# Substance in Transfer Pricing in a Post-BEPS World and Beyond…

**In this article, the authors examine the notion of substance for transfer pricing purposes in the pre- and post-BEPS era and provide some considerations in light of the current discussions on the digitization, digitalization and digital transformation of the economy.**

## 1. Introduction

The concept of substance for transfer pricing purposes, first introduced in 1979 by the OECD in its Transfer Pricing and Multinational Enterprises Report (1979 Report),[1] has since been significantly developed. In 1995, the OECD released its first Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995 OECD Guidelines),[2] which was based on the 1979 Report, in which reference was made to "economic substance" – a notion that was then further elaborated on in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Action Plan.[3] The concept of substance surfaced throughout the 15 Actions of the BEPS Project, which were originally presented under three pillars: (i) coherence; (ii) substance; and (iii) transparency, as analysed in section 3.[4]

In general, the application of tax laws involves an assessment of facts and the interpretation of the law.[5] During such assessment of facts, an interpreter should focus on (i) their *legal reality* (also referred to as legal substance); and/or (ii) their *economic reality* (also referred to as economic substance).[6] In international taxation, the notion of substance refers primarily to the "economic", "commercial activity" or "value creation", in order to tax the "real" economic activity. Over the past years, however, the development and digitalization of the economy has further facilitated the structuring of multinational enterprises' (MNEs) operations, sometimes driven by tax planning reasons.

In this context, the mandate from the G20 leaders regarding the OECD BEPS Project was to reform the international tax rules to ensure that MNEs will be taxed "where economic activities occur and value is created"[7] in order to minimize – if not entirely eliminate – artificial profit shifting toward low-tax jurisdictions. In such situations, taxation on the basis of economic reality or substance would allow tax authorities to set aside transactions that the taxpayer has not actually carried out, consequently disregarding the legal characterization of the acts to focus on the economic result.[8] Thus, the "substance over form" doctrine requires overlooking legal forms in order to apply tax laws based on the underlying economic substance.

Therefore, today more than ever, the concept of substance has become relevant in the international tax landscape, since it strongly impacts the way MNEs structure their global operations. The purpose of this article is to examine the notion of substance for transfer pricing purposes in the pre- and post-BEPS eras, as well as to provide some considerations in light of the current discussions on the digitization, digitalization and digital transformation of the economy.

Initially, the article provides a general background on the concept of substance in international taxation, as well as specifically for transfer pricing purposes. Subsequently, the article elaborates on the OECD guidance on substance before and after the 2015 BEPS Action Reports were issued and how the concept of substance has evolved and been amended by the latter. Furthermore, special considerations are provided regarding the impact of the digitization, digitalization and digital transformation of the economy on the concept of substance. The article con-

* **Raffaele Petruzzi, PhD, LLM is Managing Director of the WU Transfer Pricing Center at the Institute for Austrian and International Tax Law at WU (Vienna University of Economics and Business) and international tax advisor specializing in international corporate taxation and transfer pricing at L&P Global (Vienna) and at Ludovici Piccone & Partners (Milan). The author can be contacted at raffaele.petruzzi@wu.ac.at.**
**Argyro Myzithra, LLM is Transfer Pricing Senior Consultant at EY Greece. The author can be contacted at argyro.myzithra@gr.ey.com.**
**The authors would like to thank Professor Alfred Storck for his review and valuable inputs. This contribution reflects the personal opinion of the authors. It is unrelated to any employment of the authors and does not necessarily reflect the position of any employers.**

1. OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* para. 24 (1979), Primary Sources IBFD [hereinafter *1979 Report*].
2. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* paras. 38, 46 and 116 (OECD 1995), Primary Sources IBFD.
3. OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2015), available at https://www.oecd.org/ctp/action-plan-on-base-erosion-and-profit-shifting-9789264202719-en.htm (accessed 5 Dec. 2019).
4. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), Primary Sources IBFD.
5. F. Zimmer, *Form and Substance in Tax Law – General Report* p. 21 (IFA Cahiers vol. 87A, International Fiscal Association 2002).
6. J. Li, *"Economic Substance": Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance*, 54 Canadian Tax Journal 1, pp. 43-44 (2006).
7. S. Picciotto, *International Taxation and Economic Substance*, 70 Bull. Intl. Taxn. 12, p. 752 (2016), Journal Articles & Papers IBFD; and OECD, *BEPS Project Explanatory Statement: 2015 Final Reports*, p. 4 (OECD 2016).
8. L. De Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series 14, p. 168 (2008), Books IBFD.

 © IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

cludes by presenting final remarks and proposals for future developments on the subject.

## 2. Substance in a Pre-BEPS World

### 2.1. The general background

#### *2.1.1. Substance in international taxation*

Although the term "substance" is not officially used in double tax treaties (DTTs), it is gaining increasingly significant importance in international taxation and MNEs' tax structures. Substance is relevant in international taxation both as a determinant of tax liability and as a limitation on how national tax law provisions should be applied.[9]

In tax treaty law, substance is relevant in the field of international taxation for determining whether or not an MNE or an individual is entitled to treaty benefits. Many jurisdictions require a certain level of presence (i.e. substance) in order to grant a company the benefits of its local tax legislation and tax treaties. In this regard, most countries have specific legislation to prevent so-called "treaty shopping",[10] including specific limitation on benefits (LOB) rules, general anti-avoidance rules (GAARs) and clauses, as well as residency and beneficial ownership requirements. To this end, the OECD Multilateral Convention (MLI)[11] introduced treaty changes with regard to, among others, the prevention of tax treaty abuse (BEPS Action 6). According to the BEPS Action 6 Final Report,[12] jurisdictions must implement one of the following approaches: (i) a principal purpose test (PPT); (ii) a PPT and either a simplified or a detailed LOB provision; or (iii) a detailed LOB provision supplemented by an anti-conduit rule.[13] To determine whether obtaining a treaty benefit was one of the principal purposes of a transaction or arrangement, an objective analysis should be conducted with respect to the aims and objectives of all persons involved, also taking into consideration all the relevant circumstances. In this regard, it is not necessary to find conclusive proof regarding the intent of a (legal or physical) person, but it must be reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain a treaty benefit. For example, in case an arrangement was undertaken as part of a core commercial activity, and the form of the arrangement was not driven by tax considerations or by obtaining a tax reduction, it is unlikely that its principal purpose was to obtain a tax benefit. Additionally, obtaining a treaty benefit has to be one of the principal purposes of the transaction and not its sole or dominant purpose.

