Transfer Pricing in a Post-BEPS World

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# CHAPTER 2
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*Sébastien Gonnet*

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* The author would like to thank Pim Fris, Special Consultant at NERA, for his valuable contribution to this chapter. The views expressed in this chapter are solely those of the author and are not necessarily the opinions of NERA Economic Consulting.
I. INTRODUCTION

Mandated by Actions 9 and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan, the Organisation for Economic Co-operation and Development (OECD) has developed a substantial revision of the OECD Transfer Pricing Guidelines (TPG) with regard to a number of closely related topics that are ‘at the heart of the arm’s length principle’. Among others, the changes introduced emphasize the importance of identifying the commercial and financial relationships inside Multinational Enterprises (MNE) and accurately delineating the actual transactions against that relational background while also including guidance on risk definition and allocation among entities of an MNE.

This chapter summarizes the revisions to section D of Chapter I of the TPG which focuses on risk definition and allocation. It proceeds with a critical review of the OECD revisions in consideration of other sections of the TPG, notably Chapter VI on intangibles and Chapter IX on business restructurings and of the OECD guidance on Permanent Establishments (PEs). The chapter then introduces an economically sound and BEPS-compliant process as a guide for multinational companies to design arm’s length transfer pricing systems by taking into account an appropriate place for risk allocation. This process is thereafter illustrated through a case study. The chapter concludes by providing insight into specific areas of current concern for MNEs following the updated guidance on risk allocation.

Before taking a more detailed examination at the risk in post-BEPS transfer pricing practice, it may be beneficial to state a number of things about transfer pricing and the role of risk in a broader sense. To begin with, strictly speaking, transfer pricing is not a tax matter. Although it has a significant impact in regard to tax, it is basically a management-control concept: historically, it served a major role in performance measurement and management for multinational enterprises at a time that markets were primarily defined by country borders, and MNEs operated in country-based structures. All of this has gradually changed as the importance of country borders has faded when conducting business and as developing communication and information technologies widened the span of management control thus enabling the adoption of integrated business models. Today, business enterprises effectively operate as global players. No longer is the country-by-country rhythm the beginning point for conducting international business as, instead, it is now performing and managing global business operations. Consequently, country-related profits no longer had any relevance for performance management purposes, and transfer prices lost their relevance as a fundament for management control.

Although markets and business had globalized, taxation of businesses had not kept pace; global profits (per business unit or industry group) had to be converted and adapted exclusively for purposes of calculating national corporate income tax bills. Once tax authorities realized this, rules, methods, and practices were introduced exclusively for tax purposes, losing the old connection with management-control concepts now considered outdated, and transfer pricing became the playing field of tax experts. What followed was a revolution in transfer pricing practice that, driven by the increasing absence of comparable transactions, shifted the focus from transactions to
entity profits as the pretext for comparability. The question of whether this shift still afforded an opportunity for a correct application of the arm’s length principle was eclipsed in the unstoppable evolution of transfer pricing practice towards a quasi-exclusivity of the ‘new method’, introduced as the Comparable Profits Method in the US and embraced (hesitantly at first) by OECD in its 1995 TPG as the Transactional Net Margin Method (TNMM). This practice soon evolved into one based on stereotypical, functional profiles for group entities that did little justice to how commercial and financial relations really evolved between entities inside MNE operations. The BEPS initiative has provided a new stimulus to capture those relations in realistic terms, referring to roles and responsibilities of entities in the joint value creation inside an MNE business. It is useful to remember that Article 9 of OECD Model Tax Convention (MTC) defining the arm’s length principle primarily refers to (commercial and financial) relations and not to transactions and most certainly not to entity profits. Where it was concluded earlier that transfer prices lost their relevance for management-control purposes, transfer pricing practice can most certainly benefit from the concepts employed in management control to delineate those roles and responsibilities within the relational context. The analytical framework presented further in this chapter will rely on those concepts. What is the place of risk in this new context?

The most fundamental definition of an enterprise could be the following. It is an organization of capital and labor that enters into economic exchanges in society (the market), accepting the risks involved in doing so with the intention of generating profits and thus securing its continuity. As the fundamental challenge in operating a business is about accepting and managing risks, it may be obvious that risk is a key element of that part of economic science that addresses the management of enterprise. In this context, it is all the more amazing to find that, during the 1990s into the 2000s, transfer pricing practice developed a perception of risk that bore virtually no relationship with economics. Risk was captured in contractual stereotypes that perfectly matched the requirements of applying TNMM but lost connection with realities inside MNE businesses.

With the BEPS mission being founded on the concept of value creation by MNEs, the challenge for businesses is to develop a transfer pricing system for a specific MNE based on the arm’s length principle with roles of entities in the joint value creation as its essential reference. How would third parties have formulated their relationship in the circumstances of the specific MNE? Simple, straightforward tests of either comparable prices or comparable profits no longer deliver the answers required. In the transfer pricing practice, as it has taken shape post-BEPS, the contributions of individual entities to those processes of joint value creation decide the bargaining power that entities can be deemed to have in the simulation of arm’s length bargaining processes. Roles and responsibilities assigned to entities defined by group management are the beginning point of analysis. These can, for different purposes, be confirmed and documented in contracts; however, business reality, not the contract, is the driver.

In this context, the new, post-BEPS landscape for transfer pricing, and particularly the redefined place of risk, will be reviewed and assessed.
II. THE NEW OECD RISK FRAMEWORK

The OECD provides the summary below of the objectives of Actions 9 and 10 of the BEPS Action Plan and corresponding outcome:

Actions 9 and 10 mandate the development of:

i. ‘rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.’

ii. ‘rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to clarify the circumstances in which transactions can be recharacterised.’

The guidance ensures that:

- actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality contractual allocations of risk are respected only when they are supported by actual decision-making
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance
- tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply

The following section elaborates on the subject of risks in transfer pricing that are at the core of the OECD final guidance on revisions to Chapter I of the TPG. It is followed by a comparison of the new wording against the wording on risks of TPG’s Chapter IX and OECD guidance with respect to PEs.

