

# How OECD Developments Are Shaping Transfer Pricing

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## Introduction

Transfer pricing as a discipline is being redefined in important ways as a result of initiatives sponsored by the OECD. This article examines how these developments are shaping transfer pricing – specifically, ones relating to comparability analysis, the use of profit-based methods, the introduction of the significant people functions concept in order to substantiate the attribution of profits to permanent establishments, and business restructurings. The article concludes that taxpayers and practitioners are entering a more challenging environment in this area, and that it will become harder to justify structures that hitherto have been regarded as part of mainstream solutions. The good news is that these developments may well enable companies to build stronger and more sustainable solutions in transfer pricing.

## Comparability Analysis

In 2003, the OECD issued an open invitation to the business community to comment on comparability issues encountered when applying traditional transactional or profit-based methods in transfer pricing. In response to the comments it received, the OECD issued a discussion draft on the topic in May 2006 and solicited further comments.<sup>1</sup>

One of the preliminary conclusions reported in the discussion draft was that greater emphasis should be placed on the quality of analyses rather than “mechanical comparisons of financial indicia”.<sup>2</sup> In this regard, the draft calls for comparability analyses to go “beyond some vague categorization of one of the parties to the controlled transactions followed by the use of lightly examined comparable companies.”<sup>3</sup> It endorses the view, for instance, that prior to selecting a transfer pricing method or initiating a search for comparables, a taxpayer or practitioner should conduct a “broad-based analysis” to help understand the conditions of the controlled transaction as well as that of the uncontrolled transaction. This “essential” first step is defined as an analysis of the industry, value drivers, economic and regulatory factors, competition and other factors.<sup>4</sup> In addressing a perceived disconnect between the search for comparables and comparability analysis, the draft emphasises additionally the importance of maintaining a link between the two steps and, indeed, the whole analytical process.<sup>5</sup> The OECD’s discussion draft on profit-based methods (see below) goes still further.<sup>6</sup> It proposes, inter alia, that the OECD’s 1995 Transfer Pricing Guidelines be revised so that in selecting a transfer pricing method, the taxpayer or practitioner is specifically required to take into account “the comparability (including functional) analysis of the controlled transaction.”<sup>7</sup>

Although open to comments until January 9, 2010, with the release on September 9, 2009 of the proposed revision of Chapters I-III of the OECD Transfer Pricing Guidelines, it seems certain that greater rigour and sophistication will be required of comparability analysis and searches for comparables.<sup>8</sup> Added scrutiny of why a TNMM approach is selected and how it is applied in particular seems inevitable. These observations lead directly onto the next topic.

## Use of Profit-Based Methods

In January 2008, the OECD released an invitation to comment on a series of draft issues notes on the use of profit-based methods in transfer pricing.<sup>9</sup> These notes discuss approved transfer pricing methodologies and put forward proposals to reform the OECD’s 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). Two proposals carry particular significance for how transfer pricing analyses are conducted.

The first is a proposal to relax the OECD Guidelines’ cautious view on approved methods and recognise that in some circumstances, profit-based methods will be more reliable than traditional transactional methods. In short, the discussion draft proposes that the last resort status of profit based methods is superseded by careful consideration on a case-by-case basis of what is the best or most appropriate method (or combination of methods):

“The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, it should take account of the respective strengths and weaknesses of each of the OECD recognised methods....”<sup>10</sup>

The second is a proposal to recognise that what are called “one-sided methods” will not always be the most appropriate to use in transfer pricing analyses, in effect giving greater credence to profit split methods. This particular point was expressed as follows:

“[W]here transactions are very integrated, for instance in the global trading of financial instruments, it might be that they cannot be evaluated on a separate basis. Similarly, where there are significant non-benchmarkable contributions (e.g. intangible assets) by each party to a controlled transaction, the use of a one-sided method might not be appropriate...[T]he main strength of the profit split method is that it offers a solution to deal with cases where there is an absence of reliable comparables, such as might occur when valuable, non-benchmarkable or highly specialised intangibles are used by each party to a transaction.”<sup>11</sup>