An example that can be considered representative of the increasing role of substance in tackling tax treaty abuse is that of a company considering establishing a regional services company, which could provide group services to foreign subsidiaries.[14] After reviewing the possible locations, the company decides to establish the regional services company in a country that has a number of attractive features, including the availability of skilled staff, a stable business-friendly environment and a comprehensive tax treaty network. The chosen country has concluded tax treaties with all the countries in which the relevant foreign subsidiaries are located, and the respective treaties provide for low withholding tax rates. The conclusion of the BEPS Action 6 Final Report is that this should not necessarily lead to the application of the PPT to deny treaty benefits.[15] The Report states that merely reviewing the effects of the treaties would not enable a conclusion to be drawn on the purpose of establishing the regional company (i.e. of the arrangement). Consideration should be especially given to the business activities of the regional centre and the exercise of substantive economic functions using assets and assuming risks, i.e. ensuring that the regional company's activities (i) include making the decisions necessary for the conduct of its business; and (ii) constitute a real business exercising substantive economic functions, using real assets and assuming real risks, and that the business is carried out by the regional company and its own personnel located in the same state. This example appears to indicate that it is important not only to consider all the factors involved in the decision underlying an arrangement or transaction but also that the actual activities and assets subsequently undertaken may influence the weight given to the likely business-versus-tax factors.[16] In more basic terms, having real business or substance in the selected jurisdiction should help the taxpayer pass the PPT.

In other words, as per the MLI, where an arrangement or transaction qualifies for a treaty benefit (e.g. a reduced rate of withholding tax), certain practical points must be considered before assessing the principal purpose from a treaty perspective. When identifying the principal purpose of an arrangement or a transaction in order to support that the PPT should not be applied to deny treaty benefits, one has to determine whether, even if obtaining a treaty benefit was a principal purpose for the arrangement or transaction, granting the treaty benefit in the relevant circumstances would be in accordance with the object and purpose of the relevant provision of the treaty. In other words, as analysed above, the taxpayer should show that there is substance or economic activity in the selected jurisdiction.[17]

9. J.S. Wilkie, *Substance in International Taxation*, 21 Intl. Transfer Pricing J. 5, p. 362 (2014), Journal Articles & Papers IBFD.
10. "Treaty shopping has been described as the situation where a person who is not entitled to the benefits of a tax treaty makes use – in the widest meaning of the word – of an individual or of a legal person in order to obtain those treaty benefits that are not available directly"; *Treaty Shopping*, in J. Rogers-Glabush (ed.), *IBFD International Tax Glossary*, at p. 502 (IBFD 2015), Books IBFD.
11. OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2017), Treaties & Models IBFD [hereinafter *MLI*].
12. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015), Primary Sources IBFD [hereinafter *BEPS Action 6 Final Report*].
13. Id., at p. 9 et seq.
14. *BEPS Action 6 Final Report*, *supra* n. 12, at p. 62.
15. Id.
16. *See* International Tax Review, *MLI: Testing the 'principal purpose'* (12 Dec. 2018), available at https://www.internationaltaxreview.com/article/b1f7n2f6tqcfyx/mli-testing-the-principal-purpose (accessed 24 July 2020) [hereinafter ITR *MLI*].
17. Id.

© IBFD


Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

It should be mentioned that the topic of substance is being elaborated on by an increasing number of jurisdictions.[18] This is despite the fact that the US Treasury Regulations[19] under tax code section 482 have remained unchanged, so, as a technical matter, any changes to the OECD Guidelines or discussion drafts should not affect the interpretation or application of section 482. At least for the moment, US transfer pricing law contains no analogue to the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) rules and continues to respect contractual assumption of risks, except in extreme cases.[20]

In most jurisdictions, substance requirements play also a central role in determining the corporate residence of an enterprise. The tie breaker rule of art. 4(3) OECD Model Tax Convention on Income and on Capital 2017 (OECD Model), dealing with dual residence, sets the place of effective management of an enterprise as a criterion to determine substance.[21] This approach follows the reasoning that, as it would be senseless for an individual to have more than one centre of vital interest in two different Contracting States, the same logic applies to an enterprise.[22] In order to fulfil the substance requirement, the residence test focuses on the central management and control of an enterprise, as well as its place of effective management. The two notions are not necessarily identical; the former focuses on legal governance considerations but rather with the reality of governance relative to business operations in accordance with the intrinsic expectations of formal legal organization, while the latter focuses on a more operational test, i.e. where real corporate decision making takes place.[23]

It is also noteworthy how the concept of substance applies through the beneficial ownership requirement included in the articles regarding dividends, interest and royalty payments (articles 10, 11 and 12 of the OECD Model, respectively). The OECD Model and, therefore, most DTTs (which are based on it) provide for a treaty benefit to the residents of a Contracting State only if they are the "beneficial owners" of an income. In other words, the taxing rights of the source state regarding the aforementioned categories of income depend on whether the payee is the beneficial owner with regard to the respective payments.[24]

Although the term "beneficial owner" is not defined in the treaties, the Commentary on the OECD Model (OECD Commentary) gives a practical, non-limitative qualification criterion, affirming that beneficial ownership is "the right to use and enjoy" an income and that this income must not be constrained by a "contractual or a legal obligation to pass the payment received".[25] In other words, in order to justify the benefit from treaty relief, the non-resident has to both (i) reside in the treaty partner country to a sufficient degree to be generally taxable by that country; *and* (ii) have sufficient authority over the income in order to justify the conclusion that it owns the latter and is not a mere conduit to another person, therefore, not being entitled to the benefits of the relevant tax treaty.

Also, in the transfer pricing area, the concept of substance has a peculiar relevance. More specifically, and as analysed in this section, the OECD 2010 Guidelines consider that the outcome from a tax perspective of a transfer pricing structure (i.e. allocation of profits and losses between associated enterprises) is to be accepted by the tax administrations, under the condition that the substance of the structure matches its legal form.[26] This provision, equivalent to the respective tax treaty provisions that aim to provide the tax benefits in accordance with the substance criteria, seeks to avoid an inaccurate attribution of the taxable profits to a particular jurisdiction.[27] Both the OECD's work in this regard and the BEPS Project brought forward the issue as to whether, and to what extent, economic substance plays (or should play) a role in the application of the national tax regimes and also under the auspices of the OECD or other organizations working in this regard (e.g. the United Nations, the European Commission or the International Monetary Fund).[28]

At this stage, it should be highlighted that the meaning of the term "substance" is significantly varying (although, in some cases, overlapping) based on the specific tax legislation that is applied. This article will focus on the analysis of this concept from a transfer pricing perspective.