A. Risks under the New Chapter I of the TPG

In the new TPG’s Chapter I, the OECD introduces a six-step process1 for analyzing risks:

1. Identify economically significant risks in the relevant relational context.
2. Determine how risks are contractually assumed.
3. Determine through a functional analysis which enterprise(s) assume and manage risks, i.e.,
   - perform(s) control functions and risk mitigation functions,
   - encounter(s) upside or downside consequences of risk outcomes, and
   - have(s) the financial capacity to assume the risks.

1. Paragraph 1.60.
4. Determine whether the contractual assumption of risks is consistent with the conduct of the parties by analyzing whether:
   - the associated enterprises follow the contractual terms; and
   - the party assuming risk exercises control over the risk and has the financial capacity to assume the risk.

5. Where the party assuming risk does not control the risk or does not have the financial capacity to assume the risk, allocate risk to the party exercising control and having the financial capacity to assume the risk.
   - In case of multiple associated enterprises exercising control and having the financial capacity to assume the risk, the risk should be allocated to the associated enterprise exercising the most control.

6. Price the transaction (accurately delineated) taking into account the financial and other consequences of risk assumption.

The above process (termed as ‘new OECD risk process’ in the remainder of the chapter) clarifies the existing TPG by:

- emphasizing the importance of accurate delineation of transactions;
- providing a new categorization of risks which broadens the understanding of risks within an MNE (see below);
- recognizing that risks also entail an upside element and not just a downside;
- promoting an alignment between risk management functions, funding capabilities, and actual assumption of risks; and
- enriching the existing TPG framework in which the TNMM oriented ‘typical process’ might potentially have favored artificial risk allocation in the past.

As stated in the introduction by the OECD, the new OECD risk process (and related new definitions) aims at directly addressing transfer pricing structures attributing high returns to low functionality based on a contractual allocation of risks that are considered artificial. In this respect, the new OECD risk process established by the OECD is certainly more approximate to the corresponding wording of Chapter IX than that of the former Chapter I and has certain similarities with the Authorized OECD Approach (AOA) on the attribution of profits to PEs. The following section elaborates on these similarities.

The consistency between the new OECD risk process and the OECD guidance on intangibles as expressed by the OECD itself in the Summary of the Intangibles Report should also be noted:

The chapter places the guidance on intangibles within the wider context of the guidance on accurately delineating the transaction and the analysis of risks contained in the first chapter of this Report relating to ‘Guidance on Applying the Arm’s Length Principle’, which is relevant in dealing with the difference between anticipated and actual returns to intangibles. The framework for analysing risks contained in the chapter ‘Guidance on Applying the Arm’s Length Principle’ depends on a very specific and meaningful control requirement, which takes into account both the capability to perform relevant decision-making functions together with the actual performance of such functions. If an associated enterprise contractually assuming a specific risk does not exercise control over that risk nor has the financial capacity to assume the risk, then the framework contained in the chapter ‘Guidance on Applying the Arm’s Length Principle’ determines that the
risk will be allocated to another member of the MNE group that does exercise such control and has the financial capacity to assume the risk.2

B. Risks under Chapter IX of the TPG

Chapter IX of the TPG provides a framework for understanding risks in the context of business restructuring3 that needs to be supported and substantiated by the new OECD risk framework. The OECD suggests beginning with the contractual arrangements between the related parties that are concerned but to also review the conduct of the parties, the arm’s length nature of the risk allocation, and the consequences of such risk allocation. Key concepts for a contractual allocation of risk in order to pass a reality test include:

- The control over the risks: ‘control’ should be understood as the capacity to make decisions, to take on the risk (decision to put the capital at risk), and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions.4
- The financial capacity: whether the risk-bearer has, at the time when risk is allocated to it, the financial capacity to assume (i.e., to take on) the risk.5

Even though approximate, the new OECD risk framework has certain substantial differences with the existing Chapter IX framework:

- The new Chapter I wording tends to be more explicit with specific definitions of ‘risk management’ and ‘risk mitigation’.
- The new OECD risk framework also appears to place more emphasis (than Chapter IX) on the financial capacity to assume the risk. Chapter IX indeed provides that such financial capacity is a ‘relevant, although not determinative factor’.

Such differences may justify future reconsideration and possibly the wording adaptations of OECD Chapter IX. The new OECD risk process also has a direct impact on the ‘Authorised OECD Approach’ (AOA) introduced by the OECD in the context of attribution of profits to PEs.

3. A business restructuring under Chapter IX is a ‘cross-border redeployment by a multinational enterprise of functions, assets and/or risks’ (para. 9.1).
5. Paragraph 9.29.
C. Risks under Authorized OECD Approach

The OECD Report on the attribution of profits to permanent establishments\(^6\) addresses the attribution of profits without questioning when a PE actually exists. It advocates the use – as part of the AOA – of the functionally separate entity approach as the fundamental starting point for dealing with profit attribution to PEs.

As a component of the AOA, a two-step process is required to determine the profits attributable to a PE:

- Step 1 consists of a functional and factual analysis in order to hypothesize the PE as a distinct and separate entity and to identify its role in the context of the total enterprise.
- Step 2 consists of determining the profits by applying the arm’s length principle by analogy to what would occur between distinct legal entities.\(^7\)

Within Step 1, Significant People Functions (SPF) are identified to attribute risks and economic ownership of assets to the PE. The vital aspect of the SPF concept is the capability to assume responsibility. This very closely resembles the notion of ‘control’ as it is being employed in Chapter IX and now in the new OECD risk process.

With all of the similarities between the above notions related to PE and the new Chapter I phraseology, it remains puzzling what the meaning is of certain subtle differences in wording, while the AOA emphasizes the need for ‘active decision-making’, the new OECD risk process refers to ‘decision-making’.

