The U.S. Reaction to BEPS

As the leading economy in the OECD group, the U.S. has been expected to play a prominent role in shaping the international tax reforms that are taking place under the auspices of the OECD's BEPS project. Yet, some leading congressmen and sections of the U.S. business community are growing concerned that this agenda is being driven predominantly by European and certain other governments in the G20, with Washington a somewhat reluctant participant. The greatest concern, however, is the current status of the U.S. Congress and whether any tax legislation will be passed in the near future.

CONGRESSIONAL LEADERS PRESS GOVERNMENT ON BEPS

Given President Barack Obama's track record on international tax issues—FATCA was introduced on his watch, while his position on corporate tax is tilted towards ensuring multinational companies pay more tax rather than less—it seems strange that the U.S. Government might be indifferent to BEPS. But it is an inference that can be made when the regular pro-BEPS eulogies emerging from the finance ministries of the EU are contrasted against the near silence on the subject from the U.S. Government.

Senior Members of Congress, are becoming increasingly worried that the Government is allowing foreign powers to dictate both the international and domestic tax agenda.

Such concerns were expressed in a letter to U.S. Treasury Secretary Jack Lew by Senate Finance Committee Chairman Orrin Hatch (R—Utah) and House Ways and Means Committee Chairman Paul Ryan (R—Wisconsin), in advance of the June 2015 OECD International Tax Conference in Washington DC. The letter[28] is reproduced in full below:

> "As the leaders of the Congressional tax-writing committees, we are writing to you about the need for the Treasury Department to remain engaged with Congress as you and your colleagues negotiate and develop proposals with member countries of the [OECD] and others on fundamental changes in international tax rules under the OECD's Base Erosion and Profit Shifting project."
>
> "Congress is tasked with writing the tax laws of the United States, including those associated with cross-border activities of US companies. Regardless of what the Treasury Department agrees to as part of the BEPS project, Congress will craft the tax rules that it believes work best for US companies and the US economy. Close consultation between Congress and the Treasury Department should inform the BEPS discussions. We expect that as we move forward on

US tax reform, US tax policy will not be constrained by any concessions to other nations in the BEPS project to which Congress has not agreed."

"As your BEPS discussions continue and proposals are considered, we strongly encourage you to continue engagement with us and to solicit input from the tax-writing committees. We have been monitoring, and continue to monitor, the BEPS project, and we understand the significance it carries in the global community and its potential impact on US workers and their multinational employers. We stand ready to work with you as the BEPS discussions conclude and final reports are issued this year so that we reach good outcomes for the United States and US companies and provide an atmosphere within which we can continue to work towards US tax reform."

"We appreciate some of the work that your team has done as part of the OECD's BEPS project, especially efforts to defend and advocate certain long-standing tax principles, such as the arms-length transfer-pricing standard. However, we are troubled by some positions the Treasury Department appears to be agreeing to as part of this project. For example, we are concerned about the country-by-country (CbC) reporting standards that will contain sensitive information related to a US multinational's group operations. We are also concerned that Treasury has appeared to agree that foreign governments will be able to collect the so-called "master file" information directly from US multinationals without any assurances of confidentiality or that the information collection is needed. The master file contains information well beyond what could be obtained in public filings and that is even more sensitive for privately-held multinational companies. We are also concerned about interest-deductibility limitation proposals on the basis of questionable empirics and metrics."

"Some recent press reports have indicated that the Treasury Department believes it currently has the authority under the Internal Revenue Code to require CbC reporting by certain US companies and that Internal Revenue Service (IRS) guidance on this reporting will be released later this year. We believe the authority to request, collect, and share this information with foreign governments is questionable. In addition, the benefits to the US government from agreeing to these new reporting requirements are unclear, particularly since the IRS already has access to much of this information to administer US tax laws. Therefore, we request that, before finalizing any decisions, the Treasury Department and IRS provide the tax-writing committees with a legal memorandum detailing its authority for requesting and collecting this CbC information from certain US multinationals and master file information from US subsidiaries of foreign multinationals. We also request that you provide a document: (i) identifying how the CbC reporting and other transfer pricing documentation obtained by the IRS on foreign multinationals operating in the United States will be utilized, and (ii) providing the justification for agreeing that sensitive master file information on US multinationals can be collected directly by foreign governments. In the event we do not receive such information, Congress will consider whether to take action to prevent the collection of the CbC and master file information."

"We also have significant concerns about many of the provisions included in several other proposals of the BEPS project, including, among others, modifying the permanent establishment (PE) rules, using subjective general anti-abuse rules (GAAR) in tax treaties, and collecting even more sensitive data from US companies to analyze and measure base erosion and profit shifting. These are but a few of the areas where we recommend that we work together to find consensus and identify a path forward for consideration as part of the BEPS negotiations and, if necessary, Congressional actions."

"In the coming months, we look forward to working with you with respect to the BEPS project. In the interim, we want to remind the Treasury Department that it has the ability to refrain from signing on to the BEPS final reports, and we expect you to do just that if doing so protects the interests of the United States and of US persons. Many of the OECD's BEPS project objectives are sound, and international cooperation—as well as competition—in tax policies is desirable. We trust that you agree, however, that precipitous decisions to impose constraints on US tax policy and added burdens on US companies, especially on the basis of weak empirics and metrics, are not desirable."

Hatch has been particularly vocal on the BEPS project and America's involvement in it. On July 15, in a speech, made on the Senate floor, he outlined concerns about the BEPS project. "Congress is the steward of American taxpayer resources. Those resources are not bargaining chips for international agreements that may or may not advance our nation's interests," said Hatch. "Make no mistake, international cooperation and consensus are important. I don't object to unified actions toward common goals and shared objectives. But, when the resources of U.S. taxpayers are on the line—as they appear to be with the BEPS project—Congress must play a significant role."

Stating that Congress needs more, detailed information regarding the costs relative to the benefits of the BEPs proposals, Hatch asked the nonpartisan Government Accountability Office (GAO) to work with him to develop an in-depth analysis of issues, including whether the IRS is capable of sharing sensitive tax information with foreign tax authorities without violating the confidentiality of American businesses.

Hatch raised particular concerns regarding the confidentiality of the CbC reporting information. "Those specific proposals could have far-reaching, negative consequences for U.S. multinationals and the United States government. For example, consider the master file documentation scheme envisioned in the BEPS project. Under this proposal, companies would have to provide additional, detailed, and intricate information about their tax-planning and business models to foreign tax authorities. If we impose this requirement on U.S. businesses, what assurances do we have that these foreign governments would keep the information confidential? "

Hatch also asked the GAO to look into how such policies would impact the U.S. economy. "Before any additional steps are taken and before we can even

consider moving on any of the BEPS action items, we need more information," said Hatch. "I urge Treasury to work more closely with Congress on this and to not tie our hands as we move toward tax reform by consenting to bad outcomes. I urge them to consider the interests of U.S. taxpayers and to not make any commitments that would impose unnecessary burdens on American companies and put them at a competitive disadvantage."

CONGRESS ALSO URGED TO BECOME MORE ACTIVE

Some pressure groups are also calling on Congress itself to get more involved in this issue. This was a point made by the Coalition for Tax Competition (CTC) in July 2015 when it urged Congress to take an active role in the discussion over international corporate tax policy. Highlighting the long history of the OECD in supporting high taxes, the letter[29] contended that "the true goal of the BEPS project is to undermine tax competition and pave the way for higher taxes across the globe."

"Because the OECD is populated by tax collectors and finance ministers, new rules being drafted through the BEPS initiative are necessarily going to be skewed in their favor," the letter continued. "Businesses are given only a token voice."

It added that "BEPS recommendations already released show a troubling trend toward excessive and unnecessary demands on taxpayers to supply data not typically relevant to the collection of taxes. This includes proprietary information that is not the business of any government, and for which adequate privacy safeguards are not and likely cannot be provided."

Andrew Quinlan, President of the Center for Freedom and Prosperity (CF&P) and CTC coordinator, argued: "The OECD advances only the interests of global tax collectors, making its work on BEPS particularly dangerous. No one is speaking up for US businesses and taxpayers, which is why Congress must get involved."

Cato Institute Senior Fellow and CF&P Chairman Dan Mitchell commented that "Washington sends about USD100m in taxpayer dollars to Paris every year to subsidize a bureaucracy that consistently seeks to impose higher tax burdens throughout the world. The least they can do is make sure that money isn't being used to fund a tax grab aimed primarily at US companies."

Americans for Tax Reform President, Grover Norquist also suggested that "European governments should make themselves attractive targets for capital rather than put tax bulls-eyes on US companies."

Pete Sepp, National Taxpayers Union (NTU) President, pointed out that, according to the NTU Foundation, the OECD's recommendations "would already cost American taxpayers an extra USD68bn a year. Now with the BEPS project, businesses with perfectly legitimate overseas operations could be in for additional and costly suffering through heavier compliance burdens."

"Elected officials here have a special responsibility to protect their taxpayers from schemes like these, which impose uncompetitive tax rules from outside our borders," he concluded.