### *2.1.2. The importance of substance in transfer pricing*

The arm's length principle is fundamentally based on three pillars, namely (i) the separate entity approach; (ii) the relevance of contractual arrangements; and (iii) the comparability of the transaction.[29] Based on the first pillar (i.e. the separate entity approach), two parts of a single enterprise, or two enterprises belonging to the same group of companies, should be treated as separate legal entities pursuing their own interests. Pertaining to the second pillar (i.e. the relevance of contractual arrangements), the

18. E.g. the Anti-Tax Avoidance Directives (ATAD I and ATAD II) introduced the controlled foreign company (CFC) rules, as well as a general anti-avoidance rule as a safety net for European states incorporating the directive, which aims to tackle artificial arrangements that lack economic substance in order to shift profits into low-tax jurisdictions.
19. For the detailed US Treasury Regulations under tax code sec. 482, *see* https://www.irs.gov/pub/irs-apa/482_regs.pdf (accessed 17 Nov. 2020).
20. Bloomberg Tax, *INSIGHT: Transfer Pricing Substance in Flux—DEMPE, BEPS 2.0, and Covid-19* (2020), available at https://news.bloombergtax.com/transfer-pricing/insight-transfer-pricing-substance-in-flux-dempe-beps-2-0-and-covid-19 (accessed 12 Aug. 2020).
21. The respective notion for individuals is the "centre of vital interest"; *seeOECD Model Tax Convention on Income and on Capital* art. 4(2) (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model* (2017)].
22. P. Baker, *Chapter 8 – The Expression "Centre of Vital Interests" in Art. 4(2) of the OECD Model Convention,* in *Residence of Individuals under Tax Treaties and EC Law*, p. 171 (G. Maisto ed., IBFD 2010), Books IBFD.
23. Wilkie, *supra* n. 9, at p. 363 et seq.
24. J. Monsenego, *The Substance Requirement in the OECD Transfer Pricing Guidelines: What Is the Substance of the Substance Requirement?*, 21 Intl. Transfer Pricing J. 1, p. 17 et seq. (2014), Journal Articles & Papers IBFD.
25. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 12* para. 4.3 (21 Nov. 2017), Treaties & Models IBFD.
26. Monsenego, *supra* n. 24, at p. 9 et seq.
27. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.50 (22 July 2010), Primary Sources IBFD [hereinafter *OECD Guidelines* (2010)].
28. J.S. Wilkie, *Policy Forum: BEPS One Year In: Taking Stock*, 62 Can. Tax J. 2, p. 1 (2014).
29. R. Petruzzi, *The Arm's Length Principle: Between Legal Fiction and Economic Reality,* in *Transfer Pricing in a Post-BEPS World* pp. 1-32 (M. Lang, A. Storck & R. Petruzzi eds., Wolters Kluwer 2016).


© IBFD

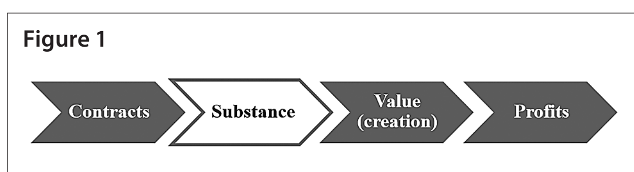
Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

analysis of the legal arrangements between the different enterprises (or "dealings", in the case of permanent establishments (PEs)) should be based on the legal structure adopted by the related parties involved in the transaction. Hence, the focus of the analysis should be primarily on the assessment of the arm's length pricing of the transaction. Regarding the third pillar (i.e. the comparability of the transaction), the assessment of the arm's length nature of the transaction should be performed by a comparison of conditions made or imposed between non-independent enterprises and those between independent enterprises. The relevance of these three pillars for the interpretation of the arm's length principle is of utmost importance, both in theory and in practice.

The topic of substance has a clear relevance for the second pillar. For example, assume that Company A, located in State X, is the parent company of ABC group and that Company B is a subsidiary of the same group and is located in State Y. Assume that Company A and Company B have entered into an intra-group service agreement, whereby Company A should provide management services to Company B and Company B should pay a service fee to Company A. In the course of an audit in State Y, the tax auditor discovers that Company B receives identical management services from a third-party service provider. If the relevance of contractual arrangements is applied without any doubt, Company B will be able to deduct the management fees paid to Company A. However, if some elements of doubt are included into the relevance of contractual arrangements and, rather, the substance of the transaction is considered relevant, there might be circumstances under which Company B would not be able to deduct the management fees (or at least part of them).[30]

Therefore, the concept of substance in transfer pricing plays a fundamental role. Indeed, in transactions between related enterprises, the basic paradigm as depicted in Figure 1 must be assumed.

Figure 1




In other words, contracts define substance, substance defines value (creation) and value (creation) defines profits. When applying this model, the entire equation should be aligned with the economically relevant characteristics (or comparability factors), such as (i) contractual terms of the transaction; (ii) functions performed by each of the parties to the transaction (taking into account assets used and risks assumed); (iii) characteristics of property transferred or services provided; (iv) economic circumstances of the parties; (v) and business strategies pursued by the parties.[31] With specific reference to substance, functions performed, assets used and risks assumed by the parties are of key relevance.

Ultimately, the analysis of the above mentioned economically relevant characteristics (or comparability factors) will provide the accurate delineation and recognition of an actual transaction. Therefore, an accurate definition of "substance" in transfer pricing is extremely important.

## 2.2. OECD guidance on substance in a pre-BEPS world

### *2.2.1. A brief historical excursus on the evolution of the concept of substance*

OECD guidance on substance in transfer pricing can be traced to its 1979 Report and has evolved significantly ever since. In the 1979 Report, the OECD observed that related parties may enter into arrangements that are not (or are very rarely) seen between independent parties and, in such cases, tax administrations are required to determine the "underlying reality behind an arrangement".[32] In this context, the 1979 Report briefly provided that the tax administration might disregard or substitute "actual transactions" in "exceptional cases",[33] however, without providing extensive details on this concept.