The similarities previously mentioned are, in fact, both logical and essential as, in the context of MNE business models, the difference between entities and other forms of presence in different countries (PEs) is often hypothetical and a situation whereby none of the competing parties has an advantage at the outset is essential in terms of attributing income based on involvement in value creation. It would, moreover, be beneficial if the recognition expressed in the TPG that business realities must be appreciated in terms of economic substance rather than contractual definitions is also extended to the issue of deciding when a PE is considered as existing. The changes to the PE definition resulting from Action 5 remain at the level of contractual definitions and seem to disregard the fact that the more refined analysis of roles in the processes of joint value creation in the MNE allows insight in the economic substance that may be more decisive in answering the PE question than contracts.

D. Critical Review

When comparing the new OECD risk framework with Chapter IX and the AOA, it can be concluded that the OECD has attempted to enhance the existing toolkit available to tax authorities for reviewing the internal allocation of risks within MNEs; allocation of


risks is a key reference for testing the ultimate allocation/attribution of profits between
the individual entities of the MNE. The OECD now provides a new risk framework
where contracts are assumed as a starting point but respected only in certain condi-
tions. In order for an entity to be faced with the upside and/or downside impact of
certain risks, it is now vital that this entity performs related risk management functions
and has the financial capacity to assume such risks. If not, tax authorities employing
the new OECD risk framework may be in a position to reallocate risks to the entity
actually performing such risk management functions and having the financial capacity
to assume the risks.

The new OECD risk process may prove as advantageous for tax authorities when
strongly criticizing extreme circumstances where risk follows neither the functions nor
the financial capacity; cash boxes illustrate good examples of such situations. For these
extreme situations, what is ambiguous is how, in practice, tax authorities will leverage
from the process and concretely apply it:

- How will the tax authorities determine which entity(ies) has control or where
the financial capacity resides?
- How will the tax authorities allocate risks to such entity(ies)?

When drafting the new OECD risk process, the OECD seems to be considering
certain exceptional and extreme situations where risks are clearly identifiable (and
quantifiable) and where the artificiality of the allocation is also obvious.

However, what about the rest, i.e., the non-extreme situations? In most situa-
tions, defining risk, identifying risk management, and financial capacity are not
obvious and free from ambiguity. The most challenging exercise is certainly the
identification of risk management and control. Currently, MNEs are becoming much
less organized with a unique decision center, hosting most (if not all) decision makers
of the group. It is increasingly the case that companies are decentralizing a number of
important responsibilities, operate with regional hubs, take decisions within a net-
work, or establish global councils to take the most important strategic decisions for the
group as a whole. Where is the control when personnel hosted by a number of different
legal entities make important decisions that entail significant upside or downside
consequences for the entire enterprise?

The above description illustrates the fundamental bias in the current transfer
pricing practice. It is the TP (tax) function inside an MNE that is expected to ensure that
business satisfies the requirements of the testing process as explained in the TPG and
applied by tax authorities. In fact, however, the responsibility of the TP (tax) function
is far wider and more fundamental than that as it must design and manage the transfer
pricing system of a company that should express and be aligned with how the company
actually operates. How a company operates can be captured not so much in functions
as in processes; the processes allow entities of an MNE to enter into the collaborative
exercise of joint value creation. An enterprise is creating value if it is successful in being
profitable and securing continuity. The perspective of a future stream of profits in
excess of the cost of funding represents this value – as yet intangible!
The new OECD risk framework indeed appears to focus on only people and control on a contemporaneous basis while the arm’s length principle refers to commercial and financial relationships between entities within a group. In order to design an arm’s length transfer pricing system, it is necessary to map the relative position of group entities involved in the process of jointly creating value by taking into account functions (with people as a key element) as well as risks and assets. Such an analysis cannot be focused exclusively on people and made on only a contemporaneous basis:

- History of an entity matters (for instance, its history in terms of cost assumption, assumption of capital expenditures investments, start-up losses).
- Legal rights of an entity should also be taken into account.
- Intangibles should not be disregarded. They generally result from a long process that an MNE has been establishing for years or even decades and have a long lifetime.

The new OECD risk process tends to invite tax authorities to review risk allocation from a purely controlling perspective as defined in the TPG, ignoring the fact that an arm’s length negotiation between entities would take into account their bargaining positions that are being extensively influenced by their history, their legal rights, and the intangibles they have built over time. In fact, these elements only emerge when paying sufficient attention to the relationships between parties in a broad sense. Any attempt to define ‘actual transactions’ without proper attention to the relational starting point is a dubious one.

The new OECD risk process, therefore, may prove misleading for tax authorities and may create risks for MNEs considering its focus on only the people perspective. This can be illustrated by a simple example. A leading MNE in a sector where brand and reputation can be claimed to be the number one Critical Success Factor (CSF) can face risks associated with the brand which range from strategic risks (less appeal to the brand vis-à-vis customers) to financial risks (a lower financial performance, higher rates of unsold products, etc.). The brand has been established over time by the Central Group entity which has been developing the brand architecture and has financed related brand promoting investments. Over the past years, however, the Group has created a strategy involving closer proximity to the markets, and marketing teams are now widespread in regional companies around the world. Regional teams are afforded the capabilities to make key decisions regarding brand advertising and promotion in their regions, events, and PR strategy and to locally adapt the brand.

These facts and circumstances create uncertainty as to how tax authorities might apply the new OECD risk process in this specific situation, notably in the countries where regional marketing teams are hosted. Tax authorities may be tempted to claim that regional teams control key brand-related strategic and financial risks and, as such, they should be entitled to related upside/downside. If so, how would local tax authorities quantify the related upside/downside of regional brand management? Notably in comparison to the central brand management activities? Is it appropriate for local tax authorities to review the set-up on an incidental contemporaneous basis only?
Should tax authorities ignore the history (brand management hosted historically centrally), the legal rights (trademarks rights at central level), and intangibles (processes involved with managing the brand result from years of elaboration and also relate to the Company’s culture and DNA)?

