Dear Mr Hickman

Actions 8, 9 and 10 (Risk, Recharacterisation and Special Measures)

Matheson welcomes the opportunity to comment on the public discussion draft issued under BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures) (the “Discussion Draft”).

Matheson is an Irish law firm and our primary focus is on serving the Irish legal and tax needs of international companies and financial institutions doing business in Ireland. Our clients include over half of the Fortune 100 companies. We also advise seven of the top ten global technology companies and over half of the world’s 50 largest banks. We are headquartered in Dublin and also have offices in London, New York and Palo Alto. More than 600 people work across our four offices, including 75 partners and tax principals and over 350 legal and tax professionals.

Comments made in this letter are made solely on our own behalf.

1 Respect for contractual arrangements

The importance of actual conduct can be emphasised without undermining the importance of the contractual relationship.

The proposed inclusion of the first sentence in paragraph 1.53 would severely disadvantage the taxpayer, in particular on audit, where it seems that it would be up to the taxpayer to establish that the actual conduct of the parties reflects the contractual arrangements. This is unnecessarily burdensome for the taxpayer. We recommend that the first sentence in paragraph 1.53 is re-drafted as follows:
“In the absence of evidence to the contrary, it should be assumed that contracts accurately and comprehensively capture the actual commercial or financial relations between the parties.”

We agree that to the extent the conduct of the parties to an intra-group contract does not align with the agreed terms it is appropriate to base pricing on the actual conduct. However, in the absence of evidence suggesting that the conduct of the parties is not in keeping with the intention of the parties, it is unclear why an assumption that the contract reflects the arrangements in practice should not apply.

Furthermore we would suggest that one-off or occasional actions, in most cases, should not be sufficient to undermine the contractual terms for the purposes of pricing. Even under third party arrangements, the parties will from time-to-time deviate from the contractual terms if such deviation is the most practical course of action. However, that behaviour does not infer that the contractual terms are obsolete or have been overwritten, nor does it go to pricing. Therefore, in order to displace the assumption that the contract accurately and comprehensively captures the actual arrangement material divergences from the material elements of a contract should be observed on a consistent basis over a sustained period of time.

2

Risk

It is appropriate that an entity that manages, controls and / or mitigates risk should, to an extent, be treated as bearing the risk.

We would be concerned as to whether the “moral hazard” concept adds anything to the collective understanding in aligning profits with risks, beyond the process for identification and management of risks as outlined in paragraph 40. In any case moral hazard has no application to those risks that cannot be managed effectively. Under third party arrangements such risks are legitimately allocated between unrelated parties who cannot control them. The risk-return trade-off is usually taken into account in pricing such arrangements. It should be open to related parties to price the allocation of such risks with regard to the risk-return trade-off.

For example, paragraph 60 of the Discussion Draft outlines a scenario where product recall risk is assigned to a distributor (who accordingly is allocated a higher margin). Stringent supplier audit programmes, extensive testing protocols, mandatory training and a culture of improvement is all managed by the manufacturer. The Discussion Draft concludes that as the risk management is actually performed and controlled by the manufacturer, the manufacturer should attract the outcome of the upside and downside risk instead of the distributor.

What if, despite the risk management efforts of the manufacturer, there is a product recall and a substantial claim for damages, all of which is covered by the distributor. Does that change the analysis? We believe that it should. Even though the manufacturer should be remunerated for the role played, the distributor should also be remunerated. Related parties should not be precluded from agreeing on an arm’s length basis where that risk should lie, provided the entity that takes the risk has capacity to bear the financial burden of the risk.
We would note that risk may indeed be shifted within MNEs for good reason. For example, many risk realignment exercises specifically seek to align risk to the jurisdiction(s) where the risk is supported, managed and controlled. This is particularly an issue for MNEs that have undergone expansion through acquisition, followed by consolidation and integration. Indeed, it can be the case that certain entities that historically supported, managed and controlled the risks (while part of a smaller group) continue to earn excessive risk related returns following combination with a larger MNE even though they no longer in fact support, manage and control such risks.

3 Non-recognition should be applied selectively

The Transfer Pricing Guidelines should specifically provide that non-recognition should be treated as a last-resort mechanism for pricing transactions entered into between related parties. Application of non-recognition disregards legal agreements signed by related parties and seems to permit an entity’s separate corporate personality to be disregarded. These are fundamental and well-understood legal concepts. They have the benefit of providing the taxpayer with some certainty in assessing tax liabilities. To the extent contracts and separate legal personalities are disregarded, tax authorities will have a broad remit to redefine legal arrangements as they see fit. Such an approach should be strongly discouraged in the vast majority of cases.

In instances where there are material divergences from the material elements of a contract on a consistent basis over a sustained period of time then non-recognition should be appropriate. Otherwise a robust transfer pricing functional analysis should deliver an arm’s length result.

The example in paragraphs 90 and 91 is perhaps overly simplistic and does not reflect the factual circumstances underpinning decisions taken by MNEs. In this regard the simplicity is most unhelpful. Even a slightly more nuanced example should consider the application of the consideration received by S1. In addition, for an MNE it is likely that the transfer of the trademark to S2 is taking place as part of an operational expansion or reorganisation across a number of regions. The trademark and license to S1 would likely sit beside numerous other trademarks and licenses to various other subsidiaries across the globe. Furthermore, it may have been the case that S1 did not have the capability or desire to jeopardise a successful home business through expansion.

We welcome the acknowledgement in the Discussion Draft that “the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised”. This is an important point for MNEs. However, it is not entirely clear from the Discussion Draft how that statement in practice should be reconciled with the proposed test for when non-recognition may apply – whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner. We would welcome clarification on this point.

4 Potential Special Measures

As a general comment, there is a significant risk that if the circumstances in which the special measure can be invoked are not clearly set out this will create substantial ongoing uncertainty for MNEs. Uncertainty for business will impact investment and global economic growth.
In particular, on Option 1 we would be concerned that it would only ever be applied to align profit and value creation in cases where the value of the intangible increases substantially (and not where value falls). On this basis while a special measure may with hindsight deliver an apparently more accurate valuation, it is not clear that as a matter of principle it is a better means of valuing transactions. In the commercial world, fixed price transactions are as common as variable or contingent price transactions. Although unrelated parties who contract at arm’s length may believe that a fixed price is fair at the time they enter the contract, with the benefit of hindsight at a later date the same parties may have a different opinion but it will be too late to seek further remuneration. This commercial reality should be reflected in all guidance on hard to value intangibles. Option 1 seems appropriate where there is no contemporaneous documentation.

Thank you for the opportunity to comment on the Discussion Draft. Should you wish to discuss any of the points raised, please do not hesitate to contact us.

Yours faithfully

Sent by email, bears no signature

MATHESON