Mexico City, February 6, 2015

Via e-mail
transferpricing@oecd.org
Mr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration

Dear Mr. Hickman,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below the comments on the Public Discussion Draft on Action 8, 9 and 10 of the BEPS Action Plan – "Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)" (the "Draft").

1) Comments to paragraph 22

> *22. [1.45 – modified slightly] Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.*

Paragraph 22 states that the identification and consideration of the material risks assumed by each party is a necessary condition for the functional analysis to be complete. However, no criterion is provided about when should a risk be considered material. Although the concept of materiality may be a matter of a case by case evaluation, further criteria should be put forward in order to avoid controversies derived from subjective evaluation.

2) Comments regarding moral hazard

The document requires commentaries around the concept of moral hazard. Specifically, it states that:

> *"[…]The term is used (for example in paragraphs 62 and 67) to introduce the concept that unrelated parties would seek to avoid moral hazard that may arise in situations where one party assumes a risk without the ability to manage the behaviour of the party creating its risk exposure. The concept extends to the safeguards or incentives that unrelated parties may incorporate into contracts between them in order that interests are better aligned and moral hazard is reduced or avoided.*
>
> *[…]*
>
> *Between associated enterprises, however, the existence of common control will generally mean that there is no need to contractually align incentives in order to ensure that one party will not act contrary to the interests of the other. Instead, the associated enterprises may operate collaboratively in order to maximise MNE group profits. The adverse effects of moral hazard may in practice not occur.*
>
> The document requires comments on the following questions:
>
> *1. Under the arm's length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?*

Moral hazard is a direct consequence of a divergence of interest between the parties involved. As the document states, the existence of common control will generally mean that there is no need to contractually align incentives.

Moral hazard should not be considered as a factor unless there is proof that the parties behave as third parties, as such situation would be the existence of moral hazard unless contractual incentives are created that align the interests of the parties.

> *2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing*

intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

Such situation may not be relevant between related parties in general. Although frequently related parties do not share insights about core competencies other than a need-to-know basis, associated enterprises frequently share the information that is needed to develop the core activities of the group in each market, as that is a natural way for the multinational enterprise to add value for the corporation as a whole.

3) Comments regarding Paragraph 84

84. Because non-recognition can be contentious and a source of double taxation, it is recommended that every effort is made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and that non-recognition is not used simply because determining an arm's length price is difficult. […]"

Although it is accepted that non-recognition should be used only under specific circumstances, the lack of sufficient guidance makes the application of the principle highly contentious and potentially subject to arbitrary judgement. We consider that non-recognition is not a sound approach for transfer pricing purposes unless specific and practical guidance is provided regarding why and when it should be applied.

4) Comments regarding Paragraphs 88 and 89

88. The concept of the fundamental economic attributes of arrangements between unrelated parties gives greater definition to the test of commercial rationality which underpinned the discussion of non-recognition in the 1995 and 2010 versions of these Guidelines. That commercial rationality test requires consideration of whether the actual arrangements differ from those which would have been adopted by independent parties behaving in a commercially rational manner, but can be challenging to apply since, as the Guidelines themselves acknowledge, controlled parties do enter into arrangements which differ from those adopted by independent parties. That test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done. In addition, the test can be interpreted as having two legs (commercial

rationality and whether the structure adopted practically impedes the determination of an appropriate transfer price) which must be met, as opposed to interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality. The two legs can lead to the assertion that if you can find a price, the arrangement is not commercially irrational, with a resulting emphasis on the quality of the process of determining an "appropriate" price rather than on whether it is appropriate in the first place to try to find a price for something which lacks the fundamental economic attributes of arrangements between unrelated parties.

89. In order for the transaction as accurately delineated to be recognised for transfer pricing purposes, the transaction should exhibit the fundamental economic attributes of arrangements between unrelated parties. An arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis, compared to other opportunities realistically available to them at the time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them, then the transaction would not be recognised for transfer pricing purposes. In applying the criterion, it is relevant to consider whether there exists an alternative for one or more of the parties, including the alternative of not entering into the transaction, which does provide the opportunity to enhance or protect their commercial or financial positions. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis. The criterion may be illustrated by the example in the following paragraph.

Comparability is a key component of the arm's length principle. Its reliance on third-party data makes the principle difficult to apply but it also limits the subjectivity associated to the diversity of financial or economic approaches available for the evaluation of an intercompany transaction.

The concept of "fundamental economic attributes" as proposed in the previous paragraphs, proposes –without sufficient guidance- an "override" to the comparability approach in which the arm's length principle relies. Its use may result in speculation and the use of hypothesis that cannot be demonstrated in practice.

Its use by the tax administration may be a potential source of uncertainty as taxpayers may face a tax liability even if they maintain documentation that includes a reasonable application of a method and comparables. As a consequence, we believe that such concept should not be incorporated at all.

5) Comments on point 3 of the Special Measures (general section)

3. However, in preparing the revised guidance in response to the mandate of the BEPS Action Plan, it has been recognised that even if these changes to the transfer pricing guidance are introduced, certain BEPS risks may remain. These residual risks mainly relate to information asymmetries between taxpayers and tax administrations and the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs. Therefore, special measures have been considered to address these risks.

It should be noted that the BEPS initiative includes a significant increase in the documentation requirements to be faced by multinational enterprises. Such increase reduces the asymmetries mentioned in the previous paragraph. The application of special measures may not be justified under such situation.

6) Comments on hard-to-value intangibles

Option 1: Hard-to-value intangibles ("HTVI")

Action 8 of the BEPS Project requires the development of transfer pricing rules or special measures for transfers of hard-to-value intangibles. The need for a measure arises because of the potential for systematic mispricing in circumstances where no reliable comparables exist, where assumptions used in valuation are speculative, and where information asymmetries between taxpayers and tax administrations are acute. The most significant issues can arise where it is difficult to verify the assumptions on which a fixed price is agreed sometimes several years before the intangible generates income.

