KPMG Meijburg & Co Tax Lawyers

New OECD Transfer Pricing Guidelines Issued

A new edition of 612 pages of the OECD Transfer Pricing Guidelines was published on July 10, 2017.

Introduction

The 2017 Transfer Pricing Guidelines provide new guidance on the application of the arm's length principle, i.e. the international consensus on the valuation, for corporate tax purposes, of cross-border transactions between associated enterprises. The 2017 Transfer Pricing Guidelines replace the previous Transfer Pricing Guidelines issued in 2010. The 2017 Transfer Pricing Guidelines incorporate the substantial revisions made to reflect the clarifications and revisions agreed in the 2015 OECD BEPS Reports on Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation and on BEPS Action 13 Transfer Pricing Documentation and Country-by-Country Reporting. It also includes the revised guidance on safe harbors, approved in 2013, which recognizes that properly designed safe harbors can help to relieve some compliance burdens and provide taxpayers with greater certainty.

In this memorandum, we discuss four main areas where the 2017 Transfer Pricing Guidelines have been revised as compared to the 2010 Transfer Pricing Guidelines:

I. Significant revisions with new rules to combat BEPS by moving intangibles among group members, covering BEPS Actions 8, 9, 10 and 13.
II. The revisions to Chapter IX to ensure the guidance on business restructurings conforms with the revisions introduced by the 2015 reports on BEPS Actions 8-10 and 13.
III. The revised guidance on safe harbors in Chapter IV.
IV. Consistency changes to align the rest of the OECD Transfer Pricing Guidelines to produce one consolidated and new edition.

General observations

- There is no new substantive content in the published version of the 2017 Transfer Pricing Guidelines beyond what was already announced in the OECD BEPS Actions 8-10 and Action 13 final reports.
- Formal publication of these 2017 Transfer Pricing Guidelines may enhance the legal standing of the guidelines in some jurisdictions (this is already the case in the Netherlands), depending on how individual countries transpose the OECD Transfer Pricing Guidelines into national law.
- The 2017 Transfer Pricing Guidelines do not incorporate forthcoming OECD guideline changes to, a.o.:
  a) the profit split guidance contained in Chapter II. A revised discussion draft on this topic was released on June 22, 2017;
  b) related-party financial transactions, where the OECD announced that it would publish important new guidance for multinationals on intercompany loans, cash pooling, and reinsurance later this year or early 2018.

2017 edition changes

The four main areas where the 2017 Transfer Pricing Guidelines have been significantly revised as compared to the 2010 Transfer Pricing Guidelines are discussed below.

I. Significant revisions with new rules to combat BEPS by moving intangibles among group members, covering BEPS Actions 8, 9, 10 and 13

See also: https://meijburg.com/uploads/files/news/2015/10/BEPSfinal.pdf

OECD BEPS Action 8 – IP

With regard to intangibles, the 2017 Transfer Pricing Guidelines:

i. include a broad and clearly delineated definition of intangibles;
ii. stipulate that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
iii. include transfer pricing rules and special measures for transfers of hard-to-value intangibles; and
iv. contain an update of the guidance on cost contribution arrangements.

Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE)

A major new OECD issue here is that contractual arrangements will come under greater scrutiny and pressure as the location of key functional substance (i.e. key personnel) will increasingly take precedence over contractual entitlement (as well as financial capital and other assets) when allocating rewards as part of a transfer pricing analysis. Legal ownership alone does not determine entitlement to returns from the exploitation of intangibles. Associated enterprises performing important value-driving functions related to development, enhancement, maintenance, protection and exploitation of intangibles can expect appropriate remuneration. A group company assuming risks with respect to the development, enhancement, maintenance, protection and exploitation of intangibles must exercise control over the risks and have the financial capacity to assume these risks. If a group company only provides funding and does not exercise control over the financial risks, it is only entitled to a risk-free return. In the case of artificial IP structures, non-recognition of the transaction applies.

Hard-to-value-intangibles

The OECD acknowledges that it is difficult for a tax authority to evaluate the reliability of information used by a taxpayer to price a hard-to-value intangible (HTVI) , given the information asymmetry between tax authorities and taxpayers. A tax authority may thus consider ex post evidence about actual financial outcomes to gauge whether the ex ante price determined by the taxpayer is reasonable. Ex post evidence is only to be used in situations where the difference between ex ante projections and ex post outcomes is “significant” and where this difference is due to events that were foreseeable at the time of the transaction. Furthermore, ex post evidence cannot be used if the HTVI is covered by an APA, where the difference in compensation for the

HTVI is immaterial (not more than 20 percent) and under certain circumstances where a commercialization period of five years has passed.