In regard to the second proposal, specific consideration was given to how combined profits should be divided up between the parties involved in a controlled transaction. The latter point is summarised by the following excerpt from the discussion draft:

“[I]n the absence of more direct evidence of how independent parties at arm’s length would have split the profit in comparable transactions, however, the allocation of profits is based on the division of functions (taking account of the division of the assets and risks) between the associated enterprises themselves...[I]n effect, the fundamental assumption in Chapter III of the TP Guidelines is that independents would have split the combined profit in proportion to the value of their respective contributions to the generation of profit in the transaction.”<sup>12</sup>

It is often noted that modern enterprises operate in an increasingly integrated manner and that intangibles have become more and more important in today’s economy. If this is correct, and there are few voices, if any, who deny this, then the proposals outlined above—which have been retained in the proposed revision now released by the OECD—seemingly will allow tax authorities to request taxpayers and practitioners alike to conduct more detailed analyses of how independent companies behave and on how value is created within enterprises.<sup>13</sup> The proposals will also make it easier for companies to employ a broader set of methods than before to substantiate their solutions in transfer pricing. From both perspectives, the proposals will increase the focus on profit split analyses and the need for more robust data.

### **Significant People Functions**

Another development that has attracted substantial interest was the release by the OECD in December 2006 of its final report on general considerations relating to the attribution of profits to permanent establishments (PEs).<sup>14</sup> This report was released in its final form by the OECD on 18 July 2008.<sup>15</sup> A detailed description of the report’s contents is not presented here, since it has already been reviewed on numerous occasions.<sup>16</sup>

The report starts by adopting the functionally separate entity approach as the “authorised OECD approach” for attributing profits to PEs. The more explicit application of this approach will imply a wider recognition of “dealings” between headquarters and PEs, and a more systematic application of approaches developed and applied in transfer pricing. Arguably one of its most salient points, however, is summarised by the following quote:

“the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management...of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE...[I]t should be stressed that a particular enterprise may have one or more significant people functions.”<sup>17</sup>

Within the context of this article, an obvious question arises. Specifically, why would the analytical approach based on significant people functions (SPF) concern only PEs? Does it not also apply to transfer pricing in a wider sense?

In strict terms, the SPF concept put forward by the OECD does indeed relate only to the attribution of profit to PEs (i.e. in the absence of transactions and contracts between entities) and applies *inter alia* on revision of the OECD Commentary on the Model Tax Convention on Income and on Capital.<sup>18</sup> The position of group entities working together in integrated operations, however, has much in common with the relationship between an entity and a PE. The SPF concept could, therefore, despite its specific focus on the attribution of profit to PEs, have a profound impact on how transfer pricing analyses are conducted, especially given that the analytical approach used in both cases will be the same. This is for a number of reasons.

First, the SPF concept seems particularly well-suited to being used in function and risk analyses and the examination of whether the activities of an entity should be characterised as routine. Furthermore, the (contractual) allocation of risks to a group entity that does not have the resources and capabilities to manage and carry them effectively will become more visible with an SPF-based analysis. A significant degree of methodological spillover is therefore inevitable, and even welcome, since it would enable practitioners to evaluate the “substance”, and appropriateness of the terms and conditions of contracts more adequately. In a broader sense, in fact, the SPF idea represents a significant step forward in specifying more precisely what is meant by the essentially undefined, and vague, concept of “substance”.

Second, the SPF concept also lends itself very well to the evaluation of how, in a profit split analysis, the combined profits in a transaction should be split between related parties. A commonly used technique in residual profit split analyses, for instance, is to split residual profit amongst transacting parties based on their contribution to the development of core intangibles. The SPF concept can play a key role in determining these contributions. In this context, it is also noteworthy how much overlap there is between the definition of the SPF concept and the OECD discussion of the division of functions (and assets and risks) in profit split analyses.

