International Fiscal Association

The Theory and Practice of Transfer Pricing: Past, Present and Future

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IFA Canada Lectureship Series

Agenda

General Overview

- What is transfer pricing?
  - Generally, income allocation in cross-border context
  - Other contexts – cross-taxpayer context
- What is the purpose of transfer pricing?
  - Neutral income measurement
  - Anti-avoidance
  - Principle of international law – EU State Aid proceedings
- What is the status of the OECD TP Guidelines?
  - Consensus-based general guidance
  - Legal status?
    - In general
    - Canada-US Treaty context (Annex A & B (9): “OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment” and dispute resolution)

General Overview

Collateral but important issues

- Residence
- PE Issues
- Net vs Gross Basis Taxation
- CFC Treatment

General Overview

- Is transfer pricing fundamentally flawed?
  - Critical impressions from various corners
  - OECD Comments
- Is transfer pricing reasonably reliable?
- Is transfer pricing efficiently administrable?
- Is this getting better/easier or worse/harder?
  - Global value chains
  - Outsourcing
  - E-commerce
  - Tax Information Sharing & Administrative Assistance
  - Country-by-Country Reporting

General Overview

- Alternative Approaches?
  - Formulary apportionment
  - Destination-based (Border Adjusted) cash flow taxes
  - Diverted Profits Taxes
  - Consumption taxes
  - Hybrid regimes
- Special measures?
  - BEPS measures / Special TP rules – safe harbours
  - Thin-capitalization rules / base erosion rules
  - Anti-Inversion Regimes

General Overview

2010 TP Guidelines

I. The Arm's Length Principle

II. Transfer Pricing Methods

III. Comparability Analysis

IV. Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes

V. Documentation

VI. Special Considerations for Intangible Property

VII. Special Considerations for Intra-Group Services

VIII. Cost Contribution Agreements

IX. Transfer Pricing Aspects of Business Restructurings

General Overview

2010 PE Attribution Report (“AOA”)

- Determination of Functions, Assets and Risks based on Functional Analysis
- Economic Ownership of Assets and Attribution of Risks based on Significant People Functions

General Overview

Functional Analysis

- FAR
  - Functions
  - Assets
  - Risks
- KERT
  - Key
  - Entrepreneurial
  - Risk-Taking (functions)
- SPF
  - Significant
  - People
  - Functions
- DEMPE
  - Development
  - Enhancement
  - Maintenance
  - Protection
  - Exploitation
- RACI
  - Responsible
  - Accountable
  - Consulted
  - Informed

General Overview

Pricing Methods

- Traditional Transaction Methods
  - Comparable uncontrolled price (CUP)
  - Resale price method
  - Cost plus method
- Transactional Profit Methods
  - Transactional net margin method (TNMM)
    - relationship between net profit and an appropriate base
    - such as costs, sales or assets
  - Profit split methods
    - Contribution analysis
    - Residual analysis

General Overview

Profit (Level) Indicators

- Return on capital employed (assets – ROCE)
- Return on sales (operating margin – ROS)
- Return on operating costs (Berry Ratio)

General Overview

Comparables

- Internal – comparable transactions of the same MNE
- External – comparable transactions of another MNE
- Some issues
  - Are transactions ever really comparable?
  - Adjustments
  - Secret comparables
  - Analogous comparables
    - JVs in connection with Profit Split Method
    - M&A transactions in connection with IP
    - Investment management services
    - Management consulting services
    - Marketing services
    - Fundamental capital vs labour economic split

General Overview

Richard Vann (*Taxing International Business Income: Hard-Boiled Wonderland and the End of the World* (2010 World Tax Journal 291):

- The firm (based on Ronald Coase's *The Theory of the Firm* (1937)) exists for the very purpose of capturing returns not available from market transactions, through the coordinated direction of resources.
  - Transfer pricing rules permit corporations to structure intra-firm contracts as they wish on an inappropriate market analogy. Freedom of contract thus often means that profit allocation is a matter of choice for firms.
  - The current rules place too much emphasis on risk and not enough on other factors in dividing up international tax revenue.
  - Current rules defining the tax presence of a corporation in a country are too narrow.
- Formulary apportionment has become more problematic in practice over the years for a variety of reasons.
- The profit split is a much more flexible apportionment methodology that tries to reflect the actual position of the firm.
- CFC rules may also be a useful approach to addressing the attribution of income to low-tax entities.

General Overview

OECD (BEPS Action 8-10 Final Reports)

As the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) identified, the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation.

The arm's length principle is used by countries as the cornerstone of transfer pricing rules. […] The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group. Therefore, the BEPS Action Plan required the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresaw the possibility of introducing special measures either within or beyond the arm's length principle.

Historical Review

Historical Review

<u>1917 Transfer Pricing Rule</u>

Purpose:

- Exchange between Finance Minister White and Sir Wilfrid Laurier

Specifics:

- Restricted to corporations
- Not restricted to cross-border dealings
- Transactions at less than “fair price”: one-way only
- Restricted to “products” and “goods and commodities”

Historical Review

<u>1924 Amendments — Highlights</u>

- Purchases at a price in excess of fair market price
- Sales at a price less than fair market price
- Rule now two-way
- Rule restricted to "commodities"
- Mention made of "associated" corporation – undefined

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- Introduction of (i) extended meaning of "carrying on business in Canada" and (ii) agency rule
- "Proportionate share" of any profit from sale outside Canada taxable
- No allocation methodology prescribed

Historical Review

League of Nations: Selected Developments

- Thomas Adams: Why Multilateral Approach preferable
- Carroll Report, 1933
- Draft Multilateral Convention on Allocation of Business Profits, 1935
- Mexico Model Treaty, 1940
- 1963 OECD Model Convention
- "The important fact is that [the] principles [of the Draft Multilateral Convention] passed via the Mexico Model into the U.S.-Canada Treaty of 1942, and thence into all the other treaties to which the U.S. became a party. The principles were adopted as well by other states." – Mitchell Carroll

Historical Review

Multilateralism

"Now, in the long run, whatever solutions are adopted by different pairs of nations, it is probable that Nation A in conducting a bilateral convention with Nation B will adopt some solution different from that which it might adopt in a similar treaty with Nation X. And if this piece-meal bargaining goes on for twenty years or more, as it is likely to go on, it may possibly result in a tangle of conflicting solutions applicable to the nationals of different countries, which will be highly complicated and highly mysterious, and about as bad as the situation that now exists. **In short, there is in my mind, looking to the longer future, the strongest reason for the adoption of one uniform solution, if we can get it, or the settlement of this problem by a multilateral convention, in which a large group of nations would adopt the same solutions for the detailed problems which have to be settled.**"

- Professor Thomas Adams, 1929 National Tax Association speech

Historical Review

Some Key Quotes: Carroll Report

"Through the arbitrary fixation of inter-establishment billing prices or charges for interest, royalties, services, etc., **profits can be shifted from place to place**, the purpose being to transfer them to the country with a low rate of tax or no income tax at all."

Historical Review

Some Key Quotes: Carroll Report (cont'd)

"Because of legal requirements of expediency, or merely to facilitate the segregation of activities within the country, foreign enterprises often form a subsidiary company. … [A]lthough many large enterprises scrupulously treat such subsidiary companies **as independent entities**, it is the practice of others to regard them **in fact as mere branches** of the entire enterprise and to incorporate their earnings in the annual accounts of the entire enterprise, just as if they accrued directly to it."

Historical Review

Some Key Quotes: Carroll Report (cont'd)

"Tax collectors complain that sometimes enterprises take the different rates of taxes in various countries into consideration, and fix the transfer price from the factory to a selling establishment at so high a figure as to show little or no profit in the books of the sales branch."

Historical Review

Canada's Submission to Carroll Report

"There is no statutory provision enacting any formula for apportionment of income arising within Canada, nor have any regulations been issued adopting a separate accounting method, empirical method, method of fractional apportionment or any other method.

The Minister has full discretion when determining the income from Canadian sources to adopt any method that the particular facts of the case, having regard to the nature of the business, would warrant."

R. Fraser Elliott Sr., Commissioner of Income Tax, Department of National Revenue

Historical Review

Separate Entity v. Unitary Method

- Did Carroll Report misstate/overstate the international consensus in favour of the "Separate Entity" approach?
- Stanley I. Langbein, *"The Unitary Method and the Myth of Arm's Length"*, Tax Notes, Feb. 17, 1986

Historical Review

US Origins of “Arm’s Length Terminology”

- Mitchell Carroll: Term in current use in 1920’s at US Treasury
- Mixed US Terminology as late as 1960’s

Historical Review

Subsequent Amendments — 1934-1943

- 1934: cross-border advances / original “Section 17”
- 1939: “unreasonable” NAL payments “for use … or for any right” may be “adjusted” by Minister; not applicable if payer and recipient “not associated, controlled one by the other, or controlled by the same interests”
- 1943: transfer pricing rule extended to individuals and partnerships

Historical Review

<u>1942 Canada-US Convention</u>

Transactions reviewable in light of “values which would prevail between independent persons dealing at arm’s length” – Separate Entity Approach

<u>1946 Canada-UK Convention</u>

Arm’s length standard not expressly referenced

Profit allocation adjustable in light of “commercial or financial” relations existing between “independent enterprises” – Separate Entity Approach

Historical Review

Administrative v. Judicial

- Minister's power originally administrative:
  - "fair price"
  - "proportionate part"
  - NAL "adjustment"
  - Cross-border advances
- 1948 shift to judicial standard

Historical Review

1948 Tax Reform — Highlights

- Subsections 17(3) and (4) enacted (renumbered as subsections 69(2) and (3) in 1972 Tax Reform)
- Arm's length standard specifically legislated — applicable generally