On May 23, 2017, a discussion draft on the implementation guidance on HTVI was issued by OECD. Until June 30, 2017, interested parties were invited to comment on the proposed draft. This discussion draft lays down the principles of the implementation of the approach to HTVI and provides examples to illustrate the application of this approach. In addition, it addresses the interaction between the approach to HTVI and the mutual agreement procedure under applicable treaty.

2013 Dutch Transfer Pricing Decree

The 2013 Transfer Pricing Decree ("2013 Decree") seems to already anticipate with OECD developments. It remains to be seen which additions and/or changes will be made to the 2013 Decree. The following specific items are currently covered in the 2013 Decree:

HTVI

The 2013 Decree already includes some guidance on HTVI. Section 5 of the 2013 Decree uses the example of a situation where a new intangible asset has been developed and which new intangible asset is transferred to an associated enterprise at a time when its success is still not sufficiently visible. In this situation the valuation at the time of the transaction is highly uncertain, and a price adjustment clause may apply.

The following example is also used. An intangible asset is transferred to a (foreign) related entity where it is largely (for instance for more than 50 percent) licensed to the transferring Dutch entity and/or to related entities established in the Netherlands. In this situation, a price adjustment clause will be deemed to have been agreed unless the taxpayer convincingly demonstrates that: i) the transaction was business-motivated and ii) the valuation at the time the agreement was entered into can be determined to such an extent that independent parties would not have demanded a price adjustment clause.

Cost contribution arrangements (CCAs)

The 2013 Decree also covers guidance on CCAs, under which the amount of remuneration the participants in a CCA receive should not differ essentially from the remuneration that the respective parties would receive had they cooperated outside a CCA. According to the 2013 Decree, the relative share of each participant in the contributions to the CCA, as well as the relative share of that participant in the total expected benefits, should be determined on the basis of the value in the open market. The 2013 Decree states that if it is likely that the average relative added value of the individual performances contributed by the various participants to the CCA is approximately equal, taking the cost price of the contributions as a starting point for determining whether each party's share in the total expected benefits corresponds with each party's share in the contributions is in line with the arm's length principle. The 2017 Transfer Pricing Guidelines show that although cost can sometimes be used as a practical means to measure the relative value of current contributions, this is not always the case.

OECD BEPS Action 9 – functions and risks

The 2017 Transfer Pricing Guidelines include new guidance to combat BEPS by transferring risks among, or allocating excessive capital to, group members. There is new transfer pricing guidance and special measures to ensure that inappropriate returns will not accrue to an entity merely because it has contractually assumed risks or has provided capital. The new Transfer Pricing Guidelines also require returns to be aligned with value creation.

Impact of Action 9 for the Netherlands

The 2013 Decree already covers a number of issues related to aligning value creation with transfer pricing outcomes, which is closely linked to Action 9. More specifically, the 2013 Decree uses three examples to illustrate this issue:

Intangible fixed assets

This example describes the situation where an intangible fixed asset is transferred to a group entity that does not have the required functionality to manage the risks associated with the intangible fixed asset. Under the 2013 Decree, the transfer of assets to an acquiring group entity that has no added value is regarded as not being at arm’s length. Because the joint profit will not increase, the price offered by a potential purchaser will be less than the asking price of the potential vendor. The transfer of the asset will then not eventuate, as the transfer will also involve transaction costs.

Central purchasing within the group

It is a given fact that local independent procurement agents primarily provide supporting activities and are generally rewarded with a remuneration related to the purchase value. Their remuneration is generally based on the cost of the purchases. In practice, it appears difficult to find reliable comparables for a purchasing office that can be used to carry out a comparison based on a percentage of the cost of purchases. In such situations, under the 2013 Decree, generally a cost plus is expected as a test to assess the arm’s length nature of the remuneration. The cost base is limited to the purchasing office’s own operating costs, given the routine tasks it performs, but excludes the cost price of the purchases.

Internal insurance/reinsurance activities

In some cases internal insurers/reinsures lack the activities that are characteristic of a professional insurer/reinsurer, such as product development, marketing and sales, screening of potential policyholders, asset/liability management and developing an independent reinsurance policy. Nor do these group entities ‘actively’ diversify (i.e. outside the group) the risks run by the reinsurer in respect of the internal insurance/reinsurance activities; any diversification that takes place is ‘passive’, i.e. within the group. Two types of insurance/reinsurance activities are explained in more detail, i.e. the passive pooler and insurance as by-product. According to the Deputy Minister of Finance, these cases purely involve an administrative function that justifies no more than a limited payment.

