

# POSITION PAPER



## **WSBI-ESBG Consultation Response: BEPS Action points 8-10: Release of discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (Including risk, recharacterisation and special measures)**

WSBI (World Savings and Retail Banking Group)  
ESBG (European Savings and Retail Banking Group)  
Rue Marie-Thérèse, 11 - B-1000 Brussels

ESBG Transparency Register ID 8765978796-80

**February 2015**



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WSBI-ESBG is grateful for the opportunity to contribute to the OECD consultation on BEPS Action Points 8-10. Please find below our comments on the draft.

## D. GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

### Section D.1 “Identifying the commercial or financial relations”

The Discussion draft (henceforth “the draft”) asserts that the process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations in combination with evaluating the conduct of the parties. That is the manner in which the transaction has been formalised by the taxpayer should be reviewed in light of the actual conduct of the parties.

In fact, the draft describes that in transactions between independent enterprises, the divergence of interests between the parties ensures that:

- (i) contractual terms are concluded that reflect the interests of both of the parties;
- (ii) the parties will ordinarily seek to hold each other to the terms of the contract; and
- (iii) contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties.

We do not believe that it is correct to assume that the situation would always be different when dealing with contracts between related parties. Additional analysis should only be required if there is evidence indicating that the contracts did not really cover all aspects as would be done with contracts between unrelated parties. Moreover, this analysis is already done with the review of other documentation that the taxpayer must prepare in respect of undertaken related party transactions.

We therefore believe that paragraph 5 which currently states the following “*It should not be automatically assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties*”, should be amended as follows: “*It should ~~not~~ be ~~automatically~~ assumed that the contracts accurately or comprehensively capture the actual commercial or financial relations between the parties*”,

Paragraph 10 states that “*the economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations of the associated enterprises to the delineated transaction can be broadly categorised as follows:*

- *The contractual terms of the transaction.*
- *The functions performed by the parties to the delineated transaction, taking into account assets employed and risks assumed and managed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.*
- *The characteristics of property transferred or services provided.*
- *The economic circumstances of the parties and of the market in which the parties operate.*
- *The business strategies pursued by the parties.”*

It is proposed that the factors described above are included in the contract to be signed between related parties or, alternatively, that the additional documentation to be provided by the taxpayer to the tax authorities outlines the factors not included in the contract.

As with unrelated parties, contracts must be complete, specific and reflect reality. We believe that this should be the starting point in order to avoid costly input and the proposed analysis should be



used as an exception. It should not be assumed that contracts between related parties are entered into differently to how unrelated parties would have done.

### **D.1.1 Functional analysis**

Paragraph 16. .... *“This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed and managed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy, and risk management.”*.....

..... *“In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution that the parties make to that value creation.”*.....

Paragraph 22. .... *“A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return.”*....

The above excerpts contain points that are repeated throughout all draft comments to the BEPS Actions and although it is very difficult to establish a unique identification between assigned functions and risks assumed, it should be possible to establish a generic guide with an indicative picture where identifying generic functions and risks which thus facilitates the taxpayer to allocate the corresponding weight to each function (and risk taking) within the overall price of a transaction. Functional analysis is a formal obligation to be met by related entities.

### **D.1.3 Economic circumstances**

Paragraph 27. *“Arm’s length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made.”*....

.... *“The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences. More detailed guidance on the importance in a comparability analysis of the features of local markets, especially local market features that give rise to location savings, is provided in Section D.6 of this Chapter and in paragraphs 9.148 to 9.153.”*....

29. .... *“The geographic market is another economic circumstance that should be identified. The identification of the relevant market is a factual question.”*....

In relation to this subject situations where a company provides services to a related company in another state where that product does not exist must be taken into account. It is not known whether the sale of such goods or services will succeed in that geographic market. While the Public Discussion Draft refers to business start-ups and the possibility that a company takes losses at baseline until the product is introduced into the market, it would perhaps also help to establish the possibility of setting the option of price review after a period of time (which is considered to be the period of maturity of a product or service in a market) in order to provide greater legal certainty.

