between associated enterprises from which the sole effect is to transfer risk should in principle, be recognized.

Under the at arm's length principle, the purpose of the transaction (whether it is to create BEPS or not) should not be decisive. The key question remains whether independent third parties would have entered into the transaction. In this respect, the risk-return trade-off is essential.

This also applies in transactions where the sole effect is to shift risk. Disallowing arguments based on the risk-return trade-off merely because the respective transaction creates BEPS does not reflect the arm's length principle. The proposed additions to the arm's length principle offer sufficient safeguards against such transactions with reference to concepts as "options realistically available" and "control over risk."

Paragraphs 90 - 92

We generally agree with the proposals made in this section. We believe that the OECD’s assessment of the outcome of the example of paragraph D.4.2, point 90 through point 92 is somewhat premature. Particularly, the following factors have not been considered:

1. The bargaining power and options realistically available to Company S1.

2. The purchase price paid by Company S2 in relation to the value of the IP for Company S1 taking into account the cash flows generated (e.g., using a DCF method).

Depending on these aspects which have not been considered, it is possible that independent third parties would have entered into the transaction.

In respect of point 1, a dire financial situation or insufficient funds to further develop the IP of company S1 could be reasons to transfer the IP to Company S2.

Regarding point 2, we believe many third parties would be willing to sell the IP for a lump sum amount if that amount exceeds the anticipated discounted value of the cash flows related to that IP. Reasons for Company S2 to offer an amount higher than the discounted cash flow of the IP to company S1 could include the possibility for Company S2 to exploit the IP in new territories (e.g., by licensing the IP to other group companies or third parties) and to make significant investments in marketing etc. Company S1 may not have had the options realistically available to do this (e.g., due to insufficient cash flows, etc.).

Assuming that S2's country's legal framework and capability to provide trademark protection is true, it is possible that the intangible asset is better placed in S2.

In conclusion, we feel that the example does not weigh all the relevant factors attributable to the transactions, but rather the example skims through selected arguments that could be offset with legitimate business considerations. In case the IP concerned a "hard to value intangible," we agree it is suitable for the arm's length principle to provide for the use of a contingent purchase price as proposed in Option 1 of Part II.

Part II, Potential Special Measures

Option 1: Hard-to-value intangibles ("HTVI")

We agree with the proposed measure. This measure will help ensure that the transferor receives an arm's length price for the intangibles sold even where the price was difficult to determine at the moment of sale.

The main benefits of this option are in our view:

1. This option fits within the arm's length principle
2. It has been a tried and tested measure in some OECD countries
3. The effect of this measure is likely a behavioural change which will ensure alignment of transfer pricing outcomes and value creation
4. It is a targeted measure which may result in less "overkill" in relation to a valuation approach
5. This measure does not create an excessive compliance burden for both taxpayers and tax administrations (in contrast with some of the other suggestions)
6. This option has less potential to result in double taxation than some of the other options

We do not see any disadvantages in adopting this measure, and will welcome further guidance with regard to determining the pricing of the contingent payments. In our view, this measure could become an integral part of transfer pricing principles.

Option 3: Thick capitalization

We are of the view that Option 3 does not reflect the arm's length principle as the OECD in the Guidelines currently describes it, nor as it is reflected in the recent reports on BEPS.

It makes sense economically to allocate more equity to high-risk entities (such as an IP owner or full fledged manufacturer) compared to low risk entities (such as a Shared Service Center). Disregarding this settled economic principle by applying a fixed debt-to-equity ratio or group ratio departs from the arm's length principle. Therefore, this measure is more likely to increase the gap between transfer pricing outcomes and value creation rather than re-align them.

Implementing a thick capitalization principle in an economically rational manner would include guidance on how to allocate debt and equity to various group companies taking into account the aforementioned economic principle. This does, however, require customized approaches for each group company. In our view this creates an excessive administrative burden to both taxpayers and tax administrations. There are in our view sufficient other manners to deal with BEPS without focusing on the debt or equity funding of companies.

Option 4: Minimal functional entity

If implemented in such a manner that this measure fits within the arm's length principle, we believe this measure could contribute to an effective and economically rational re-alignment of transfer pricing outcomes and value creation.

It would be a practical solution to determine an arm’s length price for a transaction where one party performs minimal functions by defining a minimal function threshold on the basis of qualitative attributes. We note the following:

1. Quantitative aspects should cautiously be used as a threshold to determine whether or not an entity has minimal functionality, as they often do not reflect the concrete situation of the company (e.g., only few staff are required for a specific function) and depart from the arm’s length principle. In line with the previous work on intangibles, we believe that qualitative aspects such as the capacity (taking to mean the ability to control the risks, functions and assets) of an entity should be the basis upon which profits are, in accordance with the arm’s length principle, attributed to the various entities within an MNE group.

2. A fixed pre-determined factor on the basis of which a mandatory profit split would be applied is not advisable, as we feel that a profit split should be customized to the specific functions, assets, risks employed within the various group companies, along with consideration of options realistically available and bargaining power.

3. The foregoing applies even more with respect to the proposed re-allocation of profits to the immediate parent or to the company providing functional capacity. This may lead to inconsistencies with other proposals with respect to intangibles and profit splits.

Option 5: Ensuring appropriate taxation of excess returns

Due to a lack of focus on artificial arrangements, it is our view that this option (in its current form) encroaches too much upon the sovereignty of states to determine their own tax rates. The measure has the potential to discriminate against investments in genuine operational businesses merely because that business is established in a low-tax jurisdiction. The sole fact that a jurisdiction intends to attract businesses by having a low corporate tax rate should not give another jurisdiction the authority to tax the profits of the other jurisdiction's businesses.

Preferential tax treatments provided by a jurisdiction in form of tax holiday, reduced tax rate, etc., should be considered in determining the “x% threshold.” It could be interpreted as a location savings matter.

The secondary rule would lead to implementation challenges given that it would be difficult to determine which jurisdiction (apart from the parent entity jurisdiction) has taxing rights.

It is not sufficient to apply a CFC rule merely due to the fact that the CFC is low-taxed. As required by most existing CFC rules around the world, in addition to being low-taxed, the CFC's business should be dependent on easily movable assets ("passive assets") in order for the CFC rule to apply. CFC rules have the potential of significantly limiting BEPS.

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We thank you for the opportunity to provide our input and look forward to participating in upcoming consultations. Should you have any questions on our comments, please contact Dr. Enrique Rayon at +1 949 255 6500 or Enrique.Rayon@McGladrey.com.

Yours sincerely,

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