U.S. BUSINESS CONCERNS

Certainly, a growing number of organizations representing the interests of US businesses are viewing the BEPS project with increasing trepidation.

In June 2015, three business advocacy groups wrote to Lew highlighting significant concerns with the direction of the OECD's BEPS work and urging the US Government "to advocate strongly for clear, detailed agreement on international tax rules that are consistent with the initial goal of the BEPS project."

The letter[30] stressed that "the non-consensus nature of the documents creates the potential for increased double taxation which will be both costly for US business and result in a relative increase in foreign tax credits for US companies the cost of which the US Treasury will ultimately bear."

The letter points out that the BEPS proposals "will increase the difficulty of relying on third-party comparables, indirectly promoting the use of the profit split method (finalization of which has been deferred because consensus cannot be reached). Many of the transfer pricing proposals reflect fundamental differences in opinions between countries over the arm's length standard and its continuing viability. Special measures that go beyond the ALS have been suggested, but it is not clear where such measures are going."

The letter adds that "the information required in the master file is unclear, overbroad, and will be costly to provide. The master file is proposed to be filed locally and, therefore, the treaty safeguards that apply to the country-by-country report would not apply to the master file making this information less secure. It also remains unclear how countries will be prevented from using sensitive, proprietary information inappropriately."

The letter continues: "Currently, the proposed changes to the international tax standards are lacking in clarity and will permit countries to define their taxing jurisdiction as they wish without regard to the functions, assets, and risks that take place in that country. Such an approach will allow tax auditors a great deal of flexibility in defining whether a taxpayer is subject to tax within a particular jurisdiction and if so how much income is subject to tax."

"Multinational businesses are prepared to comply with revised tax rules that may be adopted. It is, however, important that businesses understand their tax obligations and that there be an expeditious method of achieving certainty when disputes arise," it concludes.

These sentiments echo those uttered by the Business Roundtable on several occasions over the past few months.

Following the release by the OECD of the first set of BEPS recommendations in September 2014, Louis R. Chênevert, the Chair of the Business Roundtable Tax and Fiscal Policy Committee, confirmed that "the U.S. business community has been particularly concerned that the BEPS project risks increasing costs, uncertainty, and barriers to trade and investment, such as duplicative taxation."[31]

Chênevert stressed that "the Treasury must bear in mind that the U.S. tax system with its singularly high rate and worldwide system is badly out of line with international norms. Until reform occurs, however, measures aimed at restricting base erosion—*e.g.*,

limits on deductions or income inclusions—will have a disproportionate adverse impact on US-based companies and US operations."

A recent paper by the Progressive Policy Institute was in no doubt about the likely impact of BEPS measures on the US, predicting an exodus of companies to foreign jurisdictions.

Entitled "The BEPS Effect: New International Tax Rules Could Kill US Jobs,"[32] the paper suggests that "the BEPS principles give multinationals a very strong incentive to quickly move high-paying creative and research jobs from the US to Europe."

"The reason is simple," it says: "U.S. corporate tax rates are much higher than most of its rivals."

Report author Michael Mandel argues: "In a global economy, the U.S. cannot keep its corporate rates so much higher than the rest of the world without suffering the consequences. Paradoxically, the huge difference in rates between the US and Europe was obscured by the aggressive use of tax strategies by multinationals. But the BEPS project is eliminating many of those tax strategies, and now the difference in rates stands clearly revealed."

As Chênevert and Mandel have observed, as the BEPS project continues to crystallize, and foreign jurisdictions make changes to their tax regimes, the need for the US to reform its outdated corporate tax code is becoming ever more pressing. However, the ongoing division between the two parties in Congress on tax policy has made tax reform virtually impossible for the foreseeable future. Indeed, the U.S. Government's position on BEPS is almost irrelevant, because even if it were to fully support the OECD's international tax recommendations, it seems highly improbable that President Obama could push BEPS-related tax measures through the current Republican Congress.

Mel Schwartz from Grant Thornton US noted: "The U.S. might eventually adopt aspects of the Action Plan. But there is insufficient political will and consensus to adopt the Action Plan in full. That means that a critical proportion of the global economy will be outside the net." Whether this situation changes depends heavily on the outcome of the 2016 U.S. presidential election. For the time being, however, the US's role in the BEPS drama is probably going to be limited.

Global Business Concerns Relating to BEPS

Multinational enterprises (MNEs) are mostly in favor of the general thrust of the BEPS project, supportive of improvements to the international tax framework and reductions to compliance risks for companies operating in more than one jurisdiction. However, with the way the project is unfolding, several business groups and advisory firms are warning that the outcome could be more chaos and uncertainty.

Following the release of response documents on four further areas of the BEPS Action Plan, including the documents on the Permanent Establishment (PE) rules, the prevention of treaty abuse, dispute resolution mechanisms, and low value-adding services, the International Chamber of Commerce (ICC) reaffirmed its "active engagement" in the second phase of the BEPS project—but it also repeated its call for a coordinated and consistent approach to tax law changes to prevent disparate rules and double taxation.

The ICC said: "It will be crucial for both OECD member states and non-members to reach agreement on the [BEPS] project's outcomes to avoid inconsistencies and conflicts between the national tax legislation of different countries and to reduce double taxation. ICC encourages the OECD to engage with non-OECD members to obtain further commitment on a common approach in order to not stifle cross-border trade and economic growth."

The ICC said it applauds the G20's approach to modernize international tax rules and strongly believes harmonized, transparent, and predictable tax regimes are key for economic growth. However, while the ICC agrees that tax fraud and tax evasion should be stopped, it contends that this should be clearly distinguished from legal tax management and planning. "Businesses fear that governments might be too focused on combating tax evasion while losing sight of the fact that the wider business community is not engaged in abusive practices and may suffer collateral damage," the Chamber said.

The ICC also expressed concerns about the "insufficient attention" being given to the necessary analysis and study of the repercussions of potential changes to the international tax infrastructure, adding that the failure "to conduct the necessary due diligence and dialogue with stakeholders will result in faulty rules, creating difficulties for businesses and significantly hampering cross-border trade and economic growth."

It isn't the first time that the ICC has issued such a warning. During meetings with officials from the United Nations towards the end of last year, members of the ICC Commission on Taxation said that, while they support the BEPS Action Plan, they are concerned that it may inadvertently bring about severe collateral damage for compliant tax-paying companies of all sizes as a result of well-meaning measures undertaken unilaterally by states to mitigate double non-taxation.

The ICC called for coordination between governments in implementing the BEPS project deliverables to avoid inconsistencies between national tax systems. Uncoordinated actions could lead to increased risks of double taxation, more unfair competition,

and increased uncertainty over the tax consequences of cross-border transactions, the ICC said, noting that such would impede and distort international trade and investment decisions.

The ICC said that increased double taxation is unavoidable, but said that this foreseeable risk can be mitigated through a solid dispute resolution mechanism, with mandatory agreements to force competent authorities to agree on how to tax certain transactions, or—as put simply by the ICC—how to split the "tax cake."

The ICC called on policymakers to clearly distinguish illegal activities from the use of lawful methods of tax planning and tax management, provided that they are aligned with commercial and economic activities. It said: "Because taxes can only be levied on the basis of laws and because countries design their own tax regimes in pursuit of differing macro-economic policy objectives, ICC underscores that companies are often encouraged to use the tax planning measures made available to them by individual governments and should not be condemned for choosing the least costly route."

And it is not just the companies under the ICC's umbrella that the OECD is facing an uphill battle to convince of the merits of its BEPS plan. Two global business surveys conducted by advisory firm Grant Thornton have revealed that businesses are skeptical about the success of the BEPS project and want greater clarity as to what is acceptable and unacceptable tax planning, even if this provides less opportunity to reduce tax liabilities across borders. The survey of 2,500 businesses in 34 countries revealed that only 23 percent of respondents think the BEPS project is likely to be successful.

Francesca Lagerberg, global leader of tax services at Grant Thornton, said: "Many of the objectives of the BEPS Action Plan are valid. … The concern is that the scope is so broad it touches almost every area of international taxation. It's as if in an attempt to get rid of some traffic black spots, the authorities have decided to overhaul the entire road network and require every driver to modify their car."

"Businesses need things in black and white," said Lagerberg. "They have a responsibility to their investors and shareholders to keep costs down. Simply telling them to pay their 'fair share' is not a viable alternative to a clear set of rules or principles."

"We applaud the OECD in taking on this much-needed project but we caution the business community that finding a global solution will be very difficult and will not be speedy," she concluded.

CONCERNS REGARDING UNILATERAL ACTION

The ICC has pointed to the UK Government's introduction of a 25 percent "Diverted Profits Tax"[33] (DPT) in April 2015 as tackling the "artificial" profit shifting arrangements as a particularly glaring example of a Government jumping the BEPS gun. Paul Morton, Vice Chair of the ICC's Commission on Taxation, declared: "ICC strongly cautions against countries taking unilateral action before the BEPS project has successfully been concluded and consensus has been reached. ICC therefore shares the concerns expressed by many stakeholders that the proposed DPT in the UK, for example, seems to have been put forward at a rather early stage in the process."