This basic example demonstrates that the new OECD risk process raises a number of questions. By focusing on control, the process seems to disregard important aspects that would be taken into account in an arm’s length negotiation between independent parties, i.e., history, legal rights, and intangibles.

In addition to creating risk exposure for MNEs in terms of unforeseen tax liabilities (with the potential negative impact on the reputation of the company), the new OECD risk process may also simply prove to be impractical and quasi-impossible for MNEs to manage. Isolating the ‘risk management’ functions of a certain risk is certainly not a straightforward exercise. For instance, brands are often reflected in every activity of a company, and these activities ultimately relate to customer experience. When the OECD suggests that, for a certain economically significant risk, the risk management functions must be identified, it makes the assumption that companies are simple and basic organizations: the R&D team should be held responsible for technology-related risks, the marketing team should be held responsible for brand-related risks, management should be held responsible for strategic risks, etc. The reality is much more complex. Errors within certain departments may have a significant impact on other parts of the organization, thus explaining why companies place such increasing emphasis on processes and culture/values; risks can arise from different parts of the organization.

Another illustration concerns retail brands that spend tens of millions of Euros to promote their brand. The image and value of the brand can be severely impacted by mistakes made in the suppliers’ countries, for instance, if the company’s suppliers do not respect local law and/or ethics and sustainability standards. In these cases, where is the control of such risks? Is it at the level of the group company which establishes processes and standards for supplier selection? Is it at the level of the local entity which performs the suppliers’ selection at the basic level? Is it at the level of the communication team which manages the consequences of a scandal?

It should be noted that all of the questions raised above are not hypothetical. They simply need to be answered – by the MNE. They need to be answered and can be answered; however, it must be recognized that the TPG only addresses one element of the situation. The TPG explains how tax authorities approach transfer pricing for their testing purposes, which are basically always ex-post; the MNE needs to do more than anticipating and according with those tests.

The examples given tend to confirm that the new OECD risk framework will certainly achieve the tax authorities’ goals of tackling extreme situations by providing updated tools to the tax authorities to deny risks and rewards allocated to cash boxes. For all other situations, the process as stipulated by the OECD may open areas of dispute between tax authorities and tax payers regarding what the economically significant risks are, where the control is, and to which party (and how) such risks should be allocated. More worryingly, the new OECD risk process ignores important aspects at the core of arm’s length by overly focusing on human involvement as an
allocation criterion. This process is very much static and contemporaneous. It tends to ignore history, legal rights, and intangibles that are gradually established.

In that context, MNEs should still carefully review the above risk process as this is how tax authorities will likely review risk allocation within MNEs and more generally transfer pricing systems. This process is very much meant as a tool to assist tax authorities in reviewing (and challenging) certain situations. It is not meant to help MNEs in designing an arm’s length transfer pricing system.

Designing a transfer pricing system for an MNE necessitates more:

- First, it is company-specific: each industry is specific and, within an industry, each company has its own specificities (notably in terms of the business model and organization). This means that each company needs to design, develop, and implement its own solutions to risk allocation.
- Second, the new OECD risk process, as discussed extensively, is testing-only and thus too limited to serve as a full reference for MNEs in designing their TP policies.
- Third, it tends to ignore important aspects of what would be an arm’s length negotiation between entities (for instance, history, legal rights, and intangibles).
- Fourth, the new OECD risk process does not include a perspective on how to actually define an arm’s length transfer pricing policy in regard to risk allocation.

Below is a proposed framework to help MNEs design and defend an arm’s length transfer pricing system. It is based on the concept of value creation: the NERA Value Chain Analysis framework (VCA framework). Such framework is, in our opinion, BEPS-compliant; more specifically, it is compliant with the results of Actions 8-10 and embeds a comprehensive understanding of risks in accordance with the new OECD risk process. However, while the OECD wording is a tool for tax authorities to tackle extreme risk misallocation situations, the VCA framework is broader and should help any MNE categorically design and defend arm’s length transfer pricing systems.

The following section presents the VCA framework and describes to which extent such a framework is compliant with the new OECD risk process.

III. A PROPOSED FRAMEWORK FOR UNDERSTANDING RISKS IN AN MNE8

The analytical framework leading up to an appropriate definition of a company’s transfer pricing system includes:

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– analysis of how value is created in the intercompany relationships;
– identification of the responsibilities of individual parties and entities;
– assessment of the relative bargaining position of individual entities in regard to
  the contributions to value creation and risks carried; and
– definition and implementation of transactional conditions including a coher-
  ent contractual allocation of risks.

This framework allows the mapping of the responsibilities of the individual
parties for the different concerned risk categories. It begins with an understanding of
how value is created within an enterprise and relates the enterprise’s functions, risks,
and assets (including intangibles) to the individual value drivers. It subsequently
establishes the role and responsibilities of the transacting parties considering the
identified functions, assets, and risks in regard to their ability to control such risks and
their role in the development of (intangible) assets. As a final step, it should be
established how, in this pattern of value creation in the enterprise and allocation of
roles therein to individual group entities, prices would be determined between parties
that have no shareholding ties.

A. Step 1: Analyzing Value Creation

The first step of the proposed framework involves the identification and analysis of the
enterprise’s value chain.

A value chain analysis consists of understanding how value is created in the
enterprise. This requires identifying the key value drivers that influence the most
critical success factors and that can be held accountable for the enterprise’s major risks
and for developing, maintaining, and enhancing the enterprise’s intangibles. Value
chain analysis is at the center of discussions and preoccupations in transfer pricing at
the global level because of the current complex business environment.

The OECD report on BEPS had noted:

The rise of global value chains has also changed the notion of what economies do
and what they produce. It is increasingly less relevant to talk about the gross goods
or services that are exported, while it is increasingly relevant to talk about tasks
and stages of production. In a world where stages and tasks matter more than the
final products being produced, global value chains also challenge orthodox
notions of where economies find themselves on the value-added curve. From an
economic point of view, most of the value of a good or service is typically created
in upstream activities where product design, R&D or production of core compo-
nents occur, or in the tail-end of downstream activities where marketing or
branding occurs. Knowledge-based assets, such as intellectual property, software,
and organizational skills, have become increasingly important for competitiveness
and for economic growth and employment.9

B. Step 2: Linking the Enterprise’s Functions, Risks, and Assets (IP) with Value Creation

The second step involves linking of enterprise’s functions, risks, and assets (including intangibles) with value creation as identified within the enterprise’s value chain.