Historical Review

<u>1952 Amendments — Highlights</u>

- The “reasonable amount” in the circumstances
- Services included

Historical Review

<u>1971 Tax Reform</u>

- *Status quo:* subsections 69(2) and (3)
- Taxation of capital gains
- Thin-capitalization rules
- Existing CFC system replaced by Foreign Affiliate Rules
  - FAPI
  - Base Company Rules

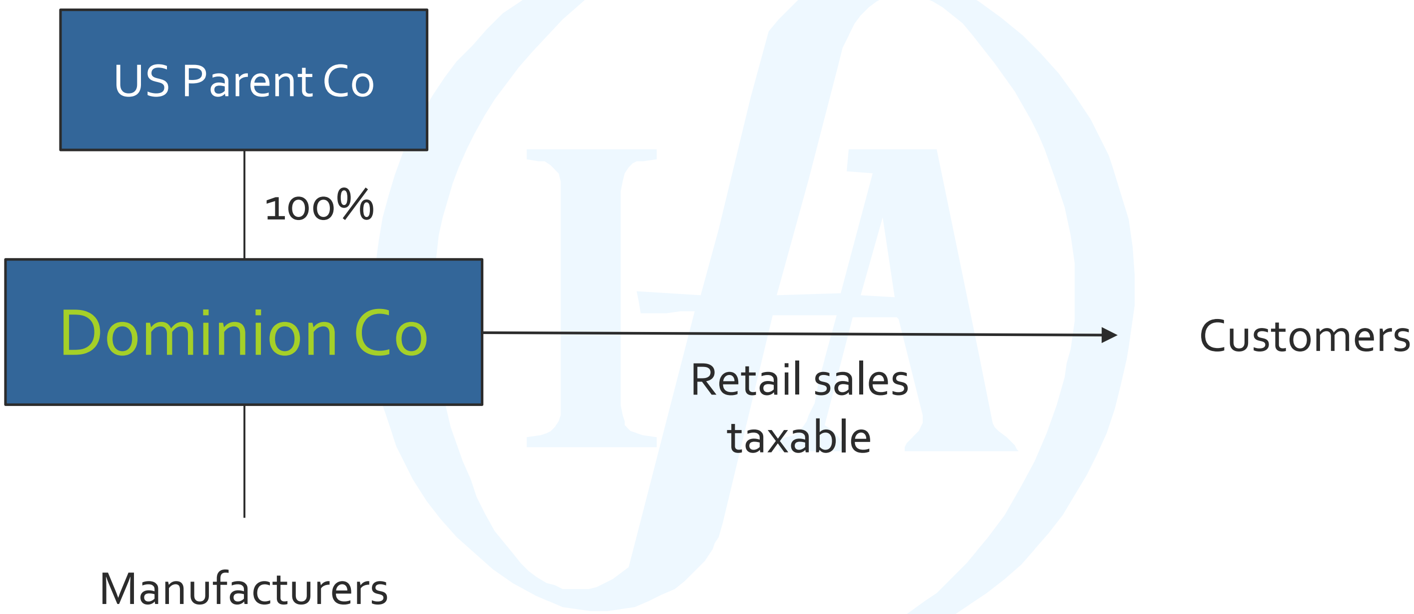
Historical Review

NAL Approach to Tax Avoidance

- The King v. Colgate-Palmolive-Peet Co. Ltd. [1933] S.C.R. 131
- Stubart Investments, 84 DTC 6305; [1984] CTC 294 (SCC) – capital owner with no functions
- Swiss Bank Corp. v. M.N.R. [1974] S.C.R. 1144

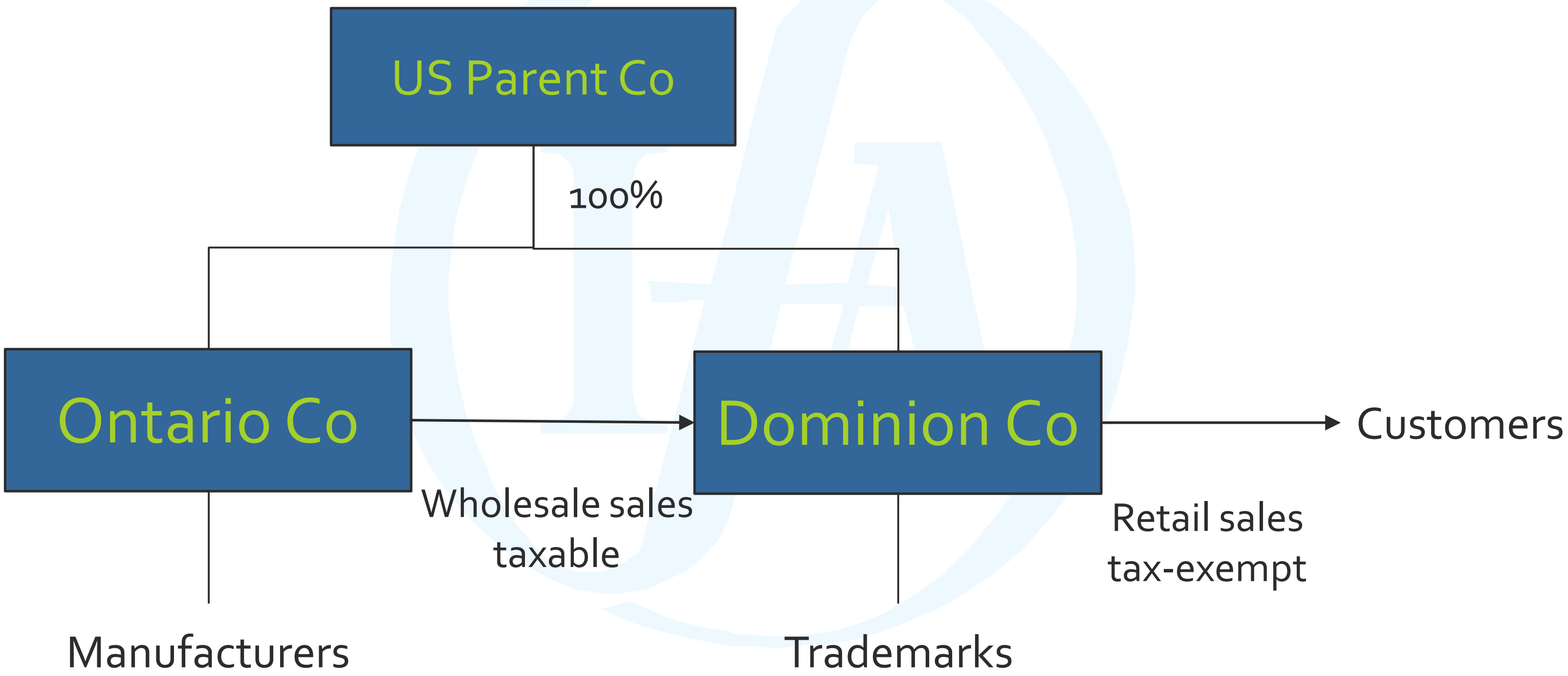
Historical Review

Colgate-Palmolive: Original Structure



Historical Review

Colgate-Palmolive: "Departmentalization" Structure



Historical Review

Unanimous Judgment SCC

Judgment delivered by Cannon, J.:

"Avoiding the incidence of taxation is one of the reasons mentioned for the incorporation of the Ontario company, and it is claimed that, by this incorporation in 1924 of a manufacturing company, the price arranged between this unit of the organization with the older company which continued to sell to the public, is the real price of the goods produced or manufactured by them and is, legally, the basis of the sales tax payable by this producer."

"I believe that the character and substance of the real transaction must, for taxation purposes, be ascertained and the tax levied on that basis."

"While the two companies are separate legal entities, yet in fact, and for all practical purposes, they are merged, the Ontario company being but a part of the Dominion company, acting merely as its agent and subject in all things to its proper direction and control."

Historical Review

OECD Developments

- UN replaces League of Nations 1945-46
- Fiscal Portfolio assumed by OEEC/OECD in 1950's
- OECD 1979 Guidelines
- OECD 1995 Guidelines

Historical Review

1997 Budget – Supplementary Information

"Canadian transfer pricing law and administrative practices are based on principles developed by the Organization for Economic Co-operation and Development (OECD). After a thorough review of existing guidelines published in 1979, the OECD issued revised guidelines in 1995 which updated the existing international standard in this area. The fundamental reference point for this standard is the "arm's length principle," the yardstick used to ensure that prices charged between related parties on cross-border transactions correspond to those that would have been charged between unrelated parties. **This standard protects the tax base against the shifting of income that can potentially occur from the discretionary determination of transfer prices on transactions made between related parties situated in different countries**."

Historical Review

1997 Budget – Supplementary Information (continued)

"The international adherence by all industrialized countries to a common standard also prevents the double taxation of profits of multinational enterprises by two or more tax jurisdictions and, consequently, promotes international trade. […]

In view of the above, the government will shortly propose changes to the *Income Tax Act* that will pursue the following objective:

- To harmonize the standard contained in section 69 of the Act with the arm's length principle as defined in the revised OECD guidelines and ensure that, in selecting the most appropriate pricing method, all the various methods described in the OECD guidelines are available to taxpayers; ..."