Indeed, the UK Government's decision to create the DPT earned it a rebuke during a parliamentary debate earlier in 2015, with Members of Parliament (MPs) warning that the measure is premature and threatens to destabilize the UK corporate tax system.

MP Shabana Mahmood told the House of Commons on January 7, 2015: "We anticipated that [the Government's] preferred way of proceeding on BEPS would be to await the final reporting in September before thinking how to go further. They have of course moved a little more quickly with the [DPT]."

While welcoming the general aim of the measure, MP Ian Swales criticized the Government for bringing uncertainty in the tax system through its proposed DPT. "Certainty is one of the functions of a good tax system, but with the DPT we are straying into an area of high uncertainty about how the tax will be assessed and paid," he said.

MP Nigel Mills also raised the issue of the DPT potentially overriding the agreements the UK has secured on the avoidance of double taxation, although Economic Secretary to the Treasury Andrea Leadsom assured him that this won't be the case because the scope of the UK's tax treaties is limited to income tax, capital gains tax, and corporation tax, and asserted blandly that the DPT isn't any of these.

Businesses and international tax experts might need some more convincing that the UK Government's arguments are sound on this front, however. Indeed, the tax treaty issue was one of a number of points raised by the United States Council for International Business (USCIB) in a critique of the DPT last year. And ominously perhaps for the UK economy, the Council warned that the DPT would, if implemented, have a major impact on US-based multinational companies.

"The UK's proposal jumps the gun on ongoing discussions concerning the scope of taxation rights on non-resident companies," said USCIB Vice President and International Tax Counsel Carol Doran Klein. "USCIB believes that the UK's unilateral assertion of the right to tax so-called diverted profits is an undisguised attempt to bring more tax revenue into the UK, whether consistent with international norms or not."

"The goal of the multilateral discussions on BEPS is to reach consensus solutions to identified international tax issues," she stated. "Unilateral assertions of taxing jurisdiction by any country increase the risk that other countries will simply abandon the process and act unilaterally."

As the proposal would override existing tax treaties, she warned the measure would "increase the likelihood of double taxation on companies, which will have a negative effect on cross-border trade and investment."

"It is intended to apply when there is no PE under the relevant rules," Klein said. "Companies should be free to structure their affairs taking into account the rules as they are. If they do not have a PE under those rules, then they should not be subject to tax on their business profits. Countries should not be able to disregard agreed-upon rules simply because they do not like the outcome."

The UK certainly isn't alone in attempting to legislate against BEPS before the OECD's recommendations are fully formed, which won't happen until the end of 2015 under the OECD's current timetable. Ireland famously dispensed with tax rules which facilitated the infamous "double Irish" tax arrangement in the last Government Budget,

while France has issued guidance on new interest deduction rules. Both measures are thought to have been made in response to the ongoing BEPS project.

Action has also been approved at EU level to tackle the use of hybrid loan arrangements by corporate groups, with changes to the Parent-Subsidiary Directive formally adopted by the EU Council on July 8, 2014, to prevent the double non-taxation of dividends distributed within corporate groups deriving from hybrid loan structures.

Transfer pricing—a key plank of the BEPS Action Plan and a hugely complex area of international taxation—is another area where individual countries seem to be taking matters into their own hands before any firm recommendations and guidance on the issue have emerged from the OECD. A 2014 survey by Ernst & Young of at least 400 senior tax executives from large public and private companies across 29 countries found that the vast majority of companies headquartered in the US expected increased scrutiny of their transfer pricing practices in the short-term as a result of the BEPS plan.

The Impact of BEPS on Developing Countries

The OECD has given special focus to the impact of the BEPS project on developing countries and how best to support them so as to address the challenges they would face.

In November 2014, the OECD published *The BEPS Project and Developing Countries: from Consultation to Participation*. In terms of transfer pricing, the OECD recognizes the challenges for developing countries, with base eroding payments, and transfer pricing documentation and CbC reporting under Actions 8, 9 and 10 identified as priority areas.

The report also notes the lack of transfer pricing comparables data as being an area of particular concern for developing countries.

In December 2014, officials from developing countries (Albania, Azerbaijan, Bangladesh, Croatia, Georgia, Jamaica, Kenya, Morocco, Nigeria, Peru, the Philippines, Senegal, South Africa, Tunisia, Vietnam, and the African Tax Administration Forum) participated in a workshop "to plan deepened engagement in [the] BEPS Project." They discussed their future participation in the Committee on Fiscal Affairs and BEPS technical working groups, with the aim of ensuring the BEPS project meets the needs of developing countries.

This includes the "significant" issue of the "availability of quality comparability data for transfer pricing purposes," as previously highlighted in the OECD's *Public Consultation—Transfer Pricing Comparability Data and Developing Countries* published in March 2014. This discussed four possible approaches to addressing this issue, namely:

- Expanding developing countries' access to data sources for comparables, including improving access to such data with a significant number of sizable independent companies
- Making more effective use of using such data sources, including guidance and assistance, the selection of foreign comparables, how to make adjustments to foreign comparables to enhance their reliability, and
- Identifying arm's length prices/results without relying on direct comparables, including:
  - Making use of the profit split method, value chain analysis and safe harbors, and
  - Evaluating the effectiveness and compatibility of using the "sixth method" currently used in some developing countries in, for example, Africa and Latin America, and
- Reviewing developing countries' experiences with APAs, negotiations to resolve transfer pricing disputes, and providing guidance or assistance on the MAP.

A major factor that could mitigate against the creation of a level playing field in international corporate taxation is the lack of administrative capacity in developing

countries to introduce the necessary changes. Naturally, this is a scenario that the OECD is hoping to avoid, so resources and technical assistance are being provided to help developing nations meet the new requirements. As a result, the OECD has invited ten developing nations to participate in the meetings of its Committee on Fiscal Affairs and will establish five regional networks, in collaboration with regional tax organizations, to provide support and capacity-building during the development of BEPS proposals and to support the implementation of recommendations.

The OECD has confirmed that its new regional network in Africa will be established in close cooperation with the African Tax Administration Forum; in Latin America and the Caribbean, its regional network will be established with the support of the Inter-American Center of Tax Administration; its Asian regional network will be launched in cooperation with the Study Group on Asian Tax Administration Research; a regional network for Francophone countries will be established with support from CREDAF (*Centre de rencontre et d'études des dirigeants des administrations fiscales*); and a final regional network for Central Europe and the Middle East will be supported by the IOTA (Intra-European Organization of Tax Administrations).

The OECD said: "Not only will developing countries be able to directly input and gain an improved understanding of the BEPS process, but OECD members and BEPS Associates will also be exposed first-hand to accounts of the specific perspectives of, and challenges faced by, developing countries."

It said: "Supporting capacity building in developing countries on BEPS issues is a priority. The regional networks will play an important role in the development of toolkits needed to support the practical implementation of the BEPS measures and the other priority issues for developing countries (tax incentives and comparables) which are outside the BEPS project. Each will be a forum for interested developing countries to discuss participation in the work on the multilateral instrument under Action 15 of the BEPS project."

"In addition to the regional networks, the OECD Global Relations Tax Programme and the Tax and Development Programme provide additional platforms for engagement and dialogue on BEPS issues—through demand-led training events and bilateral country programs which help put in place stronger international tax rules and administrative processes. All these initiatives will be coordinated with the International Monetary Fund, the World Bank Group, and the United Nations to ensure effective and efficient support to developing countries."

Developing countries' representatives have begun to attend the meetings of the relevant subsidiary bodies, such as Working Party 1 on tax treaties, Working Party 2 on tax policy and statistics, Working Party 6 on transfer pricing, Working Party 9 on consumption taxes, Working Party 11 on aggressive tax planning, the Forum on Harmful Tax Practices, and the Task Force on the Digital Economy.

Next Steps*

By Grant Thornton

Many aspects of the BEPS Action Plan could have disproportionate or unintended consequences for your business. It's therefore vital that your business moves quickly against unfair and unintended consequences and takes strong steps to prepare for what eventually lies ahead.

Many MNEs, especially fast-growing ones, have yet to evaluate the potential impact of the Action Plan proposals on their business. But they are the ones with the most to lose. So it's vital to understand the implications and seek to avert any proposals that could have a damaging impact. Business representations appear to have reduced the likely burden of country-by-country reporting, which shows it is worthwhile having your say.

Step one

A good starting point for gauging the implications is to filter out what doesn't apply to your particular business so you can focus attention on the significant impacts. Key considerations include:

1. The nature of your business (e.g. balance of value from tangible and intangible assets)
2. Where patents/intellectual property rights are located
3. The relative complexity of your supply and value chains
4. Use of hybrid structures
5. How much international transfer pricing is involved in the business.

Step two

Based on this evaluation, you can prepare the case you want to put to policymakers. As tax has become such a sensitive reputational issue, there may be some reluctance to engage directly. But you can speak through your trade association.