The 1995 OECD Guidelines and, later on, the 2010 OECD Guidelines continued to further develop the guidance on substance, based on the groundwork laid down by the 1979 Report. The 1995 Guidelines placed considerable emphasis on the "parties' conduct", which is determined by way of a functional analysis. The phrase "economic substance" was first introduced in paragraph 1.26 of these Guidelines and referred to the actual conduct of the parties or, in simpler terms, what was actually undertaken by the parties regardless of the formal contracts. Moreover, the OECD provided more details on the above mentioned concept of "exceptional cases", whereby referring to the cases of (i) economic substance of a transaction differing from its form; and (ii) arrangements made (viewed in their totality) differing from those that would have been adopted by independent enterprises behaving in a commercially rational manner (such that the actual structure practically impedes the tax administration from determining an appropriate transfer price).[34]

The 2010 Guidelines continued developing the guidance on substance within the newly developed chapter on business restructurings, in which two sections were dedicated to discussing the substance requirements for the purpose of applying the arm's length principle in such context.[35]

30. R. Petruzzi et al., *Fundamentals of Transfer Pricing: A Practical Guide* p. 16 (M. Lang et al. eds., Wolters Kluwer 2019).

31. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.36 (10 July 2017), Primary Sources IBFD [hereinafter *OECD Guidelines* (2017)].
32. *1979 Report*, *supra* n. 1.
33. Id., at para. 23.
34. *OECD Guidelines* (2010), *supra* n. 27, at para. 9.169.
35. Id., at ch. IX and parts I and IV.



Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

Furthermore, various other works of the OECD have also contributed to this topic, notably the 2010 Report on the Attribution of Profits to Permanent Establishments.[36]

### *2.2.2. Pre-BEPS guidance on substance*

The application of the arm's length principle, based on the 2010 Guidelines, seems to require the following 4-step analysis:[37]

(1) comparability analysis (considering options realistically available);
(2) recognition of the accurately delineated transaction undertaken;
(3) selection of the most appropriate transfer pricing method; and
(4) application of the most appropriate transfer pricing method.

When analysing the guidance on substance, most of the focus is placed in the first two steps of the above mentioned process. Regarding the comparability analysis, the assessment of functions performed, assets used and risks assumed by the parties (i.e. the functional analysis) is of key relevance. In any case, substance should be determined by examining the "conduct" of the parties and "all the facts and circumstances" in an "economic and commercial context" from a "practical and business point of view".[38] It is worth mentioning that most of these concepts were introduced in the 2010 Guidelines and embedded into Chapter IX (on business restructurings). Therefore, it should be kept in mind that, prior to these guidelines, the application of these concepts to any kind of transaction (i.e. outside the scope of Chapter IX) should not have been taken for granted.

As far as functions are concerned, it is relevant, on the one hand, to assess the competence of the employees[39] and, on the other hand, their authority to take decisions.[40] In this regard, it seems that (i) the competence of the employees needs to be assessed, together with control of the activities; (ii) important functions cannot be outsourced; and (iii) managerial skills are also important, together with technical and scientific skills (the latter especially with regard to transactions concerning the development and exploitation of intangibles).[41] Although the 2010 Guidelines do not explicitly refer to the first factor that defines substance, i.e. the competence of the employees to perform a task, it becomes apparent by means of examples[42] that this competence constitutes an important element in the substance question. The guidelines also provide little guidance on the second afore mentioned factor defining substance, i.e. the authority to take decisions. This criterion refers rather to the requirement of the proper authority to take valid and binding decisions (i.e. either by law or by the articles of an association). The authority to take decisions as a substance requirement can also be found in other areas of international taxation (e.g. the authority to conclude contracts in the name of the enterprise as a factor justifying the existence of a PE in tax treaty law).[43]

The relevance of functions is even stronger in the context of attribution of profits to PEs[44] where contractual arrangements are not existent and, therefore, the substance plays a more critical role. In this scenario, the OECD, within its authorized OECD approach (AOA), identifies the core focus of an analysis leading to profit attribution in the significant people functions (SPFs) or key entrepreneurial risk-taking (KERT) functions (the latter being relevant in the case of financial institutions),[45] as a starting point and as the basis of attribution of risks, assets, capital and, ultimately, profits, to PEs.[46] In this respect, a potential issue arises from functions performed automatically and/or without human intervention.[47] To this end, the AOA suggests that the functional analysis should focus on the phys-

36. OECD Ctr. for Tax Policy and Admin., *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), Primary Sources IBFD [hereinafter *OECD Report* (2010)].
37. R. Petruzzi et al., *supra* n. 30, at pp. 3-33.
38. *OECD Guidelines* (2010), *supra* n. 27, at para. 9.170.
39. Id., at paras. 9.26-9.27.
40. Id., at para. 9.23.
41. Monsenego, *supra* n. 24, at p. 12 et seq.
42. *OECD Guidelines* (2010), *supra* n. 27, at e.g. the capacity of the investor to assess the outcome of a fund manager's activities (para. 9.25), the capacity of the principal to assess the outcome of research activities (para. 9.26) or the capacity of the manufacturer to assess the outcome of manufacturing activities (para. 9.27).
43. *OECD Model* (2017), *supra* n. 21, at art. 5 para. 5.
44. R. Holzinger, *Article 7 AOA vs Article 9 OECD/UN Models*, in *Attribution of Profits to Permanent Establishments: Current Developments, Relevant Issues and Possible Solutions* p. 23 et seq. (M. Lang et al eds., Linde Verlag 2020).
45. The authorized OECD approach (AOA) attributes the core financial assets of financial services companies (i.e. the loans and insurance contracts) and, therewith, the associated opportunities and risks to the permanent establishment (PE) that has performed the KERT function, the most important function in the process of risk assumption. It should be noted that because of the special relationship between risks and financial assets in those specific sectors, the AOA uses the key entrepreneurial risk-taking (KERT) function terminology in describing the functions relevant to the attribution of both risks and assets, but that terminology is not used for other sectors. Outside the financial enterprise sector, risks may be less intimately linked with assets so that there may be less overlap between the significant people functions (SPFs) relevant to the assumption of risk and those relevant to the economic ownership of the assets; *see OECD Report* (2010), *supra* n. 36, at para. 16.
46. According to id., at Part I, sub-para. 62, the OECD underlines the relevance of the functions performed by the personnel of the enterprise as a whole, including the PE (i.e. the "people functions" for the functional and factual analysis) when assessing the significance, if any, they have in generating the profits of the business. The focus in this step is on the "people functions" performed in the PE, with respect to the functions performed in the company as a whole. The most significant differentiation regarding the SPFs between the AOA and the 2010 Guidelines derives from the fact that the risks of a PE are particularly difficult to allocate, firstly because it is the whole enterprise that bears the risk and the PE has no separate legal personality, and secondly due to the highly integrated character of its activities. However, under the AOA: "the PE should be considered as assuming any risks for which *the significant people functions* relevant to the assumption of risks are performed by the personnel of the PE's at the PE's location"; *see OECD Report* (2010), *supra* n. 36, at Part I, sub-para. 68. Therefore, the focus is always on the "people functions" performed in the PE with respect to the functions performed in the company as a whole. However, the AOA clarifies a hierarchy between risk and functions; *see OECD Report* (2010), *supra* n. 36, at Part III, sub-para. 80.
47. In particular, *see* J. Monsenego, *May a Server Create a Permanent Establishment? Reflections on Certain Questions of Principle in Light of a Swedish Case*, 21 Intl. Transfer Pricing J. 4 (2014), Journal Articles & Papers IBFD, analyses several aspects with regard to PE requirements and servers. In particular, he affirms: "The authorized OECD approach does not recognize the possibility to attribute to a server the functions that are automatically performed by the server; however, as such functions are performed automatically, i.e. with no human intervention, a server will not be attributed any significant people functions."


© IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

ical presence of the persons performing the key functions in the PE, referred to as SPFs.[48]

Regarding risks, a broad understanding is provided. Risks seem indeed related to costs,[49] price fluctuations[50] and to specific items in the financial statements (e.g. write-downs in order to ascertain which party assumes certain risks).[51,52] Remarkably, two notions are fundamental in this context: the control over risks[53] and the financial capacity to assume risks.[54] Although the general guidance on risks was mainly limited to underline that "it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control",[55] more extensive details on risk were provided in Chapter IX of the 2010 Guidelines. Here, the notion of control over risk is defined 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".[56] Nevertheless, control over risk is noted as a "relevant, although not determinative factor"[57] to examine the substance of the risk allocation among related parties. Moreover, it is pertinent to note that such examination is only required when reliable evidence of the same allocation of risks in comparable uncontrolled transactions does not exist.[58,59]

Additionally, it is also required to identify which party has the financial capacity to bear the consequences of the risk should it materialize.[60] This does not necessarily mean the risk-bearer must have the capacity to fully assume all the economic consequences should a risk be realized, as it is sufficient to have the capacity to put in place a mechanism to cover a risk and protect itself from the consequences of such risk materializing.[61] In short, the risk allocation rule applicable in the business restructuring context essentially aims at allocating the risk to the party who, on the one hand, bears the costs of managing, mitigating and realizing such risk and, on the other hand, bears potential losses or is compensated with expected returns attached to the risk.[62]

While it appears that the OECD places more emphasis on risks than on functions, a connection exists, to some extent, between functions and risks. Therefore, it can be reasonably concluded that, when assessing the substance of the functions performed, it is necessary to take into account the two criteria in connection to the new "control over risk" notion, namely (i) the competence of the personnel performing the function; and (ii) the authority that such personnel has to take decisions.[63] The examples provided as part of the explanation of the notion of control over risk seem to confirm this.[64]

Moreover, the AOA attributes to the PE the risks for which the significant functions relevant to the assumption of these risks are performed by people in the PE. It should be noted that the attribution of risks to the PE in the context of article 7 of the OECD Model, and particularly the exposure to gains/losses from the realization/non-realization of those risks, will be in relation to the assets attributed to the PE.[65] It should be borne in mind, however, that some risks are associated with activities rather than assets (e.g. liability risk). In this case, the decision making with regard to the initial acceptance and subsequent management of those risks defines the SPFs within a single enterprise.[66]

With regard to assets, the above mentioned functions and risks are relevant,[67] since the former should be attributed to the party that is both the legal and the economic owner of the assets.[68] Alternatively said, the substance required to support the economic ownership, as opposed to the legal ownership of an asset, relates also to the functions performed and the risks assumed by a transacting party.[69]

The OECD 2010 Guidelines mention that the comparability analysis should begin by examining the contractual terms between the parties in order for the allocation of assets, functions and risks between the parties to be identified.[70] What should be first examined, according to the

48. It is fundamental to establish which functions constitute the SPFs in order to determine significant economic activities and responsibilities undertaken by the PE. *See* I.J.J. Burgers, *The New OECD Approach on Profit Allocation: A Step Forward Towards Neutral Treatment of Permanent Establishments and Subsidiaries*, 10 Fla. Tax Rev. 51, p. 59 (2009). According to the AOA, risks and assets are to be allocated to a PE depending on the functions performed by the persons that are physically present in the PE (*see OECD Report* (2010), *supra* n. 36, at Part I, para. 18). Therefore, the functions performed by the employees of the PE which play a significant role in the enterprise's business are examined and depending on the outcome of the analysis, the economic ownership of assets and the assumption of risks are allocated to the PE (*see OECD Report* (2010), *supra* n. 36, at Part I, para. 15). It should be noted, at this point, that the term "functions" in this regard is equated to "activities" (*see OECD Report* (2010), *supra* n. 36, at Part I, para. 57). In this way, the profits (or losses) are fictionally shared between the enterprise and the PE (*see* J. Monsenego, *Introduction to Transfer Pricing* p. 134 (Wolters Kluwer 2015). Following this approach, in case the PE is lacking people performing functions in it, no risks and assets shall be attributed to the PE.
49. *OECD Guidelines* (2010), *supra* n. 27, at para. 9.39.
50. Id., at para. 1.46.
51. Id., at paras. 9.15-9.16.
52. Monsenego, *supra* n. 24, at p. 13.
53. *OECD Guidelines* (2010), *supra* n. 27, at paras. 9.23-9.27.
54. Id., at para. 9.30.
55. Id., at para. 1.49.
56. Id., at para. 9.23.
57. Id., at para. 9.33.
58. Id., at para. 9.33.
59. Regarding the attribution of risks in the context of PEs, the outcomes of the risk analysis under arts. 9 and 7 should be the same. In order to determine the risks to be attributed to the PE, the notions of "control over risks" and "financial capacity to assume risks" should be taken into account. However, this is not true in all cases.
60. *OECD Guidelines* (2010), *supra* n. 27, at paras. 9.29-9.30.
61. *OECD Guidelines* (2010), *supra* n. 27, at para. 9.32.
62. Id., at paras. 9.39-9.40.
63. Monsenego, *supra* n. 24, at p. 13 et seq.
64. *OECD Guidelines* (2010), *supra* n. 27, at paras. 9.26-9.27.
65. *OECD Report* (2010), *supra* n. 36, at para. 21.
66. Id., at para. 22.
67. *OECD Guidelines* (2010), *supra* n. 27, at paras. 9.23-9.28.
68. Monsenego, *supra* n. 24: "In general, it should be specified that the OECD (rightly so) does not use the term "economic owner" in its Guidelines. This term is used by the OECD only with reference to PEs. The authors agree that the use of this term is not technically correct.
69. It is worth mentioning that the 2010 Guidelines do not refer to "economic ownership", since an ownership can be only legal. However, for the sake of simplicity, this article refers to the concept of economic ownership in order to refer to situations in which the legal ownership is not aligned to the economic reality. This is not the case regarding PEs. In the AOA, the OECD refers to "economic ownership" since a PE cannot be entitled to the legal ownership of an asset.
70. Art. 9 *OECD Model* (2017), *supra* n. 21; and *OECD Guidelines* (2017), *supra* n. 31, at para. 1.42.



Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

2010 Guidelines, is whether or not contractual terms (i.e. written contracts) exist between the parties; if so, it should then be determined whether or not these terms have been adhered to. Subsequently, even if the contractual terms have been adhered to, it must be assessed whether these terms correspond to the true terms of the transaction.[71] Therefore, irrespective of the existence or absence of contracts, tax authorities should mainly focus on the conduct of the parties (i.e. search for the economic rationale rather than the legal substance in a transaction) regardless of the formal contracts. In accordance with the substance-over-form doctrine, economic ownership of an asset takes precedence over its legal ownership.[72] As a result, although legal documents (e.g. registration of patents) may constitute an indication as to the ownership of an asset, the level of substance required (i.e. the functions that should be performed, the assets that should be employed and the risks that should be assumed) in order for a party to be entitled to the ownership of an asset is of utmost importance.

In the case of PEs, since assets, risks, capital, contractual obligations, etc. refer to the enterprise as a whole,[73] it is necessary to introduce the notion of economic ownership in order to attribute the ownership of assets, risks and capital. The allocation of assets should be driven by the SPFs, while, in the case of related enterprises, their allocation should be based on the actual conduct of the parties.[74] Following the above approach, it is the economic (rather than legal) conditions that are vital in determining the characteristics of the PE for taxation purposes, because they are more likely to have a significant effect on the economic relationships between the various parts of the single legal entity.[75] Regarding assets, it should be additionally appointed which assets are owned/used by the PE and in which capacity, since the assets are normally (as mentioned above) owned by the enterprise as a whole. In the case of a PE, assets are generally attributed to the part of the enterprise that performs the SPFs relevant to the determination of economic ownership of assets. How the assets are used by each part of the enterprise is to be determined by the detailed functional and factual analysis.[76]

Besides the relevance of functions, assets and risks, an interesting question might be whether the number of employees and physical location of the (key) employees are relevant factors when defining substance. Notwithstanding the increasing relevance placed on these two factors in practice, based on the 2010 Guidelines, both factors could only provide an indication of the presence of substance[77] that needs to be assessed, in any case, according to the above described functional analysis.[78] In other terms, an entity with many employees will not necessarily be considered to have substance at arm's length, and, likewise, an entity with only one employee will not necessarily be considered as not having substance at arm's length.

After assessing the comparability analysis, the next step where substance plays a major role is the recognition of the accurately delineated transaction undertaken. In this context, the tax administration may, exceptionally, consider disregarding the structure of a transaction as adopted by a taxpayer in the above mentioned two circumstances of (i) economic substance of a transaction differing from its form; and (ii) arrangements made (viewed in their totality) differing from those that would have been adopted by independent enterprises behaving in a commercially rational manner (such that the actual structure practically impedes the tax administration from determining an appropriate transfer price).[79] When describing the first circumstance, the 2010 Guidelines mention the case of a loan that, based on its economic substance, may be treated as a subscription of capital. The second circumstance, instead, refers to the concepts of commercial rationality and reasonable expectations.

From the above mentioned guidance, it can be derived that the concept of substance in the 2010 Guidelines refers to the conditions of the transactions entered into between related parties, which, on the one side, have to reflect the economic reality behind them and, on the other side, must make commercial sense.

In summary, in the pre-BEPS world, substance was already a relevant topic in a transfer pricing analysis. However, though the importance of substance was clear, comprehensive guidance on how to define it was still not readily accessible in the pre-BEPS OECD Guidelines. Only in the specific context of Chapter IX (on business restructurings) did the OECD start providing more thorough guidance on this.

## 3. The New OECD Guidance Provided under the BEPS Project

### 3.1. Introductory remarks

The OECD BEPS Project has dedicated one of its three core pillars to the issue of substance (the other two pillars being coherence and transparency).[80] The three OECD BEPS Actions entirely dedicated to transfer pricing (Actions 8-10) have been placed under the substance pillar. Therefore, it might seem that all topics dealt with in OECD BEPS Actions 8-10 are relevant for considerations on substance in transfer pricing. However, in the analysis that follows, it will become clear that some topics discussed in OECD BEPS Actions 8-10 do not imply considerations on substance in transfer pricing. Moreover, other actions not

71. *OECD Guidelines* (2010), *supra* n. 27, at para. 1.53.
72. Id., at para. 6.1.
73. S. Buriak & R. Holzinger, *Introduction to the attribution of profits to Permanent Establishments*, in *Attribution of Profits to Permanent Establishments: Current Developments, Relevant Issues and Possible Solutions* p. 7 et seq. (M. Lang et al eds., Linde Verlag 2020).
74. R. Petruzzi & R. Holzinger, *Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era*, 9 World Tax J. (2017), at p. 295, Journal Articles & Papers IBFD.
75. *OECD Report* (2010), *supra* n. 36, at para. 72.
76. *OECD Report* (2010), *supra* n. 36, at para. 18.
77. *OECD Guidelines* (2010), *supra* n. 27, at paras. 9.190-9.194.
78. Monsenego, *supra* n. 24, at p. 19 et seq.
79. *OECD Guidelines* (2010), *supra* n. 27, at para. 1.65.
80. European Parliament Briefing, *Understanding BEPS: From tax avoidance to tax challenges* (2019), available at https://www.europarl.europa.eu/RegData/etudes/BRIE/2019/642258/EPRS_BRI(2019)642258_EN.pdf (accessed 5 Dec. 2019).

 © IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

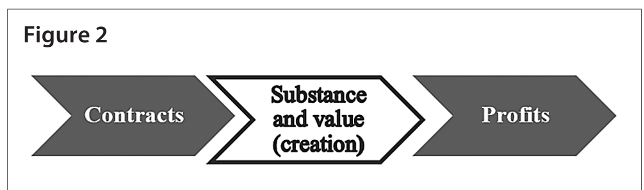
included under the substance pillar (notably, OECD BEPS Action 13) as well as other non-TP actions (notably, BEPS Action 7) could also have an impact on the topic of substance in transfer pricing. Therefore, the analysis below will avoid strictly following the OECD classification of the various OECD BEPS Actions under the three pillars of substance, coherence and transparency.

In general, it seems that the OECD BEPS Project has, on the one hand, placed more relevance on substance in transfer pricing and, alternatively, provided more guidance on the understanding of this topic. Furthermore, it should be underlined that numerous concepts previously developed by the OECD in Chapter IX of its 2010 Guidelines (and mentioned above) have been embedded into Chapter I, therefore clearly applying now to any kind of transaction between related parties and not only to the ones in place in the context of business restructurings. Sections 3.2. and 3.3. will further elaborate on these concepts.

### 3.2. More relevance of substance in transfer pricing

The main goal of the OECD inquiry into BEPS issues related to transfer pricing has been to ensure that transfer pricing outcomes are in line with value creation. Therefore, the OECD has confirmed the paradigm in section 2.1.2. illustrating that contracts define substance, substance defines value (creation) and value (creation) defines profits. Moreover, it seems the OECD has aimed at merging the two concepts of substance and value (creation), with the purpose to avoid the two concepts being separated from each other. *See* Figure 2.[81]

**Figure 2**




Overall, the BEPS Project has introduced numerous changes in various sections of the 2010 Guidelines with the aim to achieve this goal. Therefore, the topic of substance in transfer pricing will certainly increase its relevance in a post-BEPS world. In general, as underlined in section 3.3., those changes have increasingly refined the interpretation of the arm's length principle (and its three above mentioned pillars of separate entity approach, relevance of contractual arrangements, and comparability of the transaction) to better reflect the economic reality of a transaction.[82]

### 3.3. More guidance on substance

In a post-BEPS world, the application of the arm's length principle appears to require the following 4-step analysis:

(1) identification of the commercial or financial relations;
(2) recognition of the accurately delineated transaction undertaken;
(3) selection of the most appropriate transfer pricing method; and
(4) application of the most appropriate transfer pricing method.

At first glance, compared to the 2010 Guidelines, only the first step seems to have been amended. In reality, however, the BEPS Project has introduced amendments concerning all four steps. Nevertheless, as in the pre-BEPS world, when analysing the guidance on substance, most of the emphasis is placed on the first two steps of the above mentioned process.

As a preliminary remark, the work performed in the BEPS Project has resulted in a radical change in the framework for analysing the conduct of the parties, namely the functional analysis. The outcome of such exercise is the accurate delineation of the actual transaction among related parties, which is now referred to as the factual substance,[83] replacing the term "economic substance". This factual substance is then subject to a commercial rationality test, which ultimately decides whether this actual transaction should be recognized or disregarded for transfer pricing purposes. Indeed, the scope of transfer pricing has been broadened from "who does what?" to include "why" and "how".

Regarding the aspect of "why", the commercial rationality requirement when evaluating the arm's length character of a transaction, also referred to as the realistically available alternatives standard, or options realistically available (ORAs),[84] is contained in the OECD Guidelines and states: "Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive."[85] This requirement involves a two-step analysis. First, the tax examiner must identify the relevant associated enterprise's ORAs in the market. In case none exist, the analysis ends at this point and no further actions are required. Next, in case other options were realistically available for the enterprise, it must then be determined whether one or more of the identified available options were clearly more attractive for this enterprise than the transaction actually undertaken. Examples of options that do not qualify as realistically available for the enterprise can be, for example, those (i) that do not respect the business or are commercially unattractive for the MNE group as such; (ii) not readily available at the time of the transaction; or (iii) that the

81. Some literature has underlined that, in the context of BEPS, economic substance should be equal to value creation because it can be applied to digital services, anti-avoidance rules and transfer pricing matters; *see* M. Stewart, *Abuse and Economic Substance in a Digital BEPS World*, 69 Bull. Intl. Taxn. 6/7, p. 399 (2015), Journal Articles & Papers IBFD.
82. Petruzzi, *supra* n. 29, at pp. 1-32.
83. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports*, para. 1.120 (OECD 2015), Primary Sources IBFD [hereinafter *BEPS Actions 8-10 Final Reports*].
84. A. Bullen, *Arm's Length Transaction Structures: Recognizing and restructuring controlled transactions in transfer pricing* p. 523 et seq. (IBFD 2011), available at https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/andreas_bullen_summary.pdf (accessed 16 Oct. 2020), Books IBFD.
85. *OECD Guidelines* (2010), *supra* n. 27, at para. 1.34.

© IBFD


Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

taxpayer had no knowledge of at the time of the transaction.[86] The "clearly more attractive" test of the second step refers to commercial attractiveness, as opposed to, for instance, environmental, scientific or publicity-related attractiveness. This profit-maximizing commercial rationale of the actual transaction must be compared with each of the option's level of attractiveness. If the commercial rationality criterion (as described above) is not fulfilled, article 9(1) of the OECD Model will authorize the competent tax authority to restructure the examined controlled transaction. This adjustment directive essentially provides that the commercially irrational arrangements actually adopted by the associated enterprises may be substituted with the commercially rational arrangements, which independent enterprises behaving in a commercially rational manner might reasonably be expected to adopt.[87]