Revised Guidance Under BEPS Measures

Revised Guidance Under BEPS Measures

- OECD Transfer Pricing Guidelines (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010)
- 2010 Report on the Attribution of Profit to Permanent Establishments
- BEPS Reports
  - BEPS Actions 8-10 Final Reports (2015)
  - 2016 Discussion Draft – Revised Guidance on Profit Splits (Actions 8-10)
  - 2016 Discussion Draft – Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines ("Transfer Pricing Aspects of Business Restructurings)
  - 2014 Discussion Draft – Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)
  - 2016 Discussion Draft – Additional Guidance on the Attribution of Profits to Permanent Establishments (Action 7)
  - BEPS Action 4 Final Report (2015)
  - 2016 Action 4 Update – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
  - BEPS Action 5 Final Report (2015)
  - BEPS Action 3 Final Report

Revised Guidance Under BEPS Measures

BEPS Actions 8-10: Guidance for applying the Arm's Length Principle

- Revisions to Section D of Chapter I of the Transfer Pricing Guidelines
  - Identifying the commercial or financial relations
  - Recognition of the accurately delineated transaction
  - Losses
  - The effect of government policies
  - Use of customs valuations
  - Location savings and other local market features
  - Assembled work force
  - MNE Group Synergies
- Commodity Transactions
- Guidance on the Transactional Profit Split Method (NB 2016 Discussion Draft)
- Intangibles (NB 2016 Action 4 work on FIs)
- Low Value-Adding Intra-Group Services
- Cost Contribution Agreements

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization

The guidance "ensures" that:

- Actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality.
- Contractual allocations of risk are respected only when they are supported by actual decision-making. To assume a risk for transfer pricing purposes, the associated enterprise needs to control the risk and have the financial capacity to assume the risk.
- Capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance.
- Legal ownership (and funding) alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible.
- Tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply. The mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised.
- It will no longer be possible to allocate the synergistic benefits of operating as a group to members other than the ones contributing to such synergistic benefits.
- The goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports – General

The revised guidance includes two important clarifications relating to risks and intangibles.

- Risks are defined as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion that higher risks warrant higher anticipated returns made MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations. In order to address this, the Report determines that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports – General

- For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Specific guidance will ensure that the analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

- The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports – General

Finally, the guidance ensures that pricing methods will allocate profits to the most important economic activities. It will no longer be possible to allocate the synergistic benefits of operating as a group to members other than the ones contributing to such synergistic benefits. For example, discounts that are generated because of the volume of goods ordered by a combination of group companies will need to be allocated to these group companies. As part of the Report, a mandate is included for follow-up work to be done on the transactional profit split method, which will be carried out during 2016 and finalised in the first half of 2017. This work should lead to detailed guidance on the ways in which this method can usefully and appropriately be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports – General

The guidance is linked in a holistic way with other Actions. As mentioned above, this guidance will ensure that capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits. The profits the cash box is entitled to retain will be equivalent to no more than a risk-free return. Moreover, if this return qualifies as interest or an economically equivalent payment, then those already marginal profits will also be targeted by the interest deductibility rules of Action 4. In addition, it will become extremely difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance provided on preventing treaty abuse (Action 6). Finally, a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). With that, the holistic approach provided by the BEPS Action Plan will secure that the role of cash boxes in BEPS strategies is seriously discouraged.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports – General

The work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes better align with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle. Further work will be undertaken on profit splits and financial transactions. Special attention is given in the Report to the needs of developing countries. This new guidance will be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting in developing countries. Finally, the interaction with Action 14 on dispute resolution will ensure that the transfer pricing measures included in this Report will not result in double taxation.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization

The assumption of risk by a party to a transaction can significantly affect the pricing of that transaction at arm's length. The revisions expand the guidance on identifying specific risks and their impact, and provide an analytical framework to determine which associated enterprise assumes risk for transfer pricing purposes. To assume a risk for transfer pricing purposes, the associated enterprise needs to control the risk and have the financial capacity to assume the risk.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization

1.98 If it is established in step 4(ii) that the associated enterprise assuming the risk based on steps 1 – 4(i) does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control. The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

- Contrast Vann's perspective on profit splits based on relative contribution instead of finding SPF or most SPF

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization

1.99 In exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. An assessment of the commercial rationality of the transaction based on Section D.2 may be necessary.

- Is it true that it is not likely among ALP for one party to have financial capacity and the other to have skill to control risk?
- Does this suggest recharacterization where there is an AssetCo and a ServiceCo?

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization

Finally, the guidance helps to accurately determine the actual contributions made by an associated enterprise that solely provides capital. Where the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated enterprise should expect no more than a risk-free return.

See also Example 3 in paragraph 1.85, and paragraph 1.103 (asset owner gets risk-free return).

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization

Ordinarily the actual arrangements should then be priced in accordance with guidance provided in other chapters of the Transfer Pricing Guidelines. However, the revisions in this chapter reinforce the need for tax administrations to be able to disregard transactions between associated enterprises when the exceptional circumstances of commercial irrationality apply. The guidance emphasises that the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Instead, the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Delineation & Recharacterization – Investment Management Services

1.70 Assume that an investor hires a fund manager to invest funds on its account. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make portfolio investments on behalf of the investor on a day-to-day basis in a way that reflects the risk preferences of the investor, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through four relevant decisions: the decision about its risk preference and therefore about the required diversification of the risks attached to the different investments that are part of the portfolio, the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage. Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (e.g. to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk. This illustrates the fact that an investor who gives to another person the authority to perform risk mitigation activities such as those performed by the fund manager does not necessarily transfer control of the investment risk to the person making these day-to-day decisions.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Intangibles

Under this guidance, members of the MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles. Tax administrations are given new tools to tackle the problem of information asymmetry to assist in determining the appropriate pricing arrangements for intangibles, and valuation techniques are recognised as useful tools when pricing transactions involving intangibles.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Intangibles

The framework for analysing risks contained in the chapter "Guidance on Applying the Arm's Length Principle" depends on a very specific and meaningful control requirement, which takes into account both the capability to perform relevant decision-making functions together with the actual performance of such functions. <u>If an associated enterprise contractually assuming a specific risk does not exercise control over that risk nor has the financial capacity to assume the risk, then the framework contained in the chapter "Guidance on Applying the Arm's Length Principle" determines that the risk will be allocated to another member of the MNE group that does exercise such control and has the financial capacity to assume the risk</u>. This control requirement is used in this chapter to determine which parties assume risks in relation to intangibles, but also for assessing which member of the MNE group in fact controls the performance of outsourced functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Intangibles

The guidance refers to the treatment of the return to funding contained in the chapter "Guidance on Applying the Arm's Length Principle", and ensures that funding of the development, enhancement, maintenance, protection or exploitation of an intangible by an entity that does not perform any of the important functions in relation to the intangible and does not exercise control over the financial risk will generate no more than a risk-free return.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Intangibles – HTVI

In relation to arm's length pricing when valuation is highly uncertain at the time of the transaction, the guidance recognises that third parties may adopt different approaches for taking account of uncertainties that are relevant for the value of an intangible, including to conclude a contract based on contingent payments dependent on the actual results achieved. The guidance also takes into account that, because of information asymmetries, it proves difficult for a tax administration to evaluate the reliability of the information on which the taxpayer priced the transaction, especially in relation to intangibles with a highly uncertain value at the time of the transfer. To address these challenges, an approach to pricing hard-to-value intangibles has been developed which allows the taxpayer to demonstrate that its pricing is based on a thorough transfer pricing analysis and leads to an arm's length outcome, while the approach at the same time protects the tax administrations from the negative effects of information asymmetry. It does so by ensuring that tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, and the taxpayer cannot demonstrate that the uncertainty has been appropriately taken into account in the pricing methodology adopted. Guidance on the implementation of this approach will be provided during 2016, and the practical application of the exemptions, including the measurement of materiality and time periods contained in the current exemptions, will be reviewed by 2020 in the light of further experience.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

MNE Group Synergies

1.158 Paragraph 7.13 of these Guidelines suggests that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant. Consistent with this general view of benefits incidental to group membership, when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

MNE Group Synergies

1.159 In some circumstances, however, synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

MNE Group Synergies

1.162 If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party co-ordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes.

Revised Guidance Under BEPS Measures

BEPS Action 8-10 Final Reports

Cost Contribution Arrangements

Contributions made to a CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to non-arm's length results.

Example 5 (Annex):

21. The facts are the same as in Example 4 except that the functional analysis indicates Company A has no capacity to make decisions to take on or decline the risk-bearing opportunity represented by its participation in the CCA, or to make decisions on whether and how to respond to the risks associated with the opportunity. It also has no capability to mitigate the risks or to assess and make decisions relating to the risk mitigation activities of another party conducted on its behalf.

22. In accurately delineating the transactions associated with the CCA, the functional analysis therefore indicates that Company A does not control its specific risks under the CCA in accordance with the guidance in paragraph 8.15 and consequently is not entitled to a share in the output that is the objective of the CCA.

Revised Guidance Under BEPS Measures

<u>2016 Discussion Draft – Revised Guidance on Profit Splits</u>

1. [2.108] This section provides guidance on the selection and application of the transactional profit split method as the most appropriate method (see paragraph 2.2). The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) by <u>determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions</u>. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged ("the combined profits"). References to "profits" should be taken as applying equally to losses. See section C.4.2 for guidance on how to determine the profits to be split. It then splits those combined profits between the associated enterprises on an economically valid basis that <u>approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length</u>. See section C.4.4 for guidance on how to split the combined profits.

Revised Guidance Under BEPS Measures

2016 Discussion Draft – Revised Guidance on Profit Splits

9. […] In accordance with the guidance in Section D of Chapter I, such an outcome would only be consistent with the accurate delineation of the actual transaction in cases where the economically significant risks associated with the outcomes of the business activities are controlled, either separately or collectively, by the parties sharing in the actual profits, and each party has the financial capacity to assume its share of the risks.

10. […] In examining arrangements between associated enterprises, it may be difficult for a tax administration to determine whether the accurately delineated transaction represents, for example, a fee arrangement, or is an arrangement in which two or more associated enterprises share economically significant risks, such that they should split the unanticipated, actual profits arising from their combined activities. […] It would be contrary to the guidance in Section D of Chapter I to apply a transactional profit split of actual profits where the functional analysis demonstrates that one party does not exercise any degree of control over those risks, since to do so would assign to that party the impact of risks it does not control.