Step three

Preparation for all eventualities is vital. It's important to base your contingency and implementation plans on a full evaluation of all potential outcomes including the worst case scenarios. The assessments shouldn't just look at the direct tax implications, but also any reputational risks that could arise from particular tax strategies.

Other key considerations include the impact on pricing and decisions over where operations are located.

Step four

Ultimately, it is up to the board to weigh up the options and determine the right way forward. The fundamental questions that need to be addressed are: "What reputational risks are we willing to absorb to limit tax payments?" and "What can be done to minimize these risks including unwinding any overly aggressive tax arrangements?" With tax in the headlines, the key decisions should be made at the top.

The longer term priorities include a review and possible rethink of tax structures, along with the organizational collaboration, risk evaluation and reporting lines to support this.

The time for action is now

The Action Plan will fundamentally change the international tax landscape. Few think it's going to be successful. Many think it could have a significant impact on their businesses. Everyone agrees it's going to be difficult to implement. Therefore it's vital that your business makes its voice count as quickly and as forcefully as possible and is fully geared up for the more onerous demands ahead.

Endnotes

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Appendices

APPENDIX 1. BEPS ACTION 13 REPORTING (CbC REPORTING) GUIDELINES AND CHECKLISTS

Under BEPS Action 13, there are three tiers of reporting:

1. Master File
2. Local File
3. CbC Reporting

Each tier requires a Multinational Enterprise (MNE) and its constituent entities to report specific information. Due to the complex nature of the reporting, many MNEs will not have all of the required already available (whether in whole or in part) because of pre-existing reporting requirements. As a result, it is crucial that MNE's examine the requirements of each of the three tiers of reporting and take the necessary steps now to begin gathering and developing that information so that they will be able to comply with the reporting requirements when they go into effect for each of the jurisdictions in which they operate. Below are requirements listed for each of the tiers of reporting that MNE's may use to begin their compliance with these requirements.

Master File Requirements

Status	Item and Description	
	Organizational Structure	▪ Organizational chart illustrating the MNE's legal and ownership structure and the geographical location of operating entities
	Description of MNE's business(es)	▪ Drivers of business profit ▪ Description of the supply chain for the 5 largest products/service offerings by turnover plus any other products/services that amount to more than 5 percent of group turnover ▪ Description and list of important service arrangements between members of the MNE group (other than R&D services). This includes a description of the ability of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices paid for intra-group services ▪ Main geographic market for the group's products and services ▪ Functional analysis describing the principal contributions to value creation by individual entities within the group ▪ Description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year

Master File Requirements *(continued)*

Status	Item and Description	
	MNE's Intangibles	▪ Description of the overall strategy for development, ownership and exploitation of intangibles, including the location of the principal R&D facilities and management ▪ List of intangibles (or groups of intangibles) that are important for transfer pricing purposes and what entities legally own them ▪ List of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and license agreements ▪ Description of the group's transfer pricing policies related to R&D and intangibles ▪ Description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned (including entities, countries and compensation involved)
	MNE's Intercompany Financial Activities	▪ Description of how the group is financed (including important financial arrangements with unrelated lenders) ▪ Identification of any members of the group that provide a central financing function for the group, including the country under whose laws the entity is organized and the place of effective management of those activities ▪ Description of the MNEs general transfer pricing policies related to financing arrangements between associated enterprises
	MNE's Financial and Tax Positions	▪ Annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes ▪ List and description of the MNE group's existing unilateral APAs and other tax rulings relating to the allocation of income among countries

Local File Requirements

Status	Item and Description	
	Local entity	▪ Description of the management structure, a local organizational chart, and description of the individuals to whom local management reports and the countries where those individuals maintain their principal offices ▪ Detailed description of the business and business strategy pursued by the local entity including indicating whether the local entity has been involved in or affected by business restructuring or intangible transfers in the present or immediately past year and an explanation of those aspects of the transaction affecting the local entity ▪ Business competitors

Local File Requirements *(continued)*

Status	Item and Description	
	Controlled transactions	The following information needs to be provided for each material category of controlled transactions ▪ Description of the material controlled transactions and the context in which they take place ▪ Amount of intra-group payments and receipts for each category of controlled transactions involving the local entity broken down by tax jurisdiction of the foreign recipient or payor ▪ Identification of associated enterprises involved in each ▪ category of controlled transactions and the relationship between them ▪ Copies of all material intercompany agreements that were concluded by the local entity ▪ Detailed comparability and functional analysis of each taxpayer and the relevant associate enterprises with respect to each documented category of controlled transactions including changes to prior years ▪ Indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method ▪ Indication of which associated enterprise is selected for the tested party (if it applies) and an explanation of the reasons for the selection ▪ Summary of important assumptions made in applying transfer pricing methodology ▪ Explanation of the reasons for performing a multi-year analysis (if applicable) ▪ List and description of selected comparable uncontrolled transactions (internal or external) and information on relevant financial indications for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information ▪ Description of any comparability adjustments performed and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions or both. ▪ Description of the reasons for concluding that relevant transactions were priced on an arm's length basis based on the application of the selected transfer pricing method ▪ Summary of financial information used in applying the transfer pricing methodology ▪ Copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to controlled transactions described above
	Financial information	▪ Annual local entity financial accounts for the fiscal year concerned. If audited statements exist they should be supplied; otherwise existing unaudited statements should be supplied ▪ Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements ▪ Summary schedules of relevant financial data for comparable used in the analysis and the sources from which data was obtained

B. Artificial avoidance of PE status through the specific activity exemptions

10. Art. 5(4) of the OECD Model Tax Convention includes a list of exceptions (the "specific activity exemptions") according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph.

1. List of activities included in Art. 5(4)

11. The October 2011 and 2012 discussion drafts on the clarification of the PE definition[2] included a proposed change to paragraph 21 of the Commentary on Article 5 according to which, under the current wording of Article 5, paragraph 4 applies automatically where one of the activities listed in subparagraphs *a*) to *d*) is the only activity carried on at a fixed place of business. The Working Group that produced that proposal, however, invited Working Party 1 to examine "whether the conclusion that subparagraphs *a*) to *d*) are not subject to the extra condition that the activities referred therein be of a preparatory or auxiliary nature is appropriate in policy terms". This reflected the views of some delegates who argued that the proposed interpretation did not appear to conform with what they considered to be the original purpose of the paragraph, *i.e.* to cover only preparatory or auxiliary activities.

12. Regardless of the original purpose of the exceptions included in subparagraphs *a*) to *d*) of paragraph 4, it is important to address situations where these subparagraphs give rise to BEPS concerns. It is therefore agreed to modify Art. 5(4) as indicated below so that each of the exceptions included in that provision is restricted to activities that are otherwise of a "preparatory or auxiliary" character. It is also recommended to provide the additional Commentary guidance below which clarifies the meaning of the phrase "preparatory or auxiliary" using a number of examples.

13. Some States, however, consider that BEPS concerns related to Art. 5(4) essentially arise where there is fragmentation of activities between closely related parties and that these concerns will be appropriately addressed by the inclusion of the anti-fragmentation rule in section 2 below. These States therefore consider that there is no need to modify Art. 5(4) as suggested below and that the list of exceptions in subparagraphs *a*) to *d*) of paragraph 4 should not be subject to the condition that the activities referred to in these subparagraphs be of a preparatory or auxiliary character. As indicated in the Commentary below, States that share that view may adopt a different version of Art. 5(4) as long as they include the anti-fragmentation rule referred to in section 2.

MAKING ALL THE SUBPARAGRAPHS OF ART. 5(4) SUBJECT TO A "PREPARATORY OR AUXILIARY" CONDITION

Replace paragraph 4 of Article 5 by the following (changes to the existing text of the paragraph appear in ***bold italics*** *of additions and ~~strikethrough~~ for deletions):*

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ~~of a preparatory or auxiliary character~~;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *a*) to *e*), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character,~~

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

Replace paragraphs 21 to 30 of the existing Commentary on Article 5 (changes to the existing text of the Commentary appear in ***bold italics*** *of additions and ~~strikethrough~~ for deletions):*

Paragraph 4

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which ~~are not~~, ***when carried on through fixed places of business, are not sufficient for these places to constitute*** permanent establishments~~, even if the activity is carried on through a fixed place of business~~. ***The final part of the paragraph provides that these exceptions only apply if the listed activities have a preparatory or auxiliary character.*** ~~The common feature of these activities is that they are, in general, preparatory or auxiliary activities.~~ ~~This is laid down explicitly in the case of the exception mentioned in~~***Since*** subparagraph ***e) applies to any activity that is not otherwise listed in the paragraph (as long as that activity has a preparatory or auxiliary character), the provisions of the paragraph*** ~~which~~ actually amounts to a general restriction of the scope of the definition ***of permanent establishment*** contained in paragraph 1 and, when read with that paragraph, provide a more selective test~~,~~ by which to determine what constitutes a permanent establishment. To a considerable degree, ***these provisions*** ~~it~~ limits ~~the~~***at*** definition ***in paragraph 1*** and excludes from its rather wide scope a number of ~~forms of business organisations which, although they are carried on through a fixed place of business~~ ***fixed places of business which, because the business activities exercised through these places are merely preparatory or auxiliary,*** should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. *[the last two sentences and the last part of the preceding one have been moved from paragraph 23 to this paragraph]* Moreover subparagraph *f*) provides that

combinations of activities mentioned in subparagraphs *a)* to *e)* in the same fixed place of business shall be deemed not to be a permanent establishment, ***subject to the condition, expressed in the final part of the paragraph,*** ~~provided~~ that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State~~,~~ if it ***only*** carries on ~~in that other State,~~ activities of a purely preparatory or auxiliary character in that State. ***The provisions of paragraph 4.1 (see below) complement that principle by ensuring that the preparatory or auxiliary character of activities carried on at a fixed place of business must be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or closely related enterprises carry on in the same State.***

21.1~~24.~~ It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise~~,~~ does not exercise a preparatory or auxiliary activity.