Certain functions, certain risks (in accordance with the new OECD classification introduced above), and certain assets (including intangibles) of the enterprise correspond to each value driver, i.e., each step in the value creation process. In this mapping process, risks are naturally associated with functions that are influencing the risks.

A simplified illustration of the association between a value driver, functions, risks, and assets is illustrated in Figure 2.1:

Figure 2.1 Value Chain Analysis (Steps 1 & 2)

The VCA framework involves an extensive understanding of business risks as suggested by the new OECD risk process. Risks under the VCA framework are aligned with the categories outlined in the Actions 8, 9, and 10 BEPS report with two notable exceptions:

- The intellectual and human capital risks included in the VCA framework are not present in the new OECD classification.
- The transactional risks are included in the new OECD classification and not within the VCA framework.

The intellectual capital risks (including human capital risks) emerge from challenges related to a company’s talent and leadership as well as its choices to differentiate itself from the competition. The related technological, intellectual, and human capital systems are key to realizing the promises of the strategic choices. Failure will have a negative impact on continuity. In the opinion of the author, this risk category should be added to the new risk categorization proposed by the OECD.
Risk management in an enterprise is addressing the impact of volatility (both downside and upside); it is relevant to distinguish the source of volatility as well as its impact. The Figure 2.2 captures these elements in the VCA framework risk categories.  

**Figure 2.2 The Enterprise View of Risk: Managing the Impact of Volatility**

The value chain together with the related mapping of the underlying functions, risks, and assets provides an understanding of the enterprise’s value creation process, how this value creation is stimulated by functions within the entities of the enterprise, the related risks associated with the performance of said functions, and the assets (primarily intangibles) related to said functions and risks.

**C. Step 3: Mapping Roles, Responsibilities, and Control of the Individual Group Entities**

The third step establishes the role and responsibilities of the group entities/transacting parties in the identified functions, their assumption of risks regarding their ability to control such risks, and their role in the development of (intangible) assets.

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10. The opinion presented here is based on and adapted from D. Nadler & A. Slywotzky, *Risk and the Enterprise: Creating a Risk-Competent Company in an Age of Volatility*, MMC Viewpoint, issue 1 (Marsh & McLennan Companies, 2008).
In an intra-group context, a company can only be held liable for elements that it can reasonably take responsibility for, that is, for what it is equipped to manage. In that respect, the management-control concept of responsibility profiles can help define the role and responsibilities of group members involved in intra-group transactions. The responsibility profiles as given in Table 2.1 can be used.

<table>
<thead>
<tr>
<th>Transfer Pricing Responsibility Profiles Paradigm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Centers: Investment centers are profit centers, which are also responsible for investing in new products, services or work processes in order to enhance future profitability. It also assumes responsibility for the continuity of the enterprise.</td>
</tr>
<tr>
<td>Profit Centers: Profit centers are responsible for achieving the maximum profit levels by increasing revenues and/or decreasing costs.</td>
</tr>
<tr>
<td>Revenue Centers: Revenue centers are responsible for maximizing sales volumes while not exceeding the budgeted operating cost level.</td>
</tr>
<tr>
<td>Cost Centers: Cost centers are responsible for operating as efficiently as possible and producing the budgeted quantity according to the agreed quality specifications and delivery terms.</td>
</tr>
<tr>
<td>Expense Centers: Expense centers are responsible for delivering outputs according to the agreed quality specifications and delivery terms and within expense budget limits.</td>
</tr>
</tbody>
</table>

It is one thing to identify which player contractually bears the risk associated with a certain transaction; however, it is another to identify the player that is able to control, i.e., take responsibility for managing this risk. The concept of ‘control’ is crucial in this context just as it is in the new OECD risk process.

Embedded in the full-scope VCA, the new OECD risk process is more relevant for the following reasons:

- It begins with a holistic perspective on what creates value within a Company considering its chosen business model in a certain industry while the OECD testing process starts with the transactions.
- It identifies the responsibility profile of entities based on its human capabilities (control) and also on its role within the MNE by taking into account a full-scope view on functions, risks, and assets and not only on a contemporaneous basis.
- It is the relevant starting point for mapping the relative contribution of entities in the total value creation process and assessing the relative bargaining power of entities.
In order to determine which entity has ‘control’ over risk, the ‘SPP’,¹¹ and important functions¹² are crucial.

The vital aspect of the SPF concept is the capability to assume responsibility for risks. This notion was developed in the context of permanent establishments and is potentially also relevant in situations where it is questionable as to whether a contractual allocation of risk between entities is realistic.

However, it should be remembered that the notion of control is not necessarily possessed by the ‘significant people’ referred to here. The role of management in a company ranges from strategy definition (long term) through responsibility allocation or delegation in the design of the business model (medium term) to operational management responsibilities (with year-to-year reporting) allowing ‘control’ and evaluation by the management level that allocated the responsibility to the operational managers. A team or an entity can be reputed as performing an SPF only to the extent that people in the team or entity have the actual resources and competences to manage and take responsibility for the underlying risks and assets. ‘Control’ of how good the team or entity performs its operational role, notably in the form of ‘active decision-making’ in relationship to the assumption of risks and ownership of assets, rather suggests the strategic level. This is reflected in Chapter IX (context of business restructurings) where paragraph 9.23 clarifies that:

in the context of par. 1.49, ‘control’ should be understood as the capacity to make decisions to take on the risk (decision to put capital at risk) and decisions on whether and how to manage risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions.