## **D.2 Identifying risks in commercial or financial relations [This section is substantially new]**



### Moral Hazard:

*“A number of issues can be grouped around the term “moral hazard” which refers to the lack of incentive to guard against risk where one is protected from its consequences. The term is used (for example in paragraphs 62 and 67) to introduce the concept that unrelated parties would seek to avoid moral hazard that may arise in situations where one party assumes a risk without the ability to manage the behaviour of the party creating its risk exposure. The concept extends to the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided.”*

*“In commenting on this point, respondents are invited to consider the following questions:*

*Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?”*

WSBI-ESBG believe that moral hazard should not be a differential aspect as it might be considered that both parties act in good faith to achieve the objectives of each of them as should occur between unrelated parties given that otherwise the economic aspect underlying any contract would be altered.

### **Section D.3. “Interpretation [This section is substantially new]”**

Paragraph 80 clarifies that *“Formal conditions recognised in contracts may have been tested against conduct, and found not to be aligned with the substantive arrangements.”... “Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and accurately delineated the actual transaction.”*

It is very important to emphasise the idea that contracts between related parties must meet the same requirements as those signed with unrelated parties, indicating that the related parties have contracted under conditions of free competition. This should be a basic starting premise. Only if there is any evidence that the parties have acted differently than have agreed in writing, tax authorities may proceed to analyse the behaviour of the parties. This second analysis (second step) is already done as far as the documentation to be provided by companies that perform related transactions are concerned.

### **Section “D.4. Non-recognition [This section is substantially new]”**

Paragraph 83 summarises that *“This section sets out circumstances in which the transaction between the parties as accurately delineated can be disregarded for transfer pricing purposes. The section discusses why there is a need for non-recognition when the transaction does not have the fundamental economic attributes of arrangements between unrelated parties, and determines the criteria for non-recognition. The term non-recognition is intended to convey the same meaning to that understood to be conveyed by the term recharacterisation.”*

WSBI-ESBG understands this to say that related parties may sign an agreement that does not have an economic purpose in itself and which may only be signed for tax purposes. In this context it might be clearer to emphasise that the reclassification of an operation occurs when an operation is performed only for tax purposes. Such transactions fall more within the legal definition of fraud than in the area of transfer pricing which in essence stipulates that transactions between related parties are agreed at arm's length.

### **Section D.7. “Assembled workforce [Section unchanged except for paragraph numbering]”**

Paragraph 117: *“Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or*



*the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce vis-à-vis the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services."*

WSBI-ESBG believes that this section should also consider the fact that a company may hold qualified personnel because, in most cases, if not all, they have invested over time to train such personnel and to assist them in gaining experience. This initial investment then results in these employees potentially becoming profitable. The existence of such an employee group would not necessarily affect the arm's length price for services provided.

#### **Section D.8 "MNE group synergies [Section unchanged except for paragraph numbering]"**

Paragraph 122: *"Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group."*

Arguing that related parties may agree different prices because there are some economies of scale or the exploitation of synergies within the group, whether they are planned or not, does not seem entirely justified in the area of transfer pricing, since the same occurs to large companies capable of contracting a large volume of products/services thus gaining access to discounts compared to small and medium enterprises that do not qualify for any discount because of lower contracting capabilities. In our opinion, economies of scale are fully justifiable and do not imply that the pricing would differ from the market price. The question is whether the price charged, depending on the amount of purchases and other conditions such as long-term contracts, payment date, etc. are equivalent to those which would have been agreed between unrelated parties.



### **About WSBI (World Savings and Retail Banking Institute)**

WSBI brings together savings and retail banks from 90 countries, representing the interests of approximately 7,000 banks in all continents. As a global organisation, WSBI focuses on issues of global importance affecting the banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalisation that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that responsibly meet customers' transaction, saving and borrowing needs. To these ends, WSBI recognises that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.

WSBI represents more than 6,150 financial institutions from 82 countries. At the end of 2011, these institutions operate through more than 227,000 branches and outlets, employ more than 2.2 million people and serve more than 600 million customers. Assets of member institutions amounted to more than US \$15.6 trillion at the end of 2011.



World Savings and Retail Banking Institute - aisbl  
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99  
Info@wsbi-esbg.org ■ www.wsbi.org

### **About ESBG (European Savings and Retail Banking Group)**

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,480 billion and non-bank loans of €3,950 billion (31 December 2012).



European Savings and Retail Banking Group – aisbl  
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99  
Info@wsbi-esbg.org ■ www.esbg.eu