OECD BEPS Action 10 – profit splits and low value-added services

The 2017 Transfer Pricing Guidelines include new rules to combat BEPS by engaging in transactions which would not, or only very rarely, occur between third parties. This includes rules to:

i. clarify the circumstances in which transactions can be re-characterized;
ii. clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains;
iii. provide protection against common types of base eroding payments, such as management fees and head office expenses.

Impact of Action 10 for the Netherlands

It remains to be seen whether additions and/or changes will be made to the 2013 Decree and what these comprise.

With respect to the remuneration of low value-adding services, the 2017 Transfer Pricing Guidelines explicitly refer to remuneration being net cost plus a 5% markup. Although the 2013 Decree provides guidance on supporting services, no specific markups are mentioned. Therefore, the 2013 Decree may need to be amended to reflect the 2017 Transfer Pricing Guidelines on these services.

OECD BEPS Action 13 – Transfer pricing documentation and country-by-country reporting

The Netherlands implemented this Action at the beginning of 2016.

As of January 1, 2016, parent companies of Dutch-resident multinationals with a turnover of at least EUR 750 million must file the new CbC report within 12 months of the fiscal year-end closing. The CbC reports may be filed in English or Dutch language. The Dutch CbC rules are generally in line with the OECD Transfer Pricing Guidelines and require taxpayers to disclose, per country, information on revenues, profit before income tax, corporate income tax paid, corporate income tax as included in the annual accounts, stated capital, accumulated earnings, number of employees, and tangible assets other than cash and cash equivalents.

Non-compliance

Non-compliance due to the intentional or gross negligent behavior of the reporting entity regarding its obligation to file the CbC report may incur a penalty up to a maximum of EUR 820,000 and/or criminal prosecution.

Master and Local File

For financial years commencing on or after January, 1, 2016, more stringent Dutch documentation requirements apply to entities that are tax-resident in the Netherlands and are part of a group with a consolidated turnover exceeding EUR 50 million. The group entity will be required to maintain a Master File that provides an overview of the MNE as a whole, including the nature of its activities, its general transfer pricing policy, and its global allocation of income and economic activities. A Local File also has to be

maintained that contains information relevant for the transfer pricing analysis of transactions between the taxpayer and related parties in other tax jurisdictions. An important requirement is that the Master File and the Local File must be part of the entity's accounts and records when the tax return has to be filed. This is a major change from past practice, where the taxpayer had to provide transfer pricing documentation within two months of a formal request by the Dutch tax authorities. Non-compliance with the documentation requirements results in the reversal of the burden of proof.

See also: https://meijburg.nl/nieuws/netherlands-to-adopt-beps-action-13-based-country-by-country-reporting-and-documentation-requirements

II. The revisions to Chapter IX to ensure the guidance on business restructurings is in accordance with the revisions introduced by the 2015 reports on BEPS Actions 8-10 and 13

Practical implications for the Dutch practice

In reviewing cross-border internal business restructurings, taxpayers need to be prepared to respond to the following four questions:

- What is the underlying business rationale behind the restructuring?
- Will something of value be transferred and are risk-bearing functions actually transferred?
- Can functional analyses of the taxpayer before and after the reorganization be provided (along with a factual comparison of them)?
- What other options were realistically available to the taxpayer at the time it entered into the transaction(s)?

Tax authorities may also request an assessment of the financial impact of the business restructuring, pre- and post-conversion. This may include a valuation of the transferred assets, risks and/or functions, and an indemnification in the case of contract termination. Tax authorities generally also review the treatment of reorganization and closure costs of business restructurings and the underlying rationale.

III. The revised guidance on safe harbors in Chapter IV

This guidance:

a) provides opportunities for countries to offer relief from compliance burdens and greater certainty for situations involving smaller taxpayers or less complex transactions;
b) provides a basis for countries – especially developing countries – to develop a transfer pricing compliance environment that makes the best use of the limited resources available.

This guidance is not likely to have an immediate impact on the Netherlands, with the exception of the abovementioned guidance on markups on low value-added services.

IV. Consistency changes that were needed in the rest of the OECD Transfer Pricing Guidelines to produce this consolidated version

The 2017 Transfer Pricing Guidelines also include the revised recommendation by the OECD Council on the Determination of Transfer Pricing between Associated Enterprises. This recommendation reflects the need to address BEPS and the establishment of the "inclusive framework" on BEPS. Among other things, this is to ensure that developing and emerging economies that are not OECD members or members of the G20 are able to adopt the BEPS project outcomes.

Meijburg & Co
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The information contained in this memorandum is of a general nature and does not address the specific circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.