The measure could target circumstances where the taxpayer:
• fixes the price either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and

• does not contemporaneously document those projections and make them available to the tax administration.

The effect of the measure would permit the tax administration to presume that a price adjustment mechanism would have been adopted and as a result may rebase the calculations based on the actual outcome, imputing a contingent payment mechanism. A contingent payment mechanism may include any price adjustment made by reference to contingent events, including the achievement of financial thresholds such as sale or profits, or of development stages.

The presumption may be rebuttable under certain conditions. Those condition (sic) could be designed to include situations where:
• the taxpayer can demonstrate the robustness of its ex ante projections used in determining the fixed price, its experience of making such projections reliably in similar circumstances, and the comprehensiveness of its consideration of reasonably foreseeable events and other risks.
• the outcome does not differ from projections used ex ante to calculate the fixed price by more than [xx]% or the actual profitability of the transferee does not differ from anticipated profitability by more than [xx]%.

The lack of a contingent mechanism may not be coherent with the arm's length principle under certain circumstances, however, neither is an adjustment based on actual results. If third parties where to agree to a contingent mechanism, the triggering factor should be based on events whose probability of occurrence is foreseeable at the moment the transaction is carried out.

If this special measure is to be considered, the tax administrations should base their analysis on the information available to the taxpayer at the moment the transactions were closed, not on actual outcomes.

Contrary to the suggestion of the document, we believe it is for the tax administration rather than for the taxpayer to demonstrate that the adjustment is based on reasonably foreseeable events and other risks. The special measure in itself presumes that the taxpayer did not make a reasonable effort in determining an arm's length price. Hence, the idea that the presumption of the tax administration is rebuttable may not be in practice a real defense alternative for the taxpayer it the latter has to demonstrate that his analysis was reasonable rather than the tax administration being required to demonstrate otherwise.

Furthermore, if such a special measure were to be utilized, it may become a measure prone to arbitrary judgement if no clear-cut criteria are provided regarding terms like “robustness”, “experience” or “comprehensiveness”.

7) Comments on Thick Capitalisation

Option 3: Thick capitalisation

This option depends on determining and applying a thick capitalization rule based on a pre-determined capital ratio. The effect of this option would be to determine the amount of capital in excess of this ratio, and then to deem interest deductions on the excess capital which would reduce the profitability of the capital-rich company and produce deemed interest income in the company providing the excess capital.

A crucial feature for this option is to determine the level of thick capitalisation. Options might include adopting a group ratio or a fixed ratio, including consideration of a fixed ratio which may be set by reference to capital adequacy requirements as if the company were a regulated financial services business.

This option on the capital ratio to be used based on a pre-determined or group ratio is contrary to the case-by-case analysis required by the arm’s length principle. A “too-low” capital ratio would result in an ineffective measure and a “too-high” capital ratio would lead to excessive taxation and a distortion of the tax due in each jurisdiction.

If this measure were to be applied, it should be based on a capital ratio applicable to the specific circumstances of the taxpayer. However, such approach would result in information requirements and the elaboration of analysis not that different to those used under the arm’s length principle. Under that scenario, this measure would fail as a simplifying measure.

8) Comments on the Minimal functional entity

Option 4: Minimal functional entity

It may be the case in transactions between associated enterprises, especially transactions transferring key business risks or intangibles, that one of the parties to the transaction has minimal functions. Minimal functions

may also be the root cause of an arrangement lacking the fundamental economic attributes that normally underpin arrangements between unrelated parties. It may prove simpler and more effective, therefore, in dealing with such cases to adopt a targeted special measure that focuses on a level of functionality that, where lacking, would cause the profits of that entity to be reallocated.
The option would determine thresholds of functionality. Such thresholds could involve:

• Qualitative attributes
− The entity lacks the functional capacity to create value through exploiting its assets and managing its risks, and is mainly reliant on a framework of arrangements with other group companies in order to exploit its assets and manage its risks.
• Quantitative attributes
− The company in substance performs mainly routine functions, and has a small number of employees;
− A substantial part of the company's income is from arrangements with group companies
− The value of the company's assets is greater than or significant in proportion to its income, or an attribute based on a thick capitalization ratio.

The effect of falling beneath the thresholds would require the entity's profits to be reallocated. There are various options that could be considered for doing so:

• A mandatory profit split could be used based on a pre-determined factor. The profits of the minimal functional entity would be combined with the profits of the company or companies providing the relevant functional capacity to exploit the company's assets and manage its risk, and the mandatory profit split applied.
• The profits could be re-allocated to the immediate parent, and if that immediate parent is also a minimal functional entity, iteratively up the chain until the parent is not a minimal functional entity.
• The profits could be re-allocated to the company providing functional capacity, and if more than one such company, shared between them in proportion to the respective contributions.

The quantitative measures proposed are not considered to be appropriate indicators that a Minimal functional entity is in place:

If an entity has routine functions and employees, those factors in themselves should be a proof that the company is entitled to an arm's length result. If the objective is to demonstrate that the functions or number of employees are not coherent with the level of income involved, then the reasoning would lead to a standard transfer pricing analysis rather than to a special measure.

There does not seem to be a clear reasoning of why the source of the revenue (related or unrelated party) is a factor for determining that a Minimal functional entity is in place.

The comments mentioned for the thick capitalization proposed also apply to the criteria that the value of the company's assets is greater than or significant to the income. Hence, such criterion would result in arbitrary conclusions or in the elaboration of an analysis not very different from standard transfer pricing techniques.

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The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.