Revised Guidance Under BEPS Measures

2016 Action 4 Update – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

The amount of intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules. Revisions to Chapter I of the Transfer Pricing Guidelines under Actions 8-10 of the BEPS Action Plan (OECD, 2013), contained in the OECD Report *Aligning Transfer Pricing Outcomes with Value Creation* (OECD, 2015), limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided and require group synergies to be taken into account when evaluating intragroup financial payments. Further work on the transfer pricing aspects of financial transactions will be undertaken during 2017.

Revised Guidance Under BEPS Measures

2014 Discussion Draft – Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)

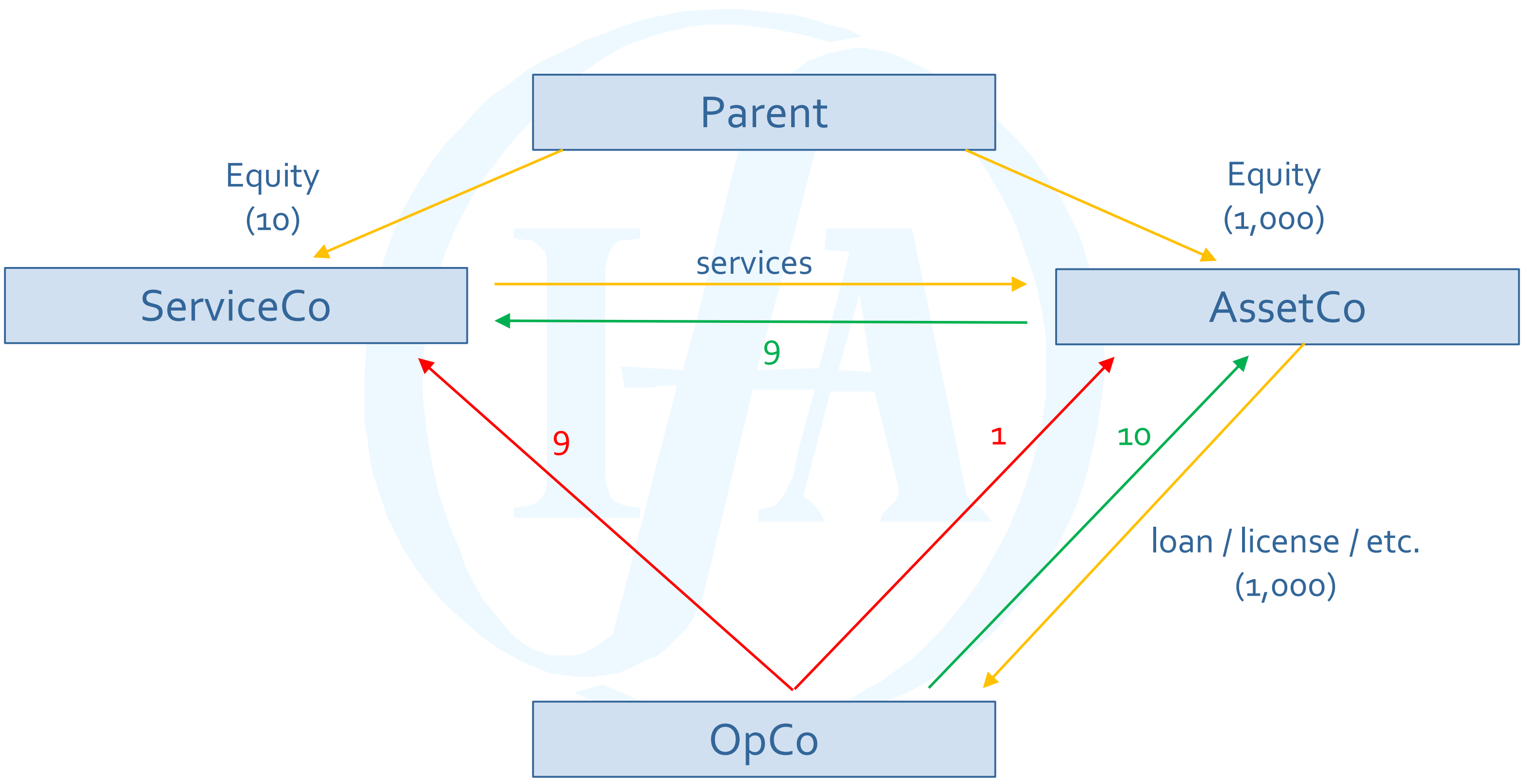
Part II – Potential Special Measures

- Option 1: Hard-to-value intangibles (“HTVI”)
- Option 2: Independent investor
- Option 3: Thick capitalisation
- Option 4: Minimal functional entity
- Option 5: Ensuring appropriate taxation of excess returns

Revised Guidance Under BEPS Measures

Reduction of Return

Gross vs. Net?



Revised Guidance Under BEPS Measures

2016 Canadian Federal Budget

The recommendations arising from the BEPS project include revisions to the Transfer Pricing Guidelines. These revisions provide an improved interpretation of the arm's length principle, and are intended to better ensure alignment of the profits of MNEs with the economic activities generating those profits. The clarifications provided in the revisions generally support the Canada Revenue Agency's current interpretation and application of the arm's length principle, as reflected in its audit and assessing practices. These revisions are thus being applied by the Canada Revenue Agency as they are consistent with current practices.

In two areas, however, where the revisions to the Transfer Pricing Guidelines are not yet complete, the Canada Revenue Agency will not be adjusting its administrative practices at this time. The BEPS project participants are still engaged in follow-up work on the development of a threshold for the proposed simplified approach to low value-adding services. Work is also continuing to clarify the definition of risk-free and risk-adjusted returns for minimally functional entities (often referred to as "cash boxes"). Canada will decide on a course of action with regards to these measures after the outstanding work is complete.

Revised Guidance Under BEPS Measures

Functional Analysis

- Delineation – "for transfer pricing purposes"
  - Legal form?
  - Legal substance?
  - Economic substance?
  - Functions ("control functions" in respect of FAR)?
- Recharacterization
  - Transactions not observed between arm's length parties
    - Not necessarily problematic
    - Condition for recharacterization?
  - Tax-motivated transactions
    - Should this be relevant?
    - Income measurement vs. anti-avoidance?
- Pricing vs Profit Sharing
  - Transaction-focussed
  - Profit-focussed

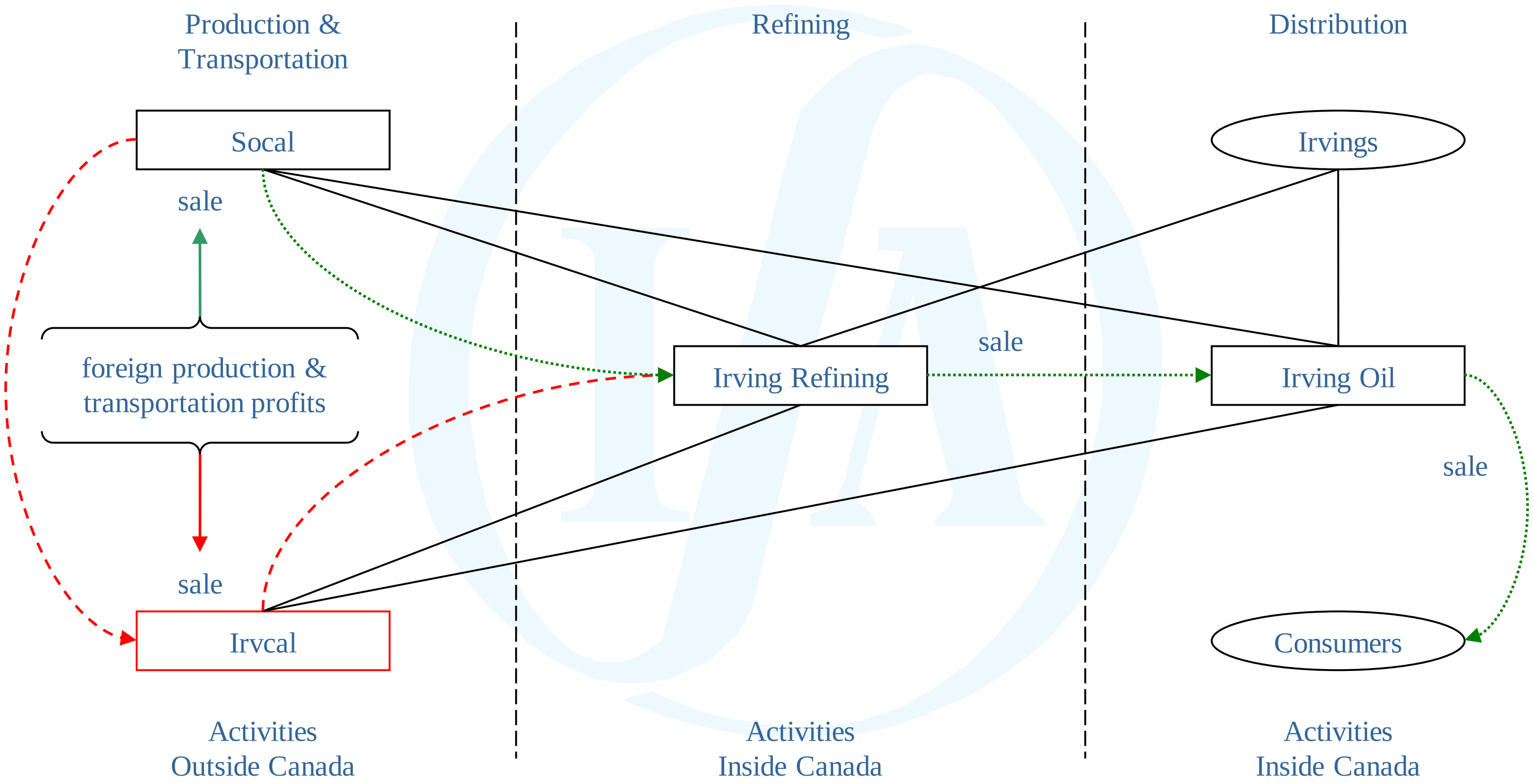
Revised Guidance Under BEPS Measures

Price vs. Participation

- Pricing at cost vs. value
- Price vs. Participation
  - Anticipated vs Actual profits
    - Anticipated is price – can be paid at once or over time
    - Actual is participation
  - No hindsight – But why not?
- Participation in equity or contractual instrument
  - This is exactly why we have CFC & Base Erosion rules
  - Can say the same for transfer of cash as IP, etc.
- Fixed vs. participating equity
- Irving Oil: arm's length equity-based actual profit split arrangement.