21.2 As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

21.3 Subparagraphs a) to e) refer to activities that are carried on for the enterprise itself. A permanent establishment~~, however,~~ ***would therefore*** exists if ***such activities were performed on behalf of other enterprises at the same fixed place of business*** ~~the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises~~. If, for instance, an ~~advertising agency~~ ***enterprise that maintained an office for the advertising of its own products or services*** were also to engage in advertising ~~for~~ ***on behalf of*** other enterprises ***at that location***, ~~it~~***that office*** would be regarded as a permanent establishment of the enterprise by which it is maintained.

22. Subparagraph *a)* relates ~~only to the case in which an enterprise acquires the use of~~ ***to a fixed place of business constituted by*** facilities ***used by an enterprise*** for storing, displaying or delivering its own goods or merchandise. ***Whether the activity carried on at such a place of business has a preparatory or auxiliary character will have to be determined in the light of factors that include the overall business activity of the enterprise. Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise's sale/distribution business and do not have, therefore, a preparatory or auxiliary character.*** ~~Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Subparagraph c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".~~

22.1 ***Subparagraph a) would cover, for instance, a bonded warehouse with special gas facilities that an exporter of fruit from one State maintains in another State for the sole purpose of storing fruit in a controlled environment during the custom clearance process in that other State. It would also cover a fixed place of business that an enterprise maintained solely for the delivery of spare parts to customers for machinery sold to those customers. Paragraph 4 would not apply, however, where*** ~~A permanent establishment could also be constituted if~~ an enterprise maintain***ed***s a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers ***and, in addition,*** ~~where, in addition, it~~ ***for the*** maintain***ance***s or repairs ***of*** such machinery, as this ***would*** goe~~s~~ beyond the pure delivery mentioned in subparagraph *a)* ~~of paragraph 4~~ ***and would not constitute preparatory or auxiliary activities*** ~~S~~since these after-sale ***activities constitute*** ~~organisations perform~~ an essential and significant part of the services of an enterprise vis-à-vis its customers.~~, their activities are not merely auxiliary ones~~ [*the preceding two sentences have been moved from paragraph 25 to this paragraph*].

22.2~~26.1~~ ***Issues may arise concerning the application of the definition of permanent establishment to*** ~~Another example is that of~~ facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where ~~they~~***these*** facilities constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether ***subparagraph a)*** ~~paragraph~~ 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a)*, which is restricted to delivery of goods or merchandise belonging to the enterprise that

uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e)* also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a)* would be applicable. ~~An additional~~*A separate* question is whether the cable or pipeline could ~~also~~ constitute a permanent establishment for the customer of the operator of the cable or pipeline, *i.e.* the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.

22.3 Subparagraph *b)* relates to the ***maintenance of a stock of goods or merchandise belonging to the enterprise*** ~~stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery~~. ***This subparagraph is irrelevant in cases where a stock of goods or merchandise belonging to an enterprise is maintained by another person in facilities operated by that other person and the enterprise does not have the facilities at its disposal as the place where the stock is maintained cannot therefore be a permanent establishment of that enterprise. Where, for example, an independent logistics company operates a warehouse in State S and continuously stores in that warehouse goods or merchandise belonging to an enterprise of State R, the warehouse does not constitute a fixed place of business at the disposal of the enterprise of State R and subparagraph b) is therefore irrelevant. Where, however, that enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, subparagraph b) is applicable and the question of whether a permanent establishment exists will depend on whether these activities constitute a preparatory or auxiliary activity.***

22.4 Subparagraph *c)* covers the situation ~~case in which~~ ***where*** a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise~~,~~ on behalf of, or for the account of, the first-mentioned enterprise. ***As explained in the preceding paragraph, the mere presence of goods or merchandise belonging to an enterprise does not mean that the fixed place of business where these goods or merchandise are stored is at the disposal of that enterprise. Where, for example, a stock of goods belonging to RCO, an enterprise of State R, is maintained by a toll-manufacturer located in State S for the purposes of processing by that toll-manufacturer, no fixed place of business is at the disposal of RCO and the place where the stock is maintained***

cannot therefore be a permanent establishment of RCO. If, however, RCO is allowed unlimited access to a separate part of the facilities of the toll-manufacturer for the purpose of inspecting and maintaining the goods stored therein, subparagraph c) will apply and it will be necessary to determine whether the maintenance of that stock of goods by RCO constitutes a preparatory or auxiliary activity. This will be the case if RCO is merely a distributor of products manufactured by other enterprises as in that case the mere maintenance of a stock of goods for the purposes of processing by another enterprise would not form an essential and significant part of RCO's overall activity. In such a case, unless paragraph 4.1 applies, paragraph 4 will deem a permanent establishment not to exist in relation to such a fixed place of business that is at the disposal of the enterprise of State R for the purposes of maintaining its own goods to be processed by the toll-manufacturer.

22.5 The first part of subparagraph d) relates to the case where premises are used solely for the purpose of purchasing goods or merchandise for the enterprise. Since this exception only applies if that activity has a preparatory or auxiliary character, it will typically not apply in the case of a fixed place of business used for the purchase of goods or merchandise where the overall activity of the enterprise consists in selling these goods and where purchasing is a core function in the business of the enterprise. The following examples illustrate the application of paragraph 4 in the case of fixed places of business where purchasing activities are performed:

- ***Example 1: RCO is a company resident of State R that is a large buyer of a particular agricultural product produced in State S, which RCO sells from State R to distributors situated in different countries. RCO maintains a purchasing office in State S. The employees who work at that office are experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type/quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products by RCO. In this example, although the only activity performed through the office is the purchasing of products for RCO, which is an activity covered by subparagraph d), paragraph 4 does not apply and the office therefore constitutes a permanent establishment because that purchasing function forms an essential and significant part of RCO's overall activity.***
- ***Example 2: RCO, a company resident of State R which operates a number of large discount stores, maintains an office in State S during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow RCO to establish stores in State S. During that period, employees of RCO occasionally purchase supplies for their office. In this example, paragraph 4 applies because subparagraph f) applies to the activities performed through the office (since subparagraphs d) and e) would apply to the purchasing, researching and lobbying activities if each of these was the only activity performed at the***

office) and the overall activity of the office has a preparatory character.

22.6 The second part of subparagraph d) relates to a fixed place of business that is used solely to collect information for the enterprise. An enterprise will frequently need to collect information before deciding whether and how to carry on its core business activities in a State. If the enterprise does so without maintaining a fixed place of business in that State, subparagraph d) will obviously be irrelevant. If, however, a fixed place of business is maintained solely for that purpose, subparagraph d) will be relevant and it will be necessary to determine whether the collection of information goes beyond the preparatory or auxiliary threshold. Where, for example, an investment fund sets up an office in a State solely to collect information on possible investment opportunities in that State, the collecting of information through that office will be a preparatory activity. The same conclusion would be reached in the case of an insurance enterprise that sets up an office solely for the collection of information, such as statistics, on risks in a particular market and in the case of a newspaper bureau set up in a State solely to collect information on possible news stories without engaging in any advertising activities: in both cases, the collecting of information will be a preparatory activity.