As for the "how" aspect, increased guidance is foreseen with regard to the five comparability factors[88] and, in particular, with regard to the functional analysis for which the functions performed must be examined in light of the relevant assets used and risks assumed in relation to each other. It should be noted that, according to the revised guidance, functions, assets and risks are more broadly perceived upon the delineation of a transaction. One of the challenging areas in transfer pricing that the BEPS Project has sought to address is the narrow focus on an activity or transaction in isolation. This may be compounded with a selective view of the tested party to the transaction without this being grounded in the MNE's global value chain, i.e. the context of how the MNE creates value. This results in an increased potential for mispricing. Under the 2017 Guidelines, however:

> [T]he analysis focuses on what the parties actually do and the capabilities they provide. […] For this purpose it might be helpful to understand the structure and organization of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to the value creation.[89]

This approach involves an investigation into the functions, risks and assets of the controlled group as a whole and an evaluation of how these aspects integrate with the group's key value drivers. The conclusions from these analyses are then used to attribute group profits to key functions, risks, assets and value drivers of the business. The OECD is, in this way, addressing the increasing demand from governments to be able to see the entire value chain of a business without being limited to the part that is residing in their country.[90] Furthermore, the BEPS Project emphasizes the need to align transfer pricing outcomes with economic value creation and provides enhanced guidance on disclosure requirements in the TP documentation in this regard. In accordance with this, Action 13 and the revised Chapter V of the 2017 Guidelines explicitly provide that the Master File has to contain detailed information on the MNE's global structure and its value chain and supply chain.[91]

Moreover, under the 2017 Guidelines, it now appears clear that the substance requirement should be implemented in the same manner whether an agreement exists or not. However, there is also a delicate balance to be respected since the actual functions performed, risks assumed and assets used ultimately determine the factual substance when there are material differences between the legal terms and the parties' conduct.[92]

When analysing the accurate delineation of the actual transaction undertaken, it still appears that the assessment of functions performed, assets used and risks assumed by the parties (i.e. the functional analysis) is of key relevance. However, the guidance on these three topics has been considerably increased.

First, the 2017 Guidelines provide further guidance on the substance requirement regarding functions, mainly in Chapter I (on the arm's length principle) and Chapter VI (on intangibles). Chapter I provides guidance on accurately delineating the actual transaction between related parties.

As mentioned above, the guiding principle for OECD BEPS Actions 8-10 is that transfer pricing outcomes should be aligned with value creation. OECD BEPS Actions 8-10 also brought significant changes to the role of risk shifting, which was already identified by the OECD as one of the key pressure areas when it first launched the BEPS Project in 2013.[93] As regards risks, the revised Chapter I of the 2017 Guidelines introduced a six-step framework for analysing transactions between associated enterprises, providing guidance on risk identification, delineation and allocation under the arm's length principle, in order to tackle contractual risk allocation that lacks the commercial rationality of uncontrolled transactions.[94]

Even though this six-step analysis undoubtedly constitutes an important facet for the accurate delineation of identifying the transaction parties assuming significant risks, in general, under the principles of Chapter I, the party assuming the significant risk must also have the financial capacity to assume it and the control over it. A transaction party is considered to possess that risk control if it performs decision-making functions related to accepting or declining the risk-bearing opportunity and responding to the risk.[95]

86. Id., at p. 25 et seq.
87. *OECD Guidelines* (2017), *supra* n. 31, at paras. 9.34-9.36.
88. Id., at para. 1.36.
89. Id., at para. 1.51.
90. PwC, *Transfer Pricing Perspectives: The new normal: Full TransParency* p. 11 (2016), available at https://www.pwc.com/hu/hu/kiadvanyok/assets/pdf/tp_perspectives_2016.pdf (accessed 16 Oct. 2020).
91. *OECD Guidelines* (2017), *supra* n. 31, at paras. 5.18-5.21.
92. *BEPS Actions 8-10 Final Reports*, *supra* n. 83, at para. 1.46.
93. OECD, *Addressing Base Erosion and Profit Shifting* p. 48 (OECD 2013), Primary Sources IBFD.
94. I. Verlinden, D. Ledure & M. Dessy, *The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard*, 23 Intl. Transfer Pricing J. 2, p. 109 (2016), Journal Articles & Papers IBFD.
95. *OECD Guidelines* (2017), *supra* n. 31, at paras. 1.49-1.50.


© IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

Regarding intangibles, in the past, tax authorities regularly expressed their concerns that MNEs were artificially shifting income to low-tax jurisdictions by contractually shifting risks to group companies in those jurisdictions, despite the fact that the entities resident in those jurisdictions did not have the corresponding operational activity to support the assumption of those risks, functions and assets.[96] Nevertheless, those entities claimed to earn significant profits by virtue of intangible ownership. To address this problem, BEPS Action 8, as enshrined in Chapter VI of the 2017 Guidelines, and the OECD's Guidance on Hard-to-Value Intangibles and Guidance on the Transactional Profit Split Method[97] elaborate further on the transactions concerning intangibles, recognizing that multiple entities within the MNE – and not the legal owner alone – may have been involved in the creation of an intangible's value.

The proposed revised Chapter VI of the 2017 Guidelines split the guidance on intangibles into four segments and provided a list of steps to be considered when undertaking a functional and comparability analysis:[98]

– *new definition of intangibles*: the OECD adopts a broader definition of "intangible property".[99] Furthermore, the previous OECD guidance made a clear distinction between trade and marketing intangibles.[100] Under the new guidance, such clear distinction will no longer be made, since the OECD states its intention to keep the definition more general and broader;[101]
– *ownership – allocating the return attributable to an intangible*: the legal ownership, as well as the contractual agreements, constitute only the starting point for the calculation of each party's contribution to the DEMPE of the intangible[102] and, thus, each party's arm's length appropriate remuneration;
– *differentiation between two types of transactions involving intangibles*: transactions involving intangibles or the right to use intangibles and transactions regarding the use of intangibles in connection with goods or services;[103]
– *supplemental guidance for applying the arm's length principle*: the application of a valuation technique may prove more reliable than the five transfer pricing methods described in the 2010 and 2017 Guidelines, since, in such transactions, the price also depends on future revenues. As part of the OECD's additional guidance with regard to intangibles, other ORAs to the parties, their perspectives, attribution of risks and aggregation of transactions should also be taken into consideration. Furthermore, features such as exclusivity, geographic scope, legal protection, useful life, rights to updates and expected future benefits should also be considered upon valuation of intangibles.[104]

In light of the above guidance, OECD BEPS Actions 8-10 introduced the DEMPE approach as a tool to prevent base erosion and profit shifting by moving intangibles within group members and align transfer pricing outcomes with value creation