Revised Guidance Under BEPS Measures

Irving Oil



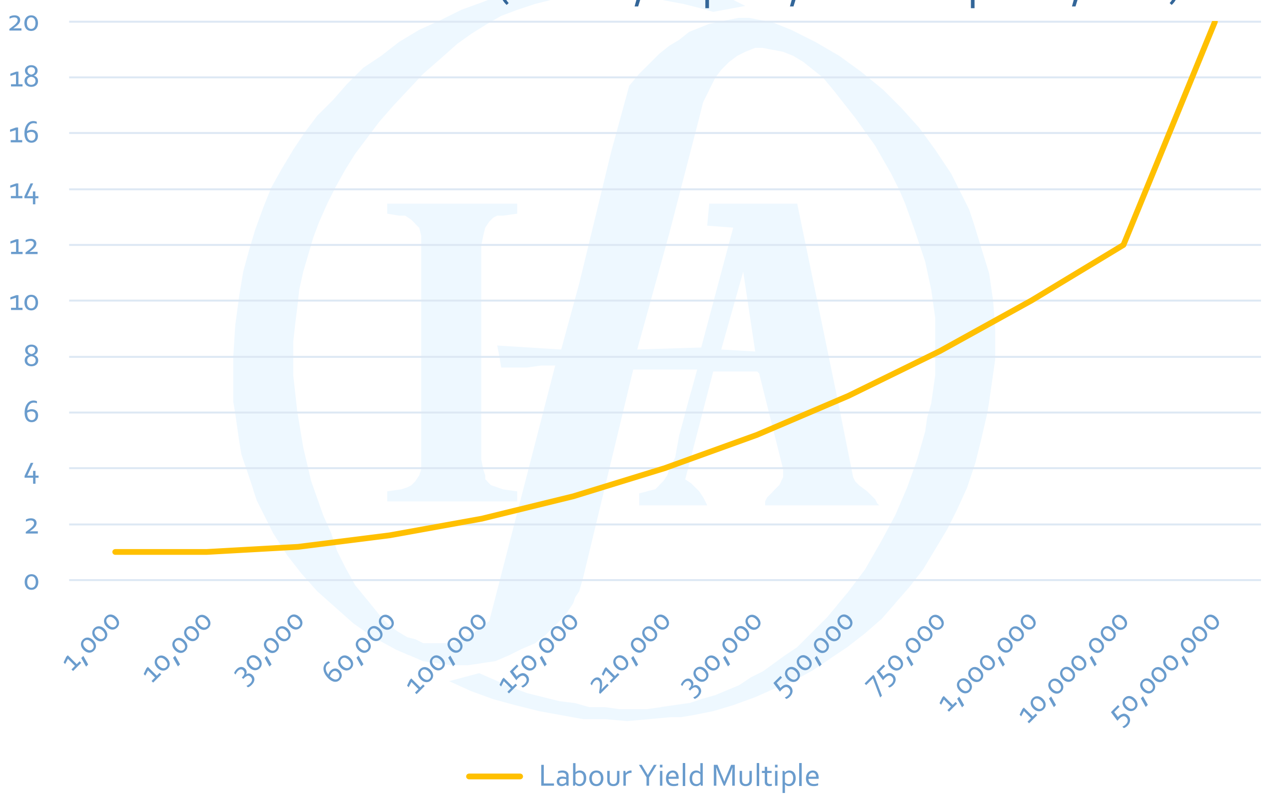
Labour Yield

Labour Yield

- We're used to talking about capital yield
- What about labour yield?
- Thesis:
  - Rate of risk and return from combining labour with capital (including intangibles) is logarithmic
- Observations
  - Reflects fundamental attribution of economic risk and return between capital owner and service provider
  - Affects attribution between DAE and DAPE
  - Affects attribution between capital-rich entities and service providing entities
  - No fundamental difference between low value-adding services vs. high value-adding services

Labour Yield Curve

Labour Yield depends on skill (creative, analytical, risk management, strategic vision, relationships, etc.) and market conditions (labour, capital, consumption, etc.)

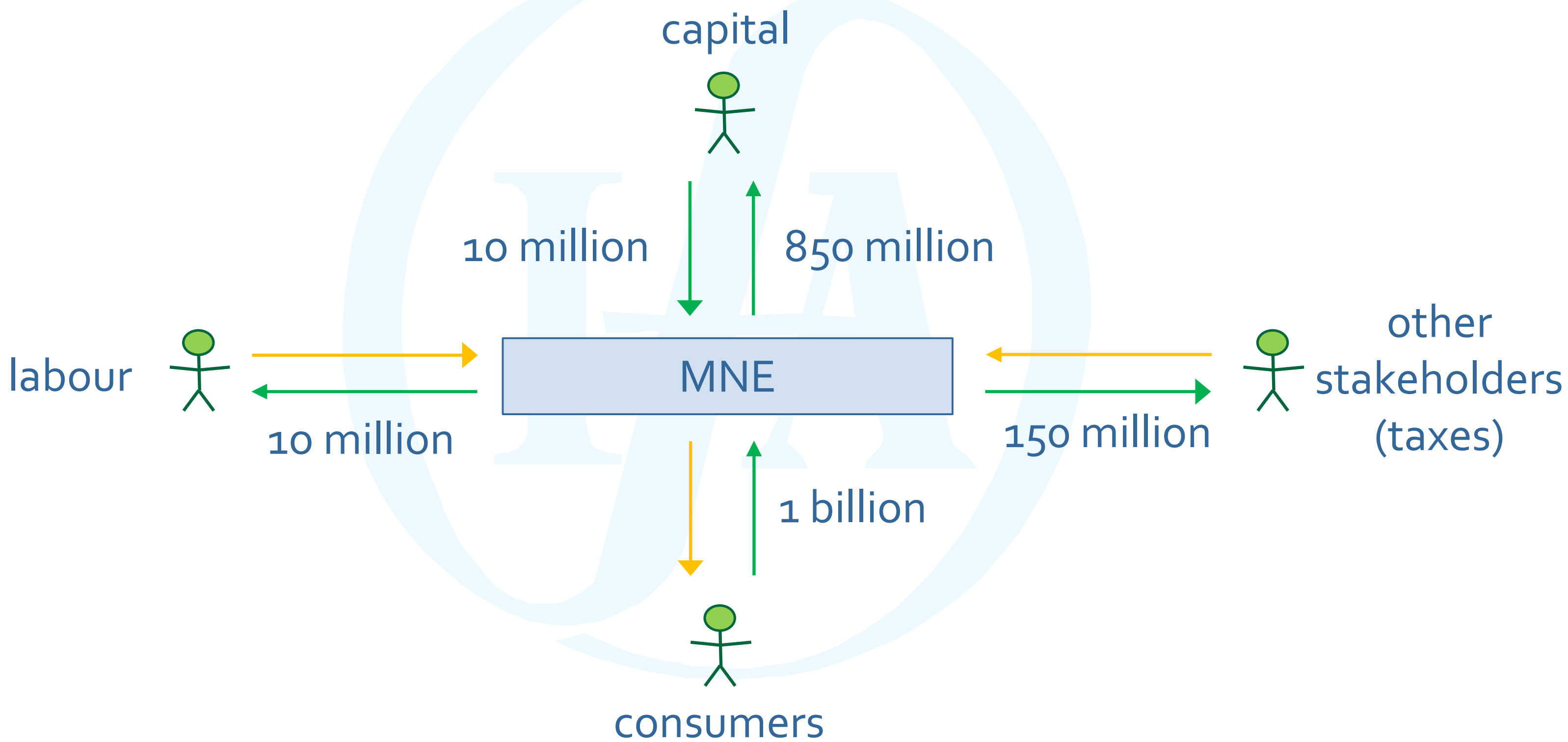


* Figures arbitrarily selected for illustrative purposes

Labour Yield Attribution

Fundamental attribution of economic risk and return between capital owner and service provider

