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Are legal rights irrelevant for transfer pricing after BEPS Actions 8, 9 and 10?

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The longstanding view on application of the arm's length principle is that it is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. A transaction, for this purpose, almost always involves a contract. This is because a contract, whether made in writing, orally or by the conduct of the parties is the expression of what each party undertakes to do by way of action or inaction (functions performed) and how risks that are relevant to the transaction are borne. Contracts may not address the resources that the parties need in order to perform their obligations, but transacting parties will be mindful of what is needed in order to do so, measuring the cost of the transaction with hoped for reward.

The OECD report that launched the BEPS Programme did not explicitly address the contractual nature of transactions, but the now well-known business structures of the multinational enterprises described in that report that triggered the programme, would have involved carefully drafted written contracts. These contracts were, no doubt, designed to deliver the allocation of profits among the companies comprising those enterprises in the way that is now regarded as unacceptable profit shifting (OECD (2013), Addressing Base Erosion and Profit Shifting).

Character of tangible and intangible property
The legal classification of property as tangible or intangible (res corporales or res incorporales), dates back at least to Roman times, in Western legal systems. Unlike tangible property which has a physical existence, intangibles only exist because the law says they exist. Thus intangibles themselves are bundles of rights and obligations. One consequence of this is that ownership (the legal relationship between the asset at a person) in the case of intangibles, is inherently tied up with the existence of the asset.

BEPS Transfer Pricing Actions
BEPS Actions 8, 9 and 10 involved rules to prevent base erosion and profit shifting by (a) moving intangibles among group members (Action 8), (b) transferring risks among, or allocating excessive capital to, group members (Action 9) and (c) by engaging in transactions which would not, or would only very rarely, occur between third parties (Action 10).

Action 9 objectives were to be achieved by "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."

On one reading, the objective and means of Action 9 are limited. For example, when comparing a controlled transaction with an uncontrolled transaction, one might ask whether an independent enterprise would agree that a risk that it would bear in the absence of the other party agreeing to accept it would be safely assumed by that other party if it did not have the capacity to bear that risk.
Instead, the OECD has taken the mandate it gave itself as widely as it could possibly be construed. The final report (OECD (2015), Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project) http://dx.doi.org/10.1787/9789264241244-en (rewrites entirely the guidance for applying the arm's length principle set out in Chapter 1 (The Arm's Length Principle). Work under Action 9 considered the contractual allocation of risks, and the resulting allocation of profits to those risks, which, it said, may not correspond with the activities actually carried out. How risks are borne in transactions between independent enterprises is not normally borne by reference to activities carried out. Often risks are borne by reference to remuneration and not the other way round.

The reason that contracts between independent enterprises are reduced to writing, is to ensure certainty. If there is no written agreement, then all facts and circumstances that may prove the existence or the terms of an agreement need to be examined. If there is a written agreement, then any variation in that agreement must be proved, again by reference to relevant facts and circumstances. To the extent that the new language of Chapter 1D of the guidelines can be interpreted in saying this, it is neither new nor revealing.

Where the contract is between associated enterprises, the arm's length principle as embodied in Art 9(1) of the OECD Model, requires the effect of the association on the transaction to be identified. That effect then permits an upwards adjustment of profits of the enterprise adversely affected.

The new guidelines recognise the difference between identifying the true terms of the contract (delineating the transaction) and determining whether it is on arm's length terms. However, the guidance is effectively the same for both steps. This carries the risk that the controlled transaction is not the actual transaction undertaken but rather a hypothesised transaction which in turn in compared with another hypothetical transaction (that which independent enterprises would have undertaken). Recasting the terms of controlled transaction before comparison with the uncontrolled transaction is close to non-recognition of the controlled transaction as undertaken.

Intangibles
The revised approach to intangibles is even more radical. The thrust of Action 8 proposals is that ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles. Instead, associated enterprises performing functions related to the development, maintenance, enhancement, protection and exploitation of an intangible can expect appropriate remuneration. This approach denies the essence of ownership which includes, the right to possess, the right to use, the right to manage, the right to the income and capital of the property (See e.g. Tony Honoré, "Ownership," in A.G. Guest, ed., Oxford Essays in Jurisprudence (Oxford 1961)).

Ownership stripped of its normal attributes
Changes to the special considerations for intangibles in Action 8 frequently refer to "legal ownership". However, the ownership that the draft guidelines propose is, in effect, nominal

ownership or bare title, striped of virtually all normal attributes of ownership. The only role of "legal ownership" as used here is to characterise the intangible. The legal link between the property and the person is ignored. This misdescription of ownership lays the foundation for attaching the return on exploitation of intangibles to those who provide services or other forms of activity in connection with the intangible. The question whether a transaction concerns intangibles or services is old. Conflation of the two in the BESPS final report brings us no closer to the answer.

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