23. Subparagraph *e) **applies to*** ~~provides that~~ a fixed place of business ***maintained solely for the purpose of carrying on, for the enterprise, any activity that is not expressly listed in subparagraphs a) to d); as long as that activity*** ~~through which the enterprise exercises solely an activity which~~ has ~~for the enterprise~~ a preparatory or auxiliary character, ***that place of business*** is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of ~~exceptions~~ ***the activities to which the paragraph may apply, the examples listed in subparagraphs a) to d) being merely common examples of activities that are covered by the paragraph because they often have a preparatory or auxiliary character***. ~~Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1.~~ *~~[(the following part of the paragraph has been moved to paragraph 21): and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of business activities which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.]~~* ~~Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.~~ *[that last sentence has been moved to paragraph 23]*

24. ~~It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.~~

~~Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity~~ *[the preceding three sentences have been moved to paragraph 21.1]*. Examples ***of places of business covered by subparagraph e)*** are fixed places of business ***used*** solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character *[this sentence currently appears at the end of paragraph 23]*. ***Paragraph 4 would not apply, however,*** ~~This would not be the case, where, for example,~~ ***if a*** fixed place of business ***used for the supply of information would*** ~~does~~ not only give information but ***would*** also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it ~~be the case~~ ***apply*** if a research establishment were to concern itself with manufacture *[these two sentences currently appear at the end of paragraph 25]*. ***Similarly,*** ~~W~~where~~, for example,~~ the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of ***paragraph 4*** ~~subparagraph e)~~. A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If ***an*** enterprises with international ramifications establish***es*** a so-called "management office" in ***a*** States in which ~~they~~***it*** maintains subsidiaries, permanent establishments, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, ***subparagraph e) will not apply to that "management office" because*** ~~a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a "place of management" within the meaning of subparagraph a) of paragraph 2. T~~the function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of ~~subparagraph e)~~ of paragraph 4.

~~25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph a) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis à vis its customers, their activities are not merely auxiliary ones. Subparagraph e) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.~~

and enhancements can be the difference between deriving a short term advantage from the intangibles and deriving a longer term advantage. It is therefore necessary to consider for comparability purposes whether or not a particular grant of rights in intangibles includes access to enhancements, revisions, and updates of the intangibles.

6.126 A very similar question, often important in a comparability analysis, involves whether the transferee of intangibles obtains the right to use the intangibles in connection with research directed to developing new and enhanced intangibles. For example, the right to use an existing software platform as a basis for developing new software products can shorten development times and can make the difference between being the first to market with a new product or application, or being forced to enter a market already occupied by established competitive products. A comparability analysis with regard to intangibles should, therefore, consider the rights of the parties regarding the use of the intangibles in developing new and enhanced versions of products.

D.2.1.7. Expectation of future benefit

6.127 Each of the foregoing comparability considerations has a consequence with regard to the expectation of the parties to a transaction regarding the future benefits to be derived from the use of the intangibles in question. If for any reason there is a significant discrepancy between the anticipated future benefit of using one intangible as opposed to another, it is difficult to consider the intangibles as being sufficiently comparable to support a comparables-based transfer pricing analysis in the absence of reliable comparability adjustments. Specifically, it is important to consider the actual and potential profitability of products or potential products that are based on the intangible. Intangibles that provide a basis for high profit products or services are not likely to be comparable to intangibles that support products or services with only industry average profits. Any factor materially affecting the expectation of the parties to a controlled transaction of obtaining future benefits from the intangible should be taken into account in conducting the comparability analysis.

D.2.2. Comparison of risk in cases involving transfers of intangibles or rights in intangibles

6.128 In conducting a comparability analysis involving the transfer of intangibles or rights in intangibles, the existence of risks related to the likelihood of obtaining future economic benefits from the transferred intangibles must be considered, including the allocation of risk between the parties which should be analysed within the framework set out in Section D.1.2 of Chapter I. The following types of risks, among others, should be considered in evaluating whether transfers of intangibles or combinations of intangibles are comparable, and in evaluating whether the intangibles themselves are comparable.

- Risks related to the future development of the intangibles. This includes an evaluation of whether the intangibles relate to commercially viable products, whether the intangibles may support commercially viable products in the future, the expected cost of required future development and testing, the likelihood that such development and testing will prove successful and similar considerations. The consideration of development risk is particularly important in situations involving transfers of partially developed intangibles.
- Risks related to product obsolescence and depreciation in the value of the intangibles. This includes an evaluation of the likelihood that competitors will introduce products

or services in the future that would materially erode the market for products dependent on the intangibles being analysed.

- Risks related to infringement of the intangible rights. This includes an evaluation of the likelihood that others might successfully claim that products based on the intangibles infringe their own intangible rights and an evaluation of the likely costs of defending against such claims. It also includes an evaluation of the likelihood that the holder of intangible rights could successfully prevent others from infringing the intangibles, the risk that counterfeit products could erode the profitability of relevant markets, and the likelihood that substantial damages could be collected in the event of infringement.
- Product liability and similar risks related to the future use of the intangibles.

D.2.3. Comparability adjustments with regard to transfers of intangibles or rights in intangibles

6.129 The principles of paragraphs 3.47 to 3.54 relating to comparability adjustments apply with respect to transactions involving the transfer of intangibles or rights in intangibles. It is important to note that differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner. Particularly in situations where amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, there may be reason to believe, depending on the specific facts, that the computation of the adjustment is not reliable and that the intangibles being compared are in fact not sufficiently comparable to support a valid transfer pricing analysis. If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing method that is less dependent on the identification of comparable intangibles or comparable transactions.

D.2.4. Use of comparables drawn from databases

6.130 Comparability, and the possibility of making comparability adjustments, is especially important in considering potentially comparable intangibles and related royalty rates drawn from commercial databases or proprietary compilations of publicly available licence or similar agreements. The principles of Section A.4.3.1 of Chapter III apply fully in assessing the usefulness of transactions drawn from such sources. In particular, it is important to assess whether publicly available data drawn from commercial databases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific features of intangibles that may be important in conducting a comparability analysis. In evaluating comparable licence arrangements identified from databases, the specific facts of the case, including the methodology being applied, should be considered in the context of the provisions of paragraph 3.38.

D.2.5. Selecting the most appropriate transfer pricing method in a matter involving the transfer of intangibles or rights in intangibles

6.131 The principles of these Guidelines related to the selection of the most appropriate transfer pricing method to the circumstances of the case are described in paragraphs 2.1 to 2.11. Those principles apply fully to cases involving the transfer of intangibles or rights in intangibles. In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given to (i) the nature of the relevant intangibles, (ii) the difficulty of identifying comparable uncontrolled

transactions and intangibles in many, if not most, cases, and (iii) the difficulty of applying certain of the transfer pricing methods described in Chapter II in cases involving the transfer of intangibles. The issues discussed below are particularly important in the selection of transfer pricing methods under the Guidelines.

6.132 In applying the principles of paragraphs 2.1 to 2.11 to matters involving the transfer of intangibles or rights in intangibles, it is important to recognise that transactions structured in different ways may have similar economic consequences. For example, the performance of a service using intangibles may have very similar economic consequences to a transaction involving the transfer of an intangible (or the transfer of rights in the intangible), as either may convey the value of the intangible to the transferee. Accordingly, in selecting the most appropriate transfer pricing method in connection with a transaction involving the transfer of intangibles or rights in intangibles, it is important to consider the economic consequences of the transaction, rather than proceeding on the basis of an arbitrary label.

6.133 This chapter makes it clear that in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

6.134 The principles set out in paragraphs 2.11, 3.58 and 3.59 regarding the use of more than one transfer pricing method apply to matters involving the transfer of intangibles or rights in intangibles.

6.135 Paragraphs 3.9 to 3.12 and paragraph 3.37 provide guidance regarding the aggregation of separate transactions for purposes of transfer pricing analysis. Those principles apply fully to cases involving the transfer of intangibles or rights in intangibles and are supplemented by the guidance in Section C of this chapter. Indeed, it is often the case that intangibles may be transferred in combination with other intangibles, or in combination with transactions involving the sale of goods or the performance of services. In such situations it may well be that the most reliable transfer pricing analysis will consider the interrelated transactions in the aggregate as necessary to improve the reliability of the analysis.

D.2.6. Supplemental guidance on transfer pricing methods in matters involving the transfer of intangibles or rights in intangibles

6.136 Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method to the circumstances of the case where the transaction involves a controlled transfer of one or more intangibles. The use of other alternatives may also be appropriate.

6.137 Where the comparability analysis identifies reliable information related to comparable uncontrolled transactions, the determination of arm's length prices for a transfer of intangibles or rights in intangibles can be determined on the basis of such comparables after making any comparability adjustments that may be appropriate and reliable.

6.138 However, it will often be the case in matters involving transfers of intangibles or rights in intangibles that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price and other conditions. This can occur if the intangibles in question have unique characteristics, or if they are of such critical importance that such intangibles are transferred only among associated enterprises. It may also result from a lack of available data regarding potentially comparable transactions or from other causes. Notwithstanding the lack of reliable comparables, it is usually possible to determine the arm's length price and other conditions for the controlled transaction.

6.139 Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle requires use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. In making such determinations, it is important to consider:

- The functions, assets and risks of the respective parties to the transaction.
- The business reasons for engaging in the transaction.
- The perspectives of and options realistically available to each of the parties to the transaction.
- The competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles.
- The expected future economic benefits from the transaction.
- Other comparability factors such as features of local markets, location savings, assembled workforce, and MNE group synergies.

6.140 In identifying prices and other conditions that would have been agreed between independent enterprises under comparable circumstances, it is often essential to carefully identify idiosyncratic aspects of the controlled transaction that arise by virtue of the relationship between the parties. There is no requirement that associated enterprises structure their transactions in precisely the same manner as independent enterprises might have done. However, where transactional structures are utilised by associated enterprises that are not typical of transactions between independent parties, the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances should be taken into account in evaluating the profits that would have accrued to each of the parties at arm's length.