Finally, the SPF concept is something that tax authorities could conceivably try and use to assert that a permanent establishment exists, not least where a tax inspector disagrees with a taxpayer’s transfer pricing. A tax authority may investigate, for instance, whether significant people functions are carried-out in a particular jurisdiction by, or on behalf of, an overseas entity. If so, then it might have a strong argument for asserting that a place of management or even dependent agent PE exists, thereby attracting more than “routine” remuneration.

The above points notwithstanding, application of the SPF concept will have its limitations. This is particularly the case where assets are concerned. In many industries, for example, intangible assets are acquired or developed over a long period of time. The SPF tool could, in such circumstances, lead to incorrect transfer pricing analysis if not properly used. As a further example, the location of marketing directors may give very little direction as to the remuneration attributable to legal ownership of a trademark. This is particularly the case since the work of such individuals will typically extend beyond the borders of a country in which an entity or a PE is established.

## **Business Restructurings**

In September 2008, the OECD published a discussion draft on transfer pricing aspects of business restructurings. The draft comprises four issues notes and makes a number of points particularly relevant to transfer pricing for IP.

Issues Note No. 1 addresses various questions relating to risk. One question is how an arm's length allocation of risks can, or should be determined. The issues note states that:

"[W]here no comparables exist to support a contractual allocation of risk between related parties, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances. One factor that can assist in this determination is the examination of which party(ies) has (have) control over the risk.... [T]he OECD is of the view that in arm's length dealings, another factor that may influence an independent party's willingness to take on a risk is its anticipated financial capacity to bear that risk."<sup>19</sup>

The note continues, remarking that paragraph 1.27 of the OECD Guidelines describes how in arm's length transactions, it generally makes sense for parties to be allocated a greater share of risks over which they have greater control. Assuming that risk is defined appropriately in the first instance, the key question then focused upon is what is meant by "control", and Issues Note 1 in this respect is particularly important. It states that:

"[T]he OECD is of the view that in the context of paragraph 1.27 of the TP Guidelines, "control" should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions."<sup>20</sup> The absence of a reference to the SPF-concept is conspicuous.

Issues Note 2, which discusses arm's length compensation for business restructurings, also refers to the term "capacity". More specifically, it comments that a factor likely to come into play at arm's length is "[t]he capacity of the transferee to maintain and / or further develop the asset transferred (assuming further development is necessary to maintain the asset's value)."<sup>21</sup> The note then refers the reader back to the discussion noted above about the relationship between risk allocation and control. Again, not surprisingly, and although it is not mentioned, there is a significant degree of overlap with the definition of the SPF concept. The above could be seen as paving the way for the OECD Guidelines to be changed in such a way as would provide tax authorities with greater latitude to challenge contractual terms and conditions in

intercompany relationships put in place by taxpayers and even attempt to re-characterise ones that are seen as particularly flawed. Issues Note 4 emphasises, however, that re-characterisation should only be contemplated in exceptional circumstances. It states that:

“[T]he OECD considers that apparent non-arm’s length behaviour should as much as possible be dealt with on the basis of pricing adjustments, rather than by not recognising transactions. In some circumstances, however, it may not be possible to arrive at an appropriate transfer price.”<sup>22</sup>

It is important to note here that the taxpayer will have a more sophisticated analytical toolset available going forward for determining arm’s length terms and conditions, and greater use of profit-split methods, for instance, should reduce the number of cases where appropriate transfer prices cannot be determined. Nevertheless, Issues Note 4 does provide one example of circumstances where most OECD countries indicate that they would consider not recognising a structure.<sup>23</sup> The example provided is rather simplistic, but the fact it is given at all is significant. Its main points are summarised below.

