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Profit Shifting

Andrus: 'Strong View' With OECD Delegates Against High Returns to Capital-Only Entities

While the Organization for Economic Cooperation and Development will continue to refine its latest work on risk and recharacterization, its members aren't likely to budge soon from their view that heavily capitalized entities—so-called cash boxes—will need to demonstrate significant substance to justify high rates of return, an OECD adviser said.

''I think there is a pretty strong view among government delegates that an entity that doesn't do anything but have capital, and the contractual assignment of risk, is not going to be entitled to huge amounts of residual income,'' said Joe Andrus, the former head of transfer pricing for the OECD who is currently working as a consultant to the organization. ''I think that message will continue to come through, and I hope people will understand why that message comes through.''

Andrus spoke June 12 during a panel at a transfer pricing conference co-sponsored by Bloomberg BNA and Baker McKenzie LLP.

'Just Nonsense.' Andrus elaborated on the notion that entities without significant business operations could be viewed as venture capital firms for arm's-length purposes.

''I would take issue with the proposition that every industrial company in America can be viewed as a Bermuda tax haven entity, that conducts the same business that Kleiner Perkins does in Silicon Valley, and writes insurance contracts on the income of every other entity in the group,'' Andrus said. ''That's just nonsense. And if that's what people think the arm's-length standard gets them to, they need to be disabused of that.''

Andrus reiterated that the discussion draft on risk and recharacterization, which was released in December 2014 as part of the OECD's base erosion and profit shifting project, would be heavily revised in regard to risk, moving to a ''process-oriented'' concept.

''That process as it's going to be laid out in the draft sort of follows some steps, and tells you how you want to think about risks in a transfer pricing context,'' Andrus said. ''Those steps start with looking at what the contracts say about risk, looking at how the taxpayer has conducted its affairs, and trying to understand that in relation to risk. Making sure that those line up with one another. And then in particular looking at what the draft calls control of risk, and determine whether the control of the risk and the contractual and substantive allocation of the risk are in the same place.''

If those conditions aren't satisfied, Andrus said, the new guidance would call for some reallocation of risk, and a repricing of the transaction.

''I think that's sort of a sensible way to go through risk issues,'' Andrus said. ''I think the draft will be much closer to what you see in Chapter 9, than was in the discussion draft.''

Recharacterization. On the controversial chapter on recharacterization, Andrus said the final draft would likely include a narrow provision identifying when income can be recharacterized.

''The discussion draft was an attempt to move that discussion off of square one, and I think that turned out not to be particularly successful,'' Andrus said. ''I will expect that the next version will contain some language about recharacterization. That language will be much closer to what the current guidelines say, than what the discussion draft said, focusing particularly on whether the transaction is commercially rational, and hopefully trying to give a little bit more guidance that current 165 guidance does about what that means.''

Andrus said on June 10 that a provision allowing recharacterization in cases where ''moral hazard'' hadn't been taken into account has been dropped from the draft.

Panelists from the private sector took issue with some of Andrus' assertions on the allocation of risk.

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"I think it is almost as inappropriate to assign a risk-free rate of return to the capital," said Patricia Lewis, a member of Caplin & Drysdale in Washington. "That just strikes me as being at odds with the arm's-length principle."

On recharacterization, Salim Rahim, a partner at Baker & McKenzie in Washington, said many arrangements accused of not reflecting economic realities do in fact have a business purpose.

"Oftentimes it is good business practice to centralize the ownership of intangibles," Rahim said. "As long as the pricing of the intangibles that were transferred are arm's-length, there should be no room for nonrecognition."

Hard-to-Value Intangibles. Speaking at a June 10 panel, Andrus commented on a recent BEPS draft on hard-to-value intangibles that was released June 4.

He said the rules should be viewed less as a prescriptive regime to deal with intangibles, and more as a set of principles to aid tax authorities with transfer pricing enforcement—particularly in regard to the guidance that allows tax administrators to consider ex post returns in the evaluation of an ex ante price.

"I think there is a strong sense that what this is supposed to be accomplishing is getting taxpayers to explain, exactly, how they balance stuff," Andrus said.

He said the rules aren't intended to be a "hard and fast set of rules that accountants would love."

"What it is supposed to be saying is that if you do your homework right, if you convey the information that you actually used in making business decisions to governments, if you take into account contingencies the way unrelated parties take into account contingencies, you ought to be OK. If you don't do these things, the governments have the ability to think about these actual results, to think about what would have been the arm's-length outcome."

Brian Jenn, an attorney-adviser in Treasury's Office of International Tax Counsel, agreed.

"I think the spirit of the rule is to really force taxpayers to show their work, to do good work, including the kind of analysis that takes into account all possible outcomes, and hopefully use payment arrangements similar to what comparables or unrelated parties would have done," Jenn said.

'Squishier' Rules. Jenn acknowledged, however, that the rules were "squishier" than the U.S. commensurate with income standard.

"There's certainly more work that could have been done to improve the draft," he said. "It is a very hard endeavor, to balance trying to give tax administrations some flexibility to respond appropriately using ex post data to what they see as a real disadvantage in information asymmetry, with the desire to give taxpayers more certainty about when a tax administration can do something like that."

The rule isn't meant to simply punish companies that are unexpectedly successful, Jenn said.

"It does involve some 'trust me' from the tax administration, but it is the intention of the rule to not capture every situation where there's a positive outcome," he said.

Is It Practical? Other panelists, however, questioned the practicality of the rule.

Holly Glenn, a principal economist with Baker & McKenzie Consulting LLP in Washington, said the rules on whether a company could have foreseen a market development sets up an "almost impossible standard."

She hypothesized a company that considered many possibilities, including a scenario with a 10 percent likelihood.

"If the future unfolds, and that 10 percent scenario is in fact the one that arises, or most closely approximates what arises, how does that work under those rules? Because it wasn't unanticipated, it wasn't unforeseeable," Glenn said. "What happens if your product just hits the sweet spot of the marketplace, and you sell more than you thought you would?"

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