6.141 Care should be used, in applying certain of the OECD transfer pricing methods in a matter involving the transfer of intangibles or rights in intangibles. One sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles. In some circumstances such mechanisms can be utilised to indirectly value intangibles by determining values for some functions using those methods and deriving a residual value for intangibles. However, the principles of paragraph 6.133 are important when following such approaches and care should be exercised to ensure that all functions, risks, assets and other factors contributing to the generation of income are properly identified and evaluated.

6.142 The use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer pricing methods based on the cost of intangible development should usually be avoided.

6.143 However, in some limited circumstances, transfer pricing methods based on the estimated cost of reproducing or replacing the intangible may be utilised. Such approaches may sometimes have valid application with regard to the development of intangibles used for internal business operations (e.g. internal software systems), particularly where the intangibles in question are not unique and valuable intangibles. Where intangibles relating to products sold in the marketplace are at issue, however, replacement cost valuation methods raise serious comparability issues. Among other concerns, it is necessary to evaluate the effect of time delays associated with deferred development on the value of the intangibles. Often, there may be a significant first mover advantage in having a product on the market at an early date. As a result, an identical product (and the supporting intangibles) developed in future periods will not be as valuable as the same product (and the supporting intangibles) available currently. In such a case, the estimated replacement cost will not be a valid proxy for the value of an intangible transferred currently. Similarly, where an intangible carries legal protections or exclusivity characteristics, the value of being able to exclude competitors from using the intangible will not be reflected in an analysis based on replacement cost. Cost based valuations generally are not reliable when applied to determine the arm's length price for partially developed intangibles.

6.144 The provisions of paragraph 2.9A related to the use of rules of thumb apply to determinations of a correct transfer price in any controlled transaction, including cases involving the use or transfer of intangibles. Accordingly, a rule of thumb cannot be used to evidence that a price or apportionment of income is arm's length, including in particular an apportionment of income between a licensor and a licensee of intangibles.

6.145 The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools. Supplemental guidance on the transfer pricing methods most likely to be useful in connection with transfers of intangibles is provided below.

D.2.6.1. Application of the CUP Method

6.146 Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. The general principles contained in paragraphs 2.13 to 2.20 apply when the CUP method is used in connection with transactions involving the transfer of intangibles. Where the CUP method is utilised in connection with the transfer of intangibles, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions. The economically relevant characteristics or comparability factors described in Section D.1 of Chapter I should be considered. The matters described in Sections D.2.1 to D.2.4 of this chapter are of particular importance in evaluating the comparability of specific transferred intangibles and in making comparability adjustments, where possible. It should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible.

6.147 In some situations, intangibles acquired by an MNE group from independent enterprises are transferred to a member of the MNE group in a controlled transaction immediately following the acquisition. In such a case the price paid for the acquired intangibles will often (after any appropriate adjustments, including adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price for the controlled transaction under a CUP method. Depending on the facts

and circumstances, the third party acquisition price in such situations will have relevance in determining arm's length prices and other conditions for the controlled transaction, even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets. Examples 23 and 26 in the annex to Chapter VI illustrate the principles of this paragraph.

D.2.6.2. Application of transactional profit split methods[18]

6.148 In some circumstances, a transactional profit split method can be utilised to determine the arm's length conditions for a transfer of intangibles or rights in intangibles where it is not possible to identify reliable comparable uncontrolled transactions for such transfers. Section C of Chapter II contains guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the transfer of intangibles or rights in intangibles. In evaluating the reliability of transactional profit split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered.

6.149 Transactional profit split methods may have application in connection with the sale of full rights in intangibles. As with other applications of the transactional profit split method, a full functional analysis that considers the functions performed, risks assumed and assets used by each of the parties is an essential element of the analysis. Where a transactional profit split analysis is based on projected revenues and expenses, the concerns with the accuracy of such projections described in Section D.2.6.4.1 should be taken into account.

6.150 It is also sometimes suggested that a profit split analysis can be applied to transfers of partially developed intangibles. In such an analysis, the relative value of contributions to the development of intangibles before and after a transfer of the intangibles in question is sometimes examined. Such an approach may include an attempt to amortise the transferor's contribution to the partially developed intangible over the asserted useful life of that contribution, assuming no further development. Such approaches are generally based on projections of cash flows and benefits expected to arise at some future date following the transfer and the assumed successful completion of further development activities.

6.151 Caution should be exercised in applying profit split approaches to determine estimates of the contributions of the parties to the creation of income in years following the transfer, or an arm's length allocation of future income, with respect to partially developed intangibles. The contribution or value of work undertaken prior to the transfer may bear no relationship to the cost of that work. For example, a chemical compound with potentially blockbuster pharmaceutical indications might be developed in the laboratory at relatively little cost. In addition, a variety of difficult to evaluate factors would need to be taken into account in such a profit split analysis. These would include the relative riskiness and value of research contributions before and after the transfer, the relative risk and its effect on value, for other development activities carried out before and after the transfer, the appropriate amortisation rate for various contributions to the intangible value, assumptions regarding the time at which any potential new products might be introduced, and the value of contributions other than intangibles to the ultimate generation of profit. Income and cash flow projections in such situations can sometimes be especially speculative. These factors can combine to call the reliability of such an application of a profit split analysis into question. See Section D.4 on hard-to-value intangibles.

6.152 Where limited rights in fully developed intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, a transactional profit split method can often be utilised to evaluate the respective contributions of the parties to earning combined income. The profit contribution of the rights in intangibles made available by the licensor or other transferor would, in such a circumstance, be one of the factors contributing to the earning of income following the transfer. However, other factors would also need to be considered. In particular, functions performed and risks assumed by the licensee/transferee should specifically be taken into account in such an analysis. Other intangibles used by the licensor/transferor and by the licensee/transferee in their respective businesses should similarly be considered, as well as other relevant factors. Careful attention should be given in such an analysis to the limitations imposed by the terms of the transfer on the use of the intangibles by the licensee/transferee and on the rights of the licensee/transferee to use the intangibles for purposes of ongoing research and development. Further, assessing contributions of the licensee to enhancements in the value of licensed intangibles may be important. The allocation of income in such an analysis would depend on the findings of the functional analysis, including an analysis of the relevant risks assumed. It should not be assumed that all of the residual profit after functional returns would necessarily be allocated to the licensor/transferor in a profit split analysis related to a licensing arrangement.

D.2.6.3. Use of valuation techniques

6.153 In situations where reliable comparable uncontrolled transactions for a transfer of one or more intangibles cannot be identified, it may also be possible to use valuation techniques to estimate the arm's length price for intangibles transferred between associated enterprises. In particular, the application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be particularly useful when properly applied. Depending on the facts and circumstances, valuation techniques may be used by taxpayers and tax administrations as a part of one of the five OECD transfer pricing methods described in Chapter II, or as a tool that can be usefully applied in identifying an arm's length price.

6.154 Where valuation techniques are utilised in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, it is necessary to apply such techniques in a manner that is consistent with the arm's length principle and the principles of these Guidelines. In particular, due regard should be given to the principles contained in Chapters I–III. Principles related to realistically available options, economically relevant characteristics including assumption of risk (see Section D.1 of Chapter I) and aggregation of transactions (see paragraphs 3.9 to 3.12) apply fully to situations where valuation techniques are utilised in a transfer pricing analysis. Furthermore, the rules of these Guidelines on selection of transfer pricing methods apply in determining when such techniques should be used (see paragraphs 2.1 to 2.11). The principles of Sections A, B, C, and D.1 of this chapter also apply where use of valuation techniques is considered.

6.155 It is essential to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes reflect conservative assumptions and estimates of the value of assets reflected in a company's balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and valuation approaches that are not necessarily consistent with the arm's length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes

as necessarily reflecting arm's length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not determinative for transfer pricing purposes and should be utilised in a transfer pricing analysis with caution and careful consideration of the underlying assumptions.

6.156 It is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilised by valuation professionals. Similarly, it is not the intention of these Guidelines to endorse or reject one or more sets of valuation standards utilised by valuation or accounting professionals or to describe in detail or specifically endorse one or more specific valuation techniques or methods as being especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these Guidelines, to the specific facts of the case, to sound valuation principles and practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm's length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available. See, however, paragraphs 6.142 and 6.143 for a discussion of the reliability and application of valuation techniques based on intangible development costs.

6.157 Valuation techniques that estimate the discounted value of projected future cash flows derived from the exploitation of the transferred intangible or intangibles can be particularly useful when properly applied. There are many variations of these valuation techniques. In general terms, such techniques measure the value of an intangible by the estimated value of future cash flows it may generate over its expected remaining lifetime. The value can be calculated by discounting the expected future cash flows to present value.[19] Under this approach valuation requires, among other things, defining realistic and reliable financial projections, growth rates, discount rates, the useful life of intangibles, and the tax effects of the transaction. Moreover it entails consideration of terminal values when appropriate. Depending on the facts and circumstances of the individual case, the calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction in arriving at an arm's length price. The arm's length price will fall somewhere within the range of present values evaluated from the perspectives of the transferor and the transferee. Examples 27 to 29 in the annex to Chapter VI illustrate the provisions of this section.