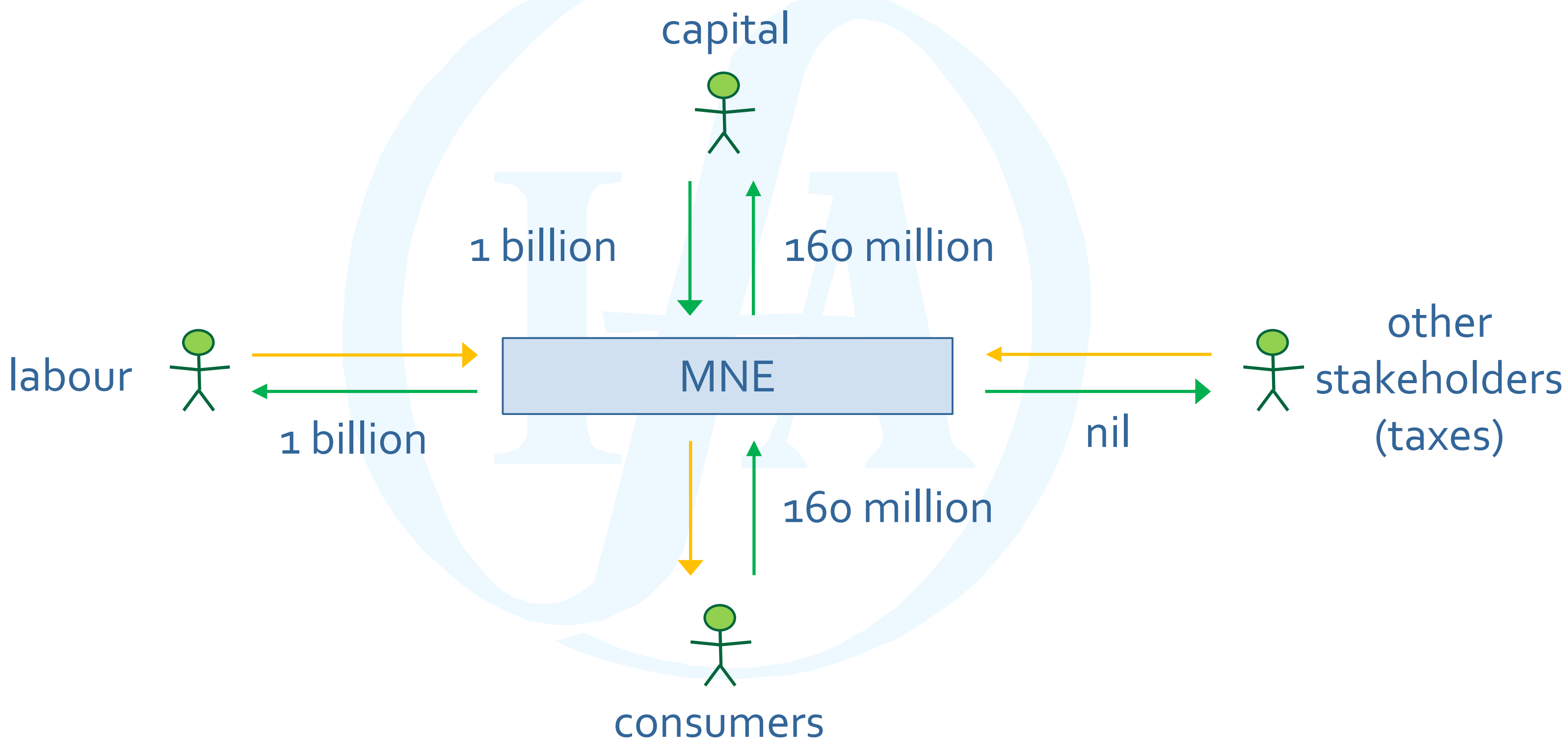
Profit



Labour Yield Attribution

Fundamental attribution of economic risk and return
between capital owner and service provider