The example provided is one in which a valuable brand is transferred from Company A to Company Z (located in Country Z) in exchange for a lump-sum payment. Although appropriate contractual relationships are put in place, little else changes. Company A’s employees continue to develop, maintain and execute a worldwide marketing strategy, and it is remunerated on a cost plus basis by Company Z. The marketing strategy drives brand strength, which in turn is a prime determinant of the group’s competitive position. Company Z does not have the people (employees or directors) to perform the control functions relating to the risks associated with development of the brand. It also does not have the financial capacity to bear those risks. Once a year, senior managers from Company A fly to Company Z to formally validate the strategic direction to be followed by the business. Company A is also remunerated for this on a cost plus basis. As noted, most OECD members would consider not recognising the transactions as it stands.

In contrast to the above, Issues Note 4 provides a second example in which a significant number of Company A’s employees are transferred to Company Z (in Country Z). Company Z additionally recruits new staff members to replace ones dismissed by Company A. Employees of Company Z have the authority to perform key risk control functions and actually do so. They also actively carry-out the development, maintenance and execution of the worldwide marketing strategy. Company A’s remaining staff provide central support services, including marketing functions, and its staff are closely monitored by Company Z employees in respect of the latter. The main reason given for the restructuring is to take advantage of a favourable tax regime in Country Z. Issues Note 4 observes that the vast majority of OECD members in these circumstances would recognise the transaction for transfer pricing purposes.

One final point to consider is that Issues Note 3 of the discussion draft emphasises that a consensus exists within the OECD that neither the arm’s length principle nor the OECD Guidelines apply differently to post-restructuring transactions compared to ones structured in the same way from the beginning.<sup>24</sup> This implies parity of treatment for identical structures arrived at by different routes, and also that principles espoused in the discussion draft will cross-over to transfer pricing outside business restructurings.

It remains to be seen in what direction the OECD will ultimately proceed on business restructurings, and there could still be changes in direction following the recently ended period of consultation. However, it is clear from the above that considerably more emphasis will be placed on determining which entities actually have the people who carry-out key functions, not least in regard to risk control, and which entities are able to bear the risks associated with those functions. This requires analysis of capabilities and competencies, both in absolute terms and relative to those of other parts of the enterprise.

### **Implications for Future Transfer Pricing**

What impact the aforementioned OECD developments have on transfer pricing will depend on a host of factors, including the specific changes ultimately made to the OECD Guidelines, Model Tax Convention and Commentary. The place accorded to the OECD Guidelines in country-specific transfer pricing rules and regulations will also play a key role, as will the evolution of tax treaties, case law and local practice. In this regard, the treatment of transfer pricing arrangements in future periods may differ from what would be expected for prior periods, and a number of methodological or analytical developments can be foreseen.

First, developments in each of the areas outlined above will allow tax authorities to challenge the way transfer pricing is conducted, and push for greater analytical rigour and sophistication. The Dixons case in the UK may provide a taste of what is to come.<sup>25</sup> In their ruling, the UK's Special Commissioners presented a detailed, economics-based comparability analysis of what had been used by the taxpayer as comparable uncontrolled price data to support an offshore structure, with particular importance being given to relative bargaining strength. Each data observation was dismissed by the Special Commissioners as insufficiently comparable to be reliable, or to be incapable of adjustment to account for differences in comparability. The Special Commissioners agreed with HMRC's expert economist that it would therefore, in view of the commercial and financial relations that existed between the parties, have been appropriate to adopt an approach based on the profit split method.

Second, it will become even more important that so-called entrepreneurial or "non-routine" entities, not least ones that own, develop and manage intellectual property, actually employ the people that carry-out the key functions (whether in the country of residence or in that of a PE), allowing them to assume control of risk. These entities will also need financially to be able to bear the risks associated with the key functions. The SPF concept here will almost inevitably become an important analytical tool. Conclusions arrived at may differ, of course, from industry-to-industry. For example, in industries such as pharmaceuticals the ability to fund R&D and bear the risk of unsuccessful development is critical, whereas the actual performance of R&D might be seen as less important. In other industries (e.g. food manufacturing), non-registered intellectual property such as trade secrets and know-how are vital and it might be difficult to divorce significant people functions from the R&D process itself.