In the context of the ‘important functions’ (introduced as an expression in the discussion draft for Chapter VI, dealing with intangibles), the key criterion is also ‘control’ which obviously refers to a group’s value creation in a wide sense, embracing all risk categories. Important functions as elaborated in Chapter VI just seem to have a more limited focus as the concept is applied only in the context of the generation of intellectual property. ‘Intangibles’, however, form a broader universe than merely intangible property depending up how they are defined by the Guidelines as intangibles or as comparability factors.

The two terms, SPF (at an operational level) and important functions (at a more strategic level), are comparable as they both emphasize the distinction between performing certain activities versus the control issue. That is exactly what can be captured by using the responsibility profiles previously introduced in combination with the different risk categories in the enterprise view on risk.

¹². OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, July 2013.
D. Step 4: Assessing Bargaining Positions in the Internal Pricing Process

The fourth and final step of the proposed framework consists of the translation of contributions of group entities/transacting parties to value creation while considering the responsibilities attributed to them in their respective bargaining positions in the process of establishing transfer prices.

Transactions are the materialization of the commercial and financial relationships between different parties. Both commercial and financial relationships between independent and associated enterprises can take many distinctive forms. They can be incidental, involving one or a limited number of transactions, or can be broad and of long duration. Furthermore, relationships constitute a different context depending upon the impact that the decision to enter into the transactional arrangement will have in terms of additional investments in capacity, i.e., in assets and people.

If one of the parties has invested heavily and that investment becomes obsolete earlier than foreseen, then the impact on the price of the transaction between the parties will be different depending upon the relationship. If the relationship is purely transactional, this would be the risk of the investing party. However, in the context of a long-term cooperative relationship, parties will re-assess their terms and conditions if and as long as they both wish to continue their relationship. In other words, they will find a way to share the consequences of an unforeseen event and of the risks arising from it.

Figure 2.3 The Relational Pricing Dynamics

The relational context dictates the dynamics of the ultimate allocation of jointly achieved results to the individual parties involved (the basic transfer pricing system design). In this respect, methods play a different role than the one identified for testing purposes. In the detailed design, the different relevant parameters of the system can be stipulated based on the bargaining positions and solidified by, potentially, a broad range of further economic analyses. Benchmarking may give relevant orientation; however, ultimate justification may have to be delivered by analytical tools such as an analysis of external long-term relationships, investment-based models, game theory, compensation-based models, surveys, and bargaining analyses.
In summary, the analytical process previously described effectively helps to assess the respective contributions by the transacting parties in an intra-group context to the joint value creation and to derive the relative bargaining position of each of them. The information on the bargaining power of the entities involved is essential for concluding an appropriate pricing system for internal transactions and allows evaluating whether or not, in the complex reality within the MNE, third parties would enter into the transactions with the prevailing terms and conditions. Only if that conclusion is justified can the prices for intercompany transactions be considered to be ‘at arm’s length’.

IV. CASE STUDY

The case study aims at illustrating how the above VCA framework may help MNEs in the design and documentation of transfer pricing policies in the post-BEPS context. It emphasizes that a crucial process of understanding value creation and risks within the entire enterprise combined with rigorous economic analyses provide the foundations for MNEs to (re)design and defend their transfer pricing policy.

This case study section is composed of an introduction of the background of the case followed by a summary of the application of the VCA framework and is concluded by the application of an economic analysis in regard to the VCA findings.

A. Background

The Company operates within an industrial sector and exclusively as a B2B business. Within the sector where the Company operates (industrial with B2B distribution), brands may or may not be valuable intangible assets.

Functions involved in the development and maintenance of the Company’s brand (the ‘Brand’) are centrally controlled and performed (including some local execution) but fully funded by the local operational entities through a management fee recharge.

The case aims at:

- determining whether the Brand is actually a valuable intangible asset for this Company in this sector;
- if so, identifying which entities are involved in the Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE\(^{13}\)) of the Brand;
- in regard to the above, assessing whether the existing transfer pricing system is arm’s length, BEPS proof, and compliant with the new OECD risk process; and
- if a change in transfer pricing system is needed, designing the new transfer pricing system for the Brand.

\(^{13}\) OECD/G20 BEPS Project, Intangibles, para. 6.32 ‘ownership of intangibles involving the development, enhancement, maintenance, protection and exploitation of intangibles’.
B. VCA Framework

The application of the VCA framework to this case is described below.

**Step 1: Analyzing Value Creation**

The analysis established that the Brand:

- acts as a guarantee of highest quality and reliability;
- helps to attract and retain most skilled employees given its reputation and culture based on strong corporate values; and
- increases cross-selling opportunities due to a uniform appearance.

Therefore, it was concluded that the Brand was indeed a CSF of the Group. Other CSFs included: (i) the technology/technological knowledge; (ii) the global size of the Group; and (iii) the dense local sales network.

**Step 2: Linking the Enterprise’s Functions, Risks, and Assets (IP) with Value Creation**

Functions related to the Brand (and related intangibles) are not only:

- Central Marketing functions, and
- Local Marketing functions,

but also:

- Central Operational Management functions.

As a matter of fact, the key Brand attribute relates to operational excellence and related processes and is, therefore, ‘controlled’ by central Operational Management functions.

Risks related to the Brand range from strategic risks (loss of reputation/trust in the event of severe product failure or accident) to financial risks (less cross-selling, reducing cash flow).

The related trademark legal rights are owned by the central group company.

**Step 3: Mapping Roles, Responsibilities, and Control of the Individual Group Entities**

Under the VCA framework, Step 3 determines the group entities that can be held responsible for the major risks related to a certain value driver. This evaluation is made relying on an understanding of the entities’ functional capabilities. This analysis is accorded to the OECD new risk process involving the identification of ‘control’.

Under both the VCA framework and the OECD new risk process, the aforementioned situation of the Company suggests that the Group’s Central company should be held responsible for the upside and downside related to the Brand.
This analysis of ‘control’ under the VCA framework and the new OECD risk process can be supplemented by the OECD DEMPE process as described in the revised Chapter VI.