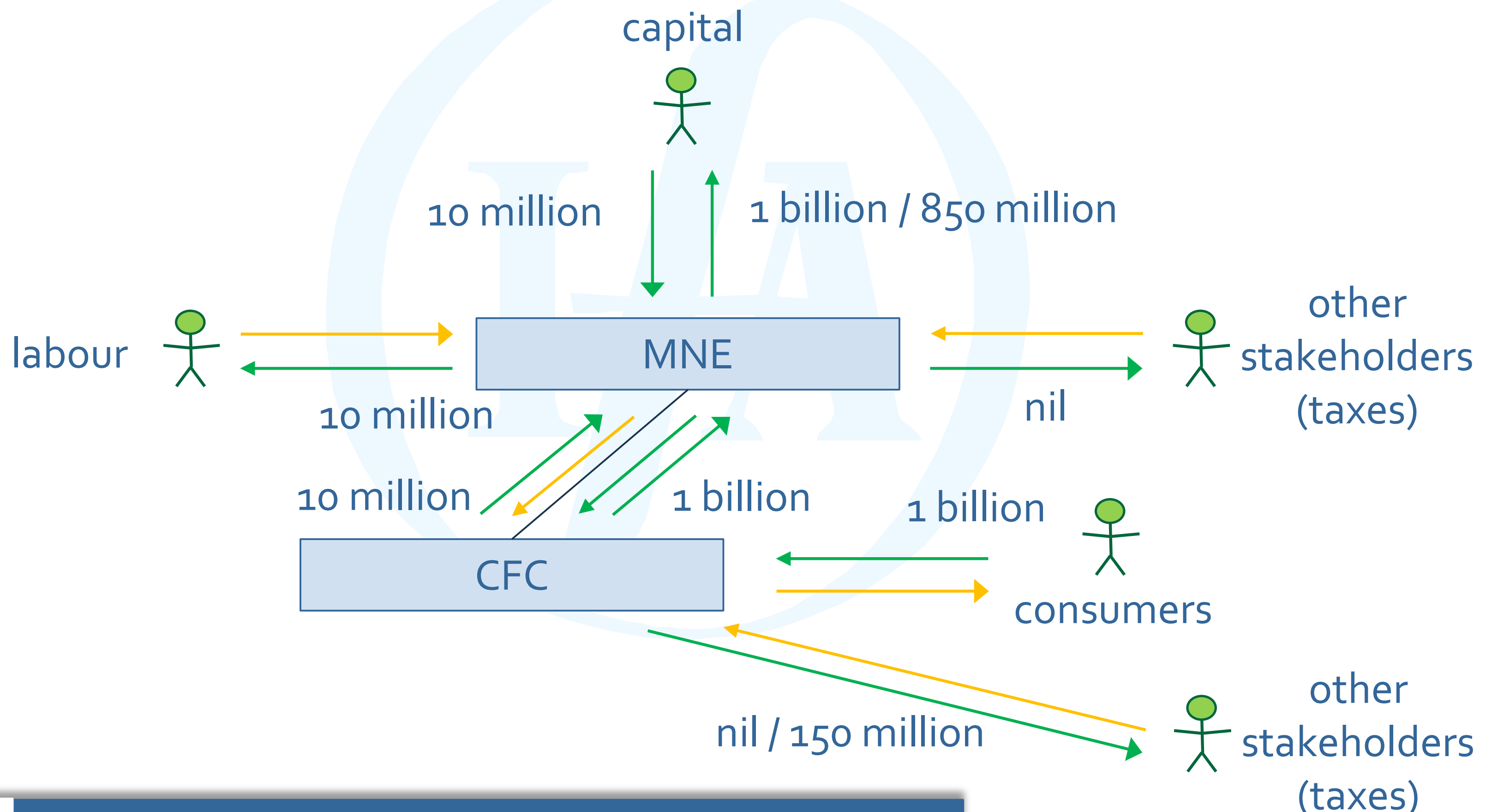
Loss



Labour Yield Attribution

Attribution between capital-rich entities and service providing entities

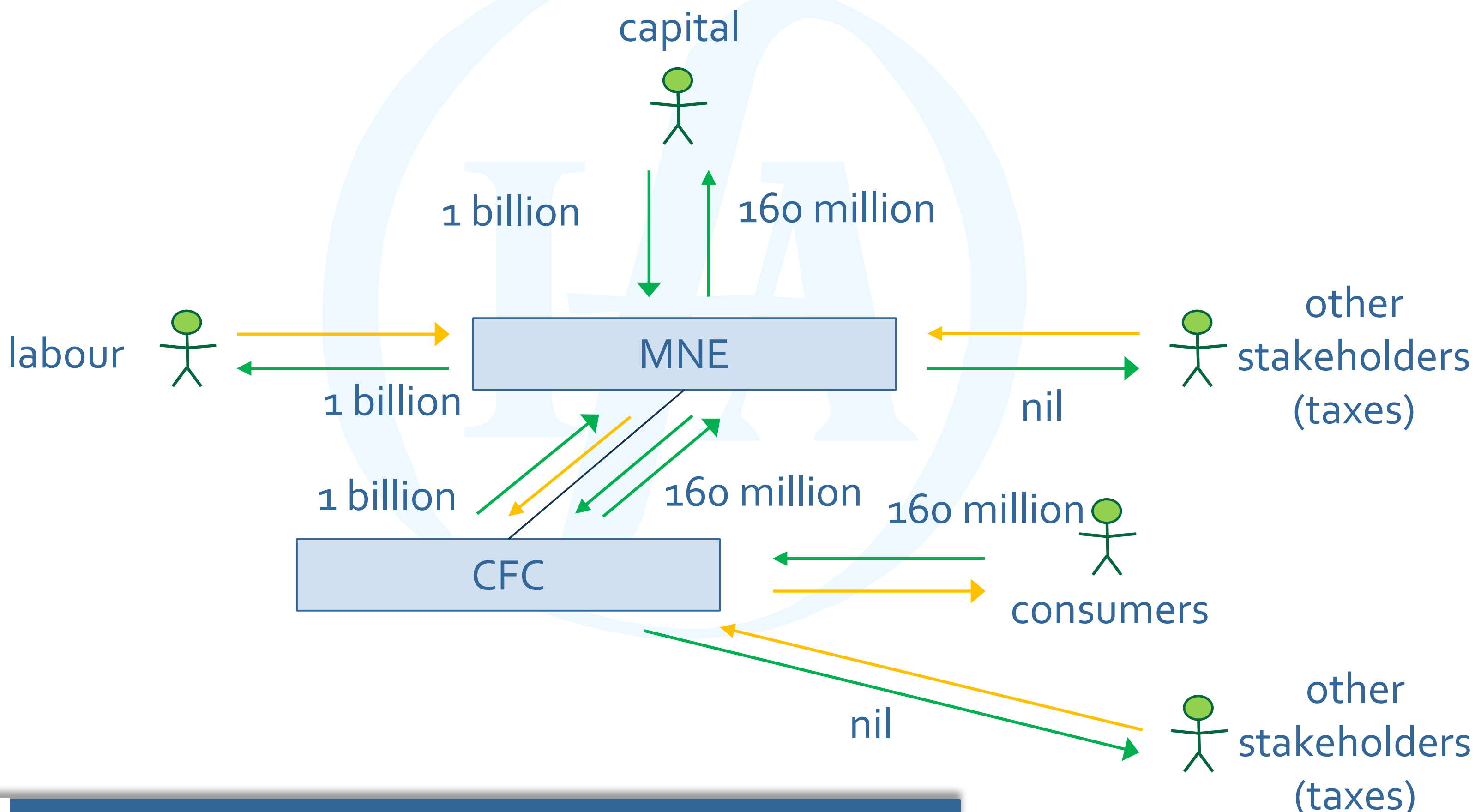
Profit



Labour Yield Attribution

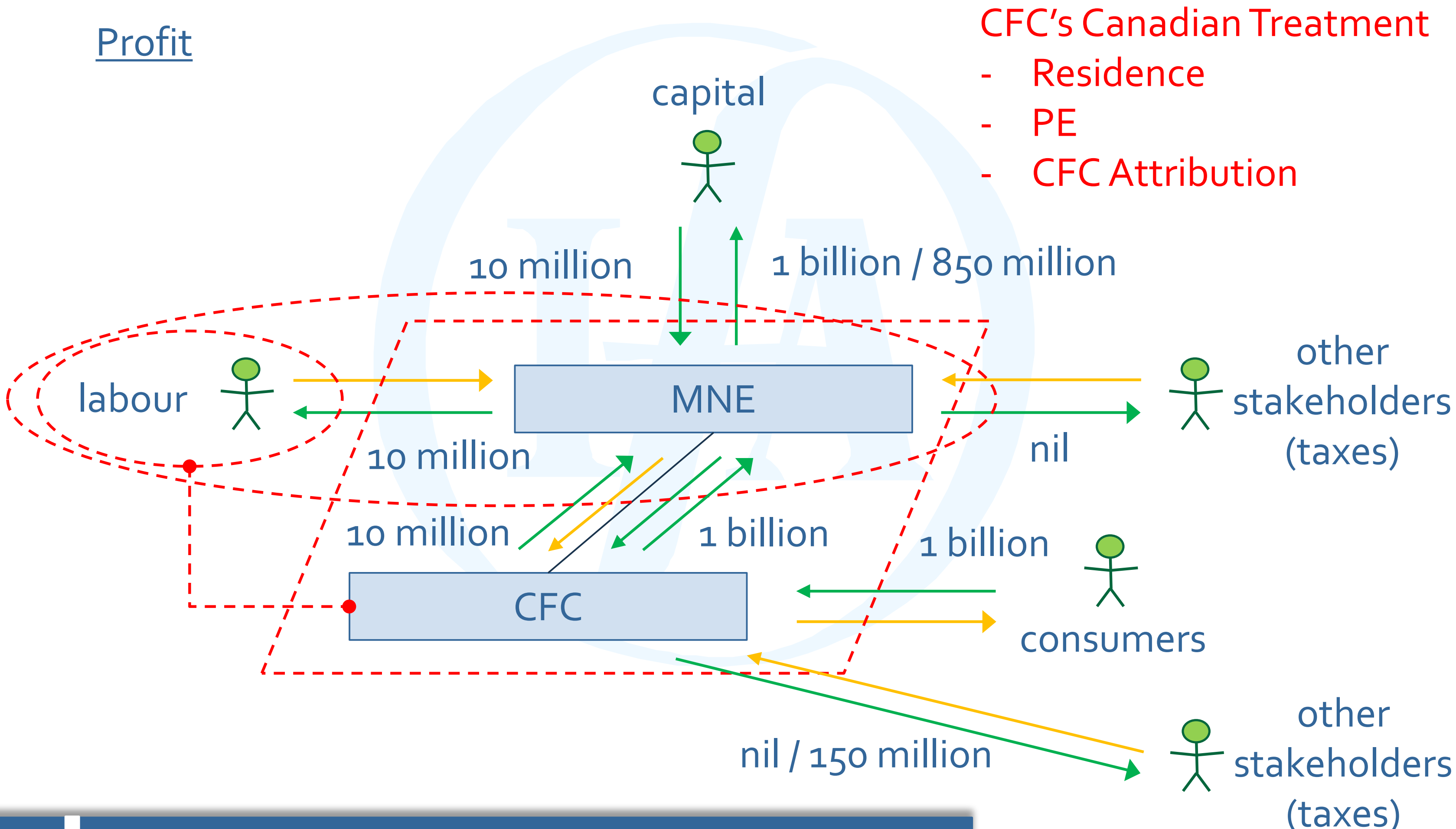
Attribution between capital-rich entities and service providing entities

Loss



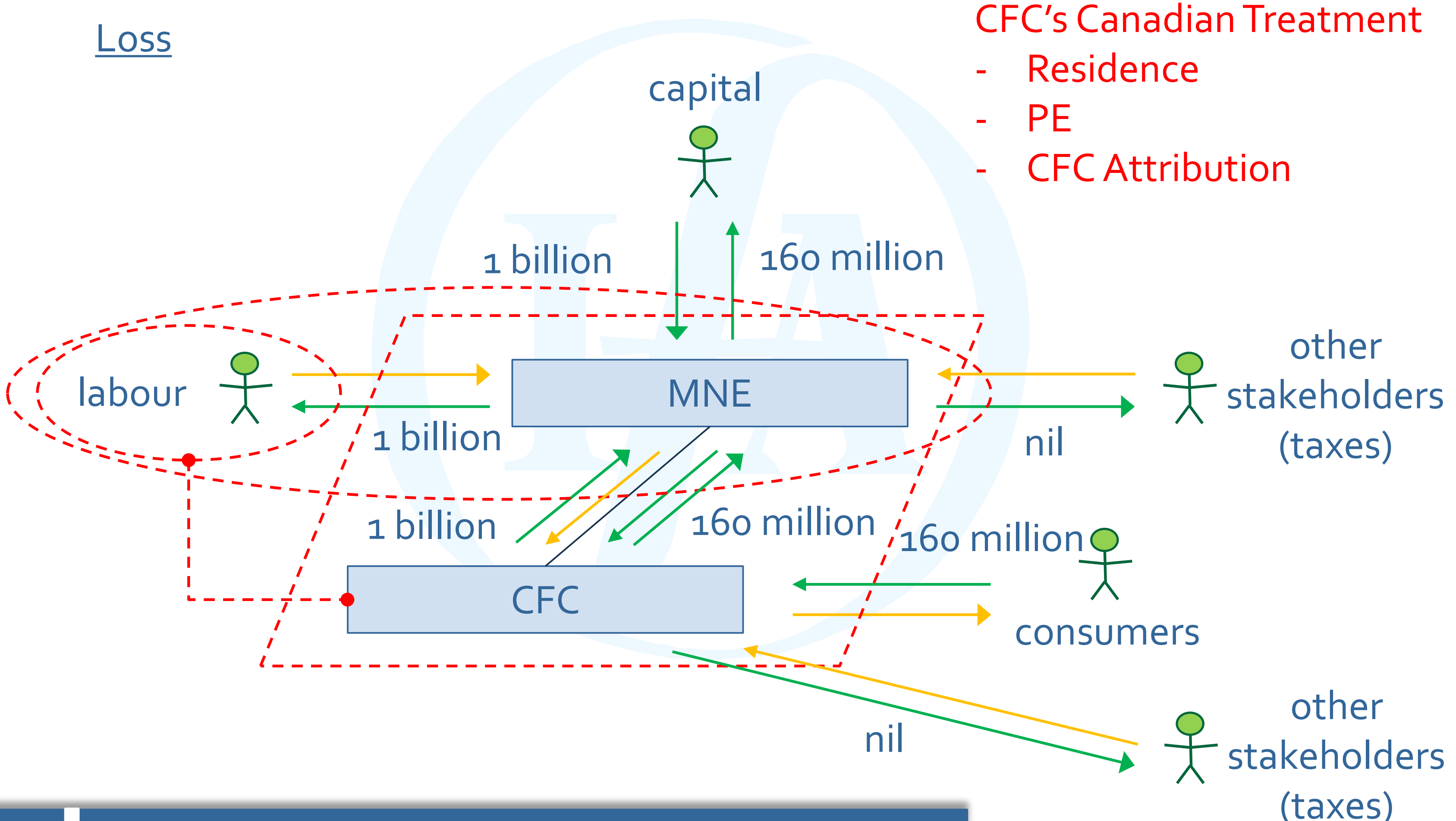
Labour Yield Attribution

Attribution between capital-rich entities and service providing entities



Labour Yield Attribution

Attribution between capital-rich entities and service providing entities



Attribution Between DAE and DAPE (MNE)