As a direct corollary to the above, tax authorities likely will have greater scope to challenge what hitherto have been central elements of mainstream structures and models (e.g. contract R&D performed on a cost plus basis, R&D cost-sharing where a party contributes little more than finance, the outsourcing of important functions to "routine" service providers), particularly when there is a clear disconnect between significant (people) functions, the contractual

characterisation of entities, and remuneration. It seems unlikely that attempts by tax authorities to re-characterise structures will succeed in all but the most egregious cases. However, it will become more difficult in many cases to defend routine cost plus remuneration and the one-sided application of transfer pricing methods (even where the analysis is two-sided). Instead, profit-split analysis can be expected to become significantly more prevalent in transfer pricing analyses, especially ones involving IP. Again, the SPF concept may very well become a key analytical tool that extends its reach well beyond permanent establishment. Properly defined contractual relationships will remain important, but the interrelationship between functions, risks, people and pricing, set within the context of value creation inside the enterprise, will become paramount.

## Conclusion

Transfer pricing as a discipline is being redefined in a number of important ways by the recent and ongoing initiatives sponsored by the OECD. Methodological developments relating to the use of profit-based methods, profit attribution to PEs, the significant people functions concept and business restructurings will provide tax authorities with greater opportunity to challenge transfer pricing in structures and models that hitherto have often formed mainstream solutions. If they do so, then the transfer pricing arena will become significantly more challenging for taxpayers and practitioners. The good news, however, is that the new developments also provide taxpayers with a more sophisticated analytical toolset for designing effective and defensible, and therefore sustainable, solutions in transfer pricing.

## Notes

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<sup>1</sup> OECD. 2006. Comparability: public invitation to comment on a series of draft issue notes.

<sup>2</sup> Ibid. p. 8, para 24.

<sup>3</sup> Ibid. p. 36, para 36.

<sup>4</sup> Ibid. p.6, paras. 10-14.

<sup>5</sup> Ibid.

<sup>6</sup> OECD. 2008. Transactional profit methods. Discussion draft for public comment.

<sup>7</sup> Ibid. p. 8.

<sup>8</sup> OECD. 2009. Proposed revision of chapters I-III of the transfer pricing guidelines.

<sup>9</sup> OECD. 2008. Transactional profit methods. Discussion draft for public comment.

<sup>10</sup> Ibid. p. 8.

<sup>11</sup> Ibid. pp. 11-12.

<sup>12</sup> Ibid. p. 65.

<sup>13</sup> Supra footnote 8.

<sup>14</sup> OECD. 2006. Report on the attribution of profits to permanent establishments. Part I.

<sup>15</sup> OECD. 2008. Report on the attribution of profits to permanent establishments.

<sup>16</sup> See for example the International Transfer Pricing Journal issues of September/October 2007 and March/April 2008, plus TP Week September 2007.

<sup>17</sup> Supra footnote 15, Part I, paras. 18-19.

<sup>18</sup> The OECD Committee on Fiscal Affairs approved the release of a discussion draft of a new Article 7 of its Model Tax Convention and its Commentary on June 24-25, 2008. Supra footnote 16 for wider discussion on implementation.

<sup>19</sup> OECD. 2008. Transfer pricing aspects of business restructurings: discussion draft for public comment. Issues Note 1, para. 28.

<sup>20</sup> Ibid. para. 30.

<sup>21</sup> Ibid. Issues Note 2, para. 86.

<sup>22</sup> Ibid. Issues Note 4, para. 205.

<sup>23</sup> Ibid. Issues Note 4, paras. 217-219.

<sup>24</sup> Ibid. Issues Note 3, para. 130.

<sup>25</sup> See the decision of the Special Commissioners in DSG Retail v HMRC published on 23 April 2009.

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