Table 2.2 illustrates that the central group entity virtually controls all of the key functions with respect to the Brand while the funding of related costs is provided by local group entities which are recharged as brand building costs as well as the costs of central functions involved in the Brand development:

<table>
<thead>
<tr>
<th>Brand</th>
<th>Functions (Perform/Control)</th>
<th>Funding (Provide)</th>
<th>Risks (Control/Bear)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development</td>
<td>C</td>
<td>L</td>
<td>?</td>
</tr>
<tr>
<td>Enhancement</td>
<td>C</td>
<td>L</td>
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</tr>
<tr>
<td>Maintenance</td>
<td>C</td>
<td>L</td>
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</tr>
<tr>
<td>Protection</td>
<td>C</td>
<td>L</td>
<td>?</td>
</tr>
<tr>
<td>Exploitation</td>
<td>L</td>
<td>L</td>
<td>L</td>
</tr>
</tbody>
</table>

where ‘C’ stands for Central group entity; ‘L’ stands for Local entities.

Following the new OECD guidance on DEMPE, it is uncertain which entities can be claimed to ‘control/bear risks’ related to the intangible when one entity controls/perform the functions and other entities fund them. Such a situation may actually qualify as an illustration of mismatch between value creating functions and assumption of related risks under the new OECD risk process.

**Step 4: Assessing Bargaining Positions in the Internal Pricing Process**

Steps 1-3 of the VCA framework suggest that:

- The Brand is a valuable intangible asset.
- Functions involved in the development and maintenance of the Brand are hosted centrally; stated otherwise, control of the brand-related risks lies centrally.
- Consequently, the Central Group company should be held responsible for the upside/downside related to the Brand.

In terms of the transfer pricing design, this could signify that:

- The central group entity could stop re-invoicing to local entities those costs that are related to the Brand development.
- The local entities could be willing to pay a trademark fee if the trademark adds benefits and value to their local business.
- It is also worth noting that the local entities may possibly claim at arm’s length that they had been funding brand building costs for years and that this would be taken into account in an arm’s length negotiation with the Brand owner.
The above suggests that:

- A trademark license contract could be established between the group central entity and the local entities.
- The trademark royalty could be assessed in regard to the underlying profitability that the local entities using the trademark are in a position to make. In the absence of reliable comparable uncontrolled transactions (in a B2B industrial context), the Profit Split Method (PSM) could be appropriate to determine arm’s length royalty between the group entity and each individual entity.
- Any transfer pricing method could take into account the past and history of the entities. Prior funding by the local entities should be accounted for at arm’s length in the royalty determination.

If the above is achieved, an alignment between value creation and profit allocation will be achieved. This alignment is illustrated in Table 2.3:

<table>
<thead>
<tr>
<th>Brand</th>
<th>Functions (Perform/Control)</th>
<th>Funding (Provide)</th>
<th>Risks (Control/Bear)</th>
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<td>Protection</td>
<td>C</td>
<td>C, L</td>
<td>C, L</td>
</tr>
<tr>
<td>Exploitation</td>
<td>L</td>
<td>C, L</td>
<td>C, L</td>
</tr>
</tbody>
</table>

### C. New Transfer Pricing System

The OECD Guidelines describe the ‘PSM’ as a method which ‘seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (...) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions’.14

The PSM could qualify as the appropriate method to determine the royalty fee to be agreed upon between the central group entity and the individual entities if the following conditions are met:

- the contributions of both the Central Group entity and local entities are both unique and valuable; and/or
- the economic circumstances under which the parties operate are unique; and/or

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the sharing of costs/risks as reflected by the conduct of the parties is unique; and/or
the Brand is unique.

In this case, as noted above:

The Brand has been identified as a valuable intangible asset.
Central functions are key contributors to the Brand value.
The license contract is negotiated under unique circumstances where the local entities had been funding the Brand building costs in the past.

No external relevant reference may provide insight into the royalty value considering the B2B industrial sector in which the Company operates.

Under these circumstances, the PSM is selected. It is worth noting that method selection depends upon the facts and circumstances of the case.

Under the PSM, different types of analyses may be conducted. Three are presented here – non-mutually exclusive – of the usually most promising types of PSM:

The Contribution Profit Split Method (Contribution PSM): the combined profits (generally, the combined operating profits) are divided among the participants in the value chain based upon the relative value of the functions that are performed. In order to justify this division, the OECD Guidelines recommend the use of external market data. In practice, the determination may be based upon an analysis of the relative value of each participant’s contribution. This analysis can either be based on external data (such as data from joint ventures, for example) or internal data (including financial data).

The Comparable Profit Split Method (CPSM): the combined operating profits of participants are divided among the participants in the value chain based on data from observed comparable transactions between third parties. Comparable transactions should refer to a division of profits and should satisfy comparability criteria (similar activities and circumstances).

The Residual Profit Split Method (RPSM): this relies on a categorization of functions, risks and assets according to which benchmarkable functions are distinguished from entrepreneurial functions. Once arm’s length returns have been attributed to routine functions, residual profits are divided between the two affiliates based on an appropriate allocation principle.

In this case, the RPSM may prove superior in terms of methodology as benchmarkable returns can be identified for the benchmarkable activities, including technology, thus allowing a determination of the residual return and what intangible assets and entities contribute to this residual. It is worth noting that selecting the RPSM within the PSM depends upon the facts and circumstances of the case.

The Brand value and, within the brand value, the share attributable to the licensor lies within the residual as illustrated in the graph below:
The residual profit acquired by the local entities represents the incremental value that they may possibly generate. Therefore, it reflects the returns that can be attributed to the company’s competitive advantage and directly relates to the development of intangibles – in the case at hand – the Brand (provided that there has been remuneration for technology). How third parties would decide to split this incremental value relating to the development of intangibles depends upon their respective bargaining power; such bargaining power depending itself on their contribution to value creation and to the development of such intangibles.