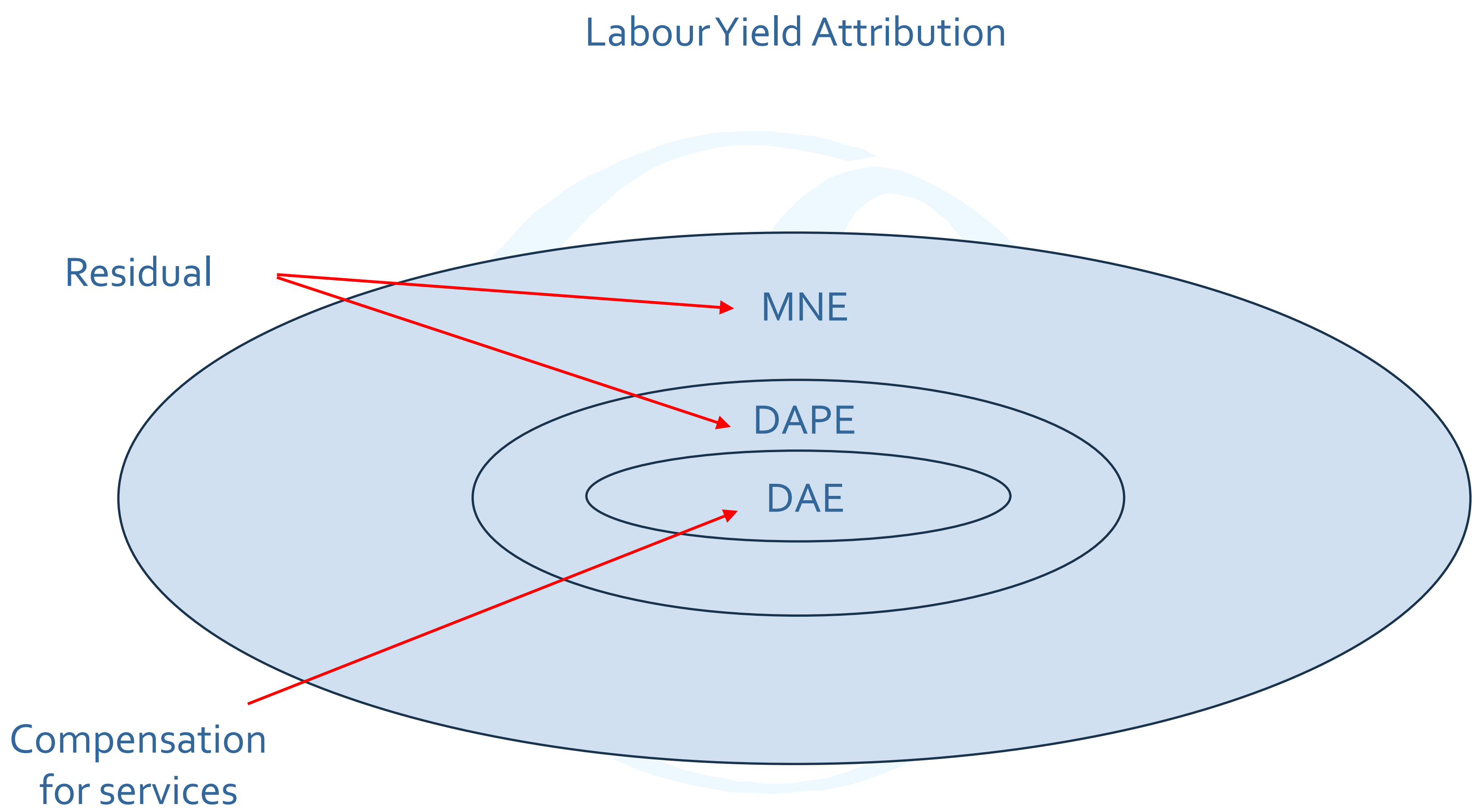
Attribution Between DAE and DAPE (MNE)

2016 Discussion Drafts

Action 7: Additional Guidance on the Attribution of Profits to PEs

- DAE – dependent agent enterprise
- DAPE – dependent agent PE
- Attribution of profits to DAPE is not the same as remuneration of DAE

Attribution Between DAE and DAPE (MNE)



Attribution between DAE and DAPE (MNE)

2016 Revised Guidance on PE Attribution

Example 1			
Article 9 Analysis			
PRIMA (Country A)		SELLCO (Country B)	
Sales income	200	Income from sales commission (200 x 0.05)	10
COGS	40		
Gross profit	160		
OPEX		OPEX (other than advertising expenses	
* Sales commission to Sellco	-10	reimbursed by Prima)	-8
* Reimbursement of advertising	-7		
expenses incurred by Sellco			
* Bad debt losses	-4		
* Inventory losses	-3		
* Warehousing	-6		
Attribution	130		2

Attribution between DAE and DAPE (MNE)

2016 Revised Guidance on PE Attribution

Example 1			
Article 7 Analysis			
PRIMA Head Office (Country A)		PRIMA DAPE (Country B)	
Sales income	190	Sales income	200
COGS	-40	COGS	-190
Gross Profit	150	Gross Profit	10
OPEX		OPEX	
* Reimbursement of advertising	-7	Sales Commission to Sellco	-10
expenses incurred by Sellco			
* Bad debt losses	-4		
* Inventory losses	-3		
* Warehousing	-6		
Operating Profit	130	Operating Profit	0

Attribution between DAE and DAPE (MNE)

2016 Revised Guidance on PE Attribution

Example 2			
Article 9 Analysis			
PRIMA (Country A)		SELLCO (Country B)	
Sales income	200	Income from sales commission (200 x 0.05)	30
COGS	40		
Gross profit	160		
OPEX		OPEX (other than advertising expenses	
* Sales commission to Sellco	-30	reimbursed by Prima)	-8
* Reimbursement of advertising	-7		
expenses incurred by Sellco		* Bad debt losses	-4
		* Inventory losses	-3
		* Warehousing	-6
Operating Profit	123		9
Funding Return from Sellco	2	Funding Return to Prima	2

Attribution between DAE and DAPE (MNE)

2016 Revised Guidance on PE Attribution

Example 2			
Article 7 Analysis			
PRIMA Head Office (Country A)		PRIMA DAPE (Country B)	
Sales income	170	Sales income	200
COGS	-40	COGS	-170
Gross Profit	130	Gross Profit	30
OPEX		OPEX	
* Reimbursement of advertising	-7	Sales Commission to Sellco	-30
expenses incurred by Sellco			
		* Bad debt losses	0
		* Inventory losses	0
		* Warehousing	0
Operating Profit	123	Operating Profit	0
Funding Return from Sellco	0	Funding Return from Sellco	2

Alternative Approaches to Attribution

Alternative Approaches to Attribution

2016 Revised Guidance on PE Attribution

Example 1			
Article 7 Analysis			
PRIMA Head Office (Country A)		PRIMA DAPE (Country B)	
Sales income	190	Sales income	200
COGS	-40	COGS	-190
Gross Profit	150	Gross Profit	10
OPEX		OPEX	
* Reimbursement of advertising	-7	Sales Commission to Sellco	-10
expenses incurred by Sellco			
* Bad debt losses	-4		
* Inventory losses	-3		
* Warehousing	-6		
Operating Profit	130	Operating Profit	0 (2)

Alternative Approaches to Attribution

Formulary Apportionment – Sales and Expenses

PRIMA (Country A)		SELLCO (Country B)	
		A	B
Sales Income	200	0	200
GOGS	40	40	0
Gross Profit	160		
OPEX			
* Sales expense (Sellco)	-8	0	8
* Advertising expenses	-7	0	7
* Bad debt losses	-4		
* Inventory losses	-3		
* Warehousing	-6	0	6
Operating Profit	132		
Revenues		0	200
Expenses		40	21
		40	221
Attribution (combined)	20.23		111.77
Attribution (bifurcated)	43.28		88.72

Alternative Approaches to Attribution

Formulary Apportionment – Single Factor

PRIMA (Country A)		SELLCO (Country B)	
Sales Income	0		200
Attribution	0		132
Expenses	40		21
Attribution	86.56		45.44

Alternative Approaches to Attribution

Destination-Based Cash Flow Taxes & VATs

DBCFT			
PRIMA (Country A)		SELLCO (Country B)	
Sales Income	0		200
GOGS	-40		0
OPEX			
* Sales expense (Sellco)	0		-8
* Advertising expenses	0		-7
* Bad debt losses	0		-4
* Inventory losses	-3		0
* Warehousing	0		-6
Attribution	-43		175
Attribution to suppliers	43		25
Net	0		200
VAT			
	0		200

Alternative Approaches to Attribution

Comparison of Approaches

	Summary	
Approach	PRIMA (Country A)	SELLCO (Country B)
ALP	130	2
FA (S&E combined)	20	112
FA (S&E bifurcated)	43	89
FA (sales only)	0	132
FA (expenses only)	87	45
DBCFT (net of loss refund)	0	200
VAT	0	200

Selected Jurisprudence

Selected Jurisprudence

- Supreme Court
  - GlaxoSmithKline Inc., [2013] 1 CTC 99, 2012 DTC 5147

- Federal Courts
  - Marzen Artistic Aluminum Ltd., 2016 DTC 5018
  - AgraCity Ltd, 2016 DTC 5006
  - General Electric Capital Canada Inc., [2011] 2 CTC 126, 2011 DTC 5011

- Tax Court of Canada
  - Mckesson Canada Corporation, [2014] 3 CTC 2001, 2014 DTC 1040
  - Alberta Printed Circuits Ltd., 2011 DTC 1177
  - Blackburn Radio Inc., [2009] 4 CTC 2213, 2009 DTC 1099
  - 1143132 Ontario Limited, 2009 DTC 1312; [2010] 1 CTC 2109

- Other
  - Irving Oil, 91 DTC 5106; [1991] 1 CTC 350 (FCA) – pricing
  - Harris, 64 DTC 5332; [1964] CTC 562 (ECC) – delineation
  - Daishowa-Marubeni, 2013 DTC 5085; [2013] 4 CTC 97 (SCC) – delineation
  - Gee-Gee Investments, 94 DTC 1419; [1994] 1 CTC 2707 (TCC) – exercise of option (69 vs 247)
  - Kieboom, [1992] 2 CTC 59, 92 DTC 6382 (FCA) – disposition of economic interest non-exercise
  - Consolidated Bathurst, 87 DTC 5001; [1987] 1 CTC 55 (FCA) – risk
  - Colgate-Palmolive-Peet Co. Ltd., [1933] S.C.R. 131 – business restructuring
  - Stubart Investments, 84 DTC 6305; [1984] CTC 294 (SCC) – capital owner with no functions
  - Canada Safeway Limited, [2012] 5 CTC 243 (Alta CA) – inter-provincial finco not GAARable
  - Husky Energy Inc., [2012] 6 CTC 202 (Alta CA) – inter-provincial finco not GAARable
  - Inter-Leasing, Inc., [2014] 6 CTC 153 (Ont CA) – taxation of inter-provincial finco

Conclusions
and
Thank You!