D.2.6.4. Specific areas of concern in applying methods based on the discounted value of projected cash flows

6.158 When applying valuation techniques, including valuation techniques based on projected cash flows, it is important to recognise that the estimates of value based on such techniques can be volatile. Small changes in one or another of the assumptions underlying the valuation model or in one or more of the valuation parameters can lead to large differences in the intangible value the model produces. A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumptions regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters.

6.159 The reliability of the intangible value produced using a valuation model is particularly sensitive to the reliability of the underlying assumptions and estimates on which it is

based and on the due diligence and judgment exercised in confirming assumptions and in estimating valuation parameters.

6.160 Because of the importance of the underlying assumptions and valuation parameters, taxpayers and tax administrations making use of valuation techniques in determining arm's length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. Moreover, it is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

6.161 It may be relevant in assessing the reliability of a valuation model to consider the purposes for which the valuation was undertaken and to examine the assumptions and valuation parameters in different valuations undertaken by the taxpayer for non-tax purposes. It would be reasonable for a tax administration to request an explanation for any inconsistencies in the assumptions made in a valuation of an intangible undertaken for transfer pricing purposes and valuations undertaken for other purposes. For example, such requests would be appropriate if high discount rates are used in a transfer pricing analysis when the company routinely uses lower discount rates in evaluating possible mergers and acquisitions. Such requests would also be appropriate if it is asserted that particular intangibles have short useful lives but the projections used in other business planning contexts demonstrate that related intangibles produce cash flows in years beyond the "useful life" that has been claimed for transfer pricing purposes. Valuations used by an MNE group in making operational business decisions may be more reliable than those prepared exclusively for purposes of a transfer pricing analysis.

6.162 The following sections identify some of the specific concerns that should be taken into account in evaluating certain important assumptions underlying calculations in a valuation model based on discounted cash flows. These concerns are important in evaluating the reliability of the particular application of a valuation technique. Notwithstanding the various concerns expressed above and outlined in detail in the following paragraphs, depending on the circumstances, application of such a valuation technique, either as part of one of the five OECD transfer pricing methods or as a useful tool, may prove to be more reliable than application of any other transfer pricing method, particularly where reliable comparable uncontrolled transactions do not exist.

D.2.6.4.1. Accuracy of financial projections

6.163 The reliability of a valuation of a transferred intangible using discounted cash flow valuation techniques is dependent on the accuracy of the projections of future cash flows or income on which the valuation is based. However, because the accuracy of financial projections is contingent on developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken, and to this extent such projections are speculative, it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense.

6.164 In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial projections for business planning purposes. It can be that such analyses are used by management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections

prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

6.165 The length of time covered by the projections should also be considered in evaluating the reliability of the projections. The further into the future the intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

6.166 A further consideration in evaluating the reliability of projections involves whether the intangibles and the products or services to which they relate have an established track record of financial performance. Caution should always be used in assuming that past performance is a reliable guide to the future, as many factors are subject to change. However, past operating results can provide some useful guidance as to likely future performance of products or services that rely on intangibles. Projections with respect to products or services that have not been introduced to the market or that are still in development are inherently less reliable than those with some track record.

6.167 When deciding whether to include development costs in the cash flow projections it is important to consider the nature of the transferred intangible. Some intangibles may have indefinite useful lives and may be continually developed. In these situations it is appropriate to include future development costs in the cash flow forecasts. Others, for example a specific patent, may already be fully developed and, in addition not provide a platform for the development of other intangibles. In these situations no development costs should be included in the cash flow forecasts for the transferred intangible.

6.168 Where, for the foregoing reasons, or any other reason, there is a basis to believe that the projections behind the valuation are unreliable or speculative, attention should be given to the guidance in Section D.3 and D.4.

D.2.6.4.2. Assumptions regarding growth rates

6.169 A key element of some cash flow projections that should be carefully examined is the projected growth rate. Often projections of future cash flows are based on current cash flows (or assumed initial cash flows after product introduction in the case of partially developed intangibles) expanded by reference to a percentage growth rate. Where that is the case, the basis for the assumed growth rate should be considered. In particular, it is unusual for revenues derived from a particular product to grow at a steady rate over a long period of time. Caution should therefore be exercised in too readily accepting simple models containing linear growth rates not justified on the basis of either experience with similar products and markets or a reasonable evaluation of likely future market conditions. It would generally be expected that a reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products.

D.2.6.4.3. Discount rates

6.170 The discount rate or rates used in converting a stream of projected cash flows into a present value is a critical element of a valuation model. The discount rate takes into account the time value of money and the risk or uncertainty of the anticipated cash flows. As small variations in selected discount rates can generate large variations in the calculated value of intangibles using these techniques, it is essential for taxpayers and tax administrations to give close attention to the analysis performed and the assumptions made in selecting the discount rate or rates utilised in the valuation model.

6.171 There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. Neither taxpayers nor tax administrations should assume that a discount rate that is based on a Weighted Average Cost of Capital (WACC) approach or any other measure should always be used in transfer pricing analyses where determination of appropriate discount rates is important. Instead the specific conditions and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate.

6.172 It should be recognised in determining and evaluating discount rates that in some instances, particularly those associated with the valuation of intangibles still in development, intangibles may be among the most risky components of a taxpayer's business. It should also be recognised that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile than others. For example, the likelihood that a projected level of research and development expense will be incurred may be higher than the likelihood that a projected level of revenues will ultimately be generated. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cash flows under the circumstances of each individual case.

6.173 Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken to avoid double discounting for risk.

D.2.6.4.4. Useful life of intangibles and terminal values

6.174 Valuation techniques are often premised on the projection of cash flows derived from the exploitation of the intangible over the useful life of the intangible in question. In such circumstances, the determination of the actual useful life of the intangible will be one of the critical assumptions supporting the valuation model.

6.175 The projected useful life of particular intangibles is a question to be determined on the basis of all of the relevant facts and circumstances. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded the intangible. The useful life of intangibles also may be affected by the rate of technological change in the industry, and by other factors affecting competition in the relevant economic environment. See paragraphs 6.121 and 6.122.

6.176 In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that non-routine returns are attributable to such intangibles in perpetuity.

6.177 In this regard, where specific intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, it will sometimes be the case that a terminal value for the intangible related cash flows is calculated. Where terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly set out and the underlying assumptions thoroughly examined, particularly the assumed growth rates.

D.2.6.4.5. Assumptions regarding taxes

6.178 Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of projected future income taxes on the projected cash flows. Tax effects to be considered include: (i) taxes projected to be imposed on future cash flows, (ii) tax amortisation benefits projected to be available to the transferee, if any, and (iii) taxes projected to be imposed on the transferor as a result of the transfer, if any.

D.2.7. Form of payment

6.179 Taxpayers have substantial discretion in defining the form of payment for transferred intangibles. In transactions between independent parties, it is common to observe payments for intangibles that take the form of a single lump sum. It is also common to observe payments for intangibles that take the form of periodic payments over time. Arrangements involving periodic payments can be structured either as a series of instalment payments fixed in amount, or may take the form of contingent payments where the amount of payments depends on the level of sales of products supported by the intangibles, on profitability, or on some other factor. The principles of Section D.1.1 of Chapter I should be followed in evaluating taxpayer agreements with regard to the form of payment.

6.180 In evaluating the provisions of taxpayer agreements related to the form of payment, it should be noted that some payment forms will entail greater or lesser levels of risk to one of the parties. For example, a payment form contingent on future sales or profit will normally involve greater risk to the transferor than a payment form calling for either a single lump-sum payment at the time of the transfer or a series of fixed instalment payments, because of the existence of the contingency. The chosen form of the payment must be consistent with the facts and circumstances of the case, including the written contracts, the actual conduct of the parties, and the ability of the parties to bear and manage the relevant payment risks. In particular, the amount of the specified payments should reflect the relevant time value of money and risk features of the chosen form of payment. For example, if a valuation technique is applied and results in the calculation of a lump-sum present value for the transferred intangible, and if a taxpayer applies a payment form contingent on future sales, the discount rate used in converting the lump-sum valuation to a stream of contingent payments over the useful life of the intangible should reflect the increased risk to the transferor that sales may not materialise and that payments would therefore not be forthcoming, as well as the time value of money consequences arising from the deferral of the payments to future years.

D.3. Arm's length pricing of transactions involving intangibles for which valuation is highly uncertain at the time of the transaction

6.181 Intangibles or rights in intangibles may have specific features complicating the search for comparables and in some cases making it difficult to determine the value of an intangible at the time of the transaction. When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction. To this aim, the guidance and recommended process in Section D of Chapter I and the principles in Chapter III as supplemented by the guidance in this chapter for conducting a comparability analysis are relevant.