The investments on brand development by local entities prior to the trademark license contract and by the group central company from the initiation of the license contract can be used as a proxy to arrive at an arm’s length split of residual profits. The reasons for including historical brand development costs in the model is to recognize the contribution and intangibles development role of local entities prior to the creation of the licensing agreement.

It must be acknowledged, however, that not all costs have the same importance. Some of them are of a more strategic nature and have a longer lifetime while others have a shorter reach or investments need to be renewed frequently considering the nature of the costs or the cycles of the business.

Therefore, rather than looking at costs expensed on a yearly basis by the negotiating parties, the ‘economic capital’ developed by each of them should be
examined. It is worth noting that the choice of method for determining the split factor depends on the facts and circumstances of the case.

This approach (use of capital instead of expenses) is supported by the OECD which tends to suggest approaches based on capital rather than yearly expenses:

An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added.\(^{15}\)

Cost-based allocation keys have the advantage of simplicity. It is however not always the case that a strong correlation exists between relative expenses and relative value.\(^ {16}\)

‘Asset-based or capital-based allocation keys can be used where there is a strong correlation between tangible or intangible assets or capital employed and creation of value […]’.\(^ {17}\)

By dividing the residual profit based on the respective economic capital of the transacting parties, the returns achieved by each party on the capitalized costs and not on the costs expensed is equalized. The capitalization (build-up of the economic capital) takes into account appropriate assumptions on gestation lag and economic lifetime:

- The gestation lag is the time between when the investment is made and the moment it generates the first revenues.
- The economic lifetime is the period of time during which the investments may generate revenues.

Each party’s economic capital is calculated every year as following:

\[
EC_i^n = EC_i^{n-1} - Depr_i^{n,n-1} + Inv_i^{n-x}
\]

\[
EC_j^C = EC_{j-1}^C - Depr_j^{C,n-1} + Inv_j^{C,x'}
\]

where:

- \(EC_i^n\): Economic Capital of party \(i\) in year \(n\)
- \(Depr_i^{n,n-1}\): Economic Depreciation in year \(n\) of the Economic capital of party \(i\) in year \(n-1\) based on the economic lifetime of the investments made
- \(Inv_i^{n-x}\): Investments made by party \(i\) in year \(n-x\)
- \(Inv_j^{C,x'}\): Investments made by party \(j\) in year \(n-x'\)
- \(x\) and \(x'\): Investments’ gestation lags

\(^{15}\) Paragraph 2.138.
\(^{16}\) Paragraph 2.139.
\(^{17}\) Paragraph 2.136.
As seen in the previous equation, each party’s economic capital does not equal the yearly costs incurred by each party (accounting approach) but includes the entrepreneurial investments capitalized by taking into account a gestation lag.

Comparing the economic capital of each party is then a beneficial proxy for assessing their respective contributions and for how these two parties would share profits at arm’s length.

\[
\text{Share of Residual Profit}_n^k \ = \ \frac{EC_n^k}{EC_n^k + EC_n^c}
\]

\[
\text{Share of Residual Profit}_n^c \ = \ \frac{EC_n^c}{EC_n^k + EC_n^c}
\]

The model fulfills the objectives set out in regard to the very special circumstances of the case as it takes into account the prior investments and funding by local entities. Concretely and schematically, what the model does is that the royalty charged by the central entity includes a ramp-up of the rate to acknowledge that the central entity has full economic ownership of the brand’s intangibles after the contribution of local entities has been extinguished in accordance with the intangibles’ life duration – as can be illustrated in the figure below:

**Figure 2.5 Determination of Brand Royalty Ramp-Up**

- Proportion of central HQ in Entrepreneurial Capital
- Proportion of local entities in Entrepreneurial Capital

Gradual ramp-up of royalty
D. Case Study Summary

In the opinion of the author, the case study provides a beneficial illustration of how the VCA framework can help MNEs in navigating the post-BEPS requirements and, more specifically, the requirements related to the new OECD risk process.

This case study demonstrates that the VCA framework goes deeper than the OECD new risk process. Beginning with a holistic/top down approach, it helps qualify the bargaining power of transacting parties and is a useful tool for method selection and application.

While the OECD new risk process focuses only on human contribution made on a contemporaneous basis, the VCA framework brings the control/SPF/important functions aspect into a broader context where history, legal rights, and intangibles development are taken into account.

We can also note that rigorous economic analyses can be made to quantitatively interpret what the VCA has determined qualitatively. In the previous example, a cost capitalization model under RPSM helps to take into account the funding activities by the local entities of brand building costs in the past.

V. CONCLUSIONS

This chapter provides a comparative analysis of the OECD new risk process under revised Chapter I with (new) guidance from Chapter VI, (existing) guidance from Chapter IX, and PE-related concepts and definitions.

The new OECD risk process may prove to be useful for tax authorities when challenging extreme arrangements where risk follows neither the functions nor the financial capacity, with cash boxes being good examples of such situations. For the non-extreme situations, it still remains uncertain how, in practice, tax authorities will define risk and identify the entities performing risk management functions, having control, and the financial capacity. It is also not clear how tax authorities will reallocate risks in the event that they determine a discrepancy between control and risk assumption.

The new OECD process incites a number of questions as it creates an opportunity for consideration of control at a certain point in time only (ignoring the history, legal rights, and intangibles development of an entity). However, the arm’s length principle itself refers to commercial and financial relationships between entities within a group which necessitates mapping the relative position of group entities involved in the process of jointly creating value. This relative position must be assessed through a full-scope VCA which should encompass functions (and people) as well as risks and assets.
Chapter 2: Risks Redefined in Transfer Pricing Post-BEPS

The BEPS context calls for a comprehensive understanding of where value is created within MNEs. Guidance from revised Chapter I on risk, the new OECD risk process, is a tool primarily directed towards tax authorities to review extreme situations and, therefore, may appear to be unpractical to MNEs. The broader VCA framework is certainly more relevant for MNEs that would like to review the arm’s length nature of their transfer pricing systems in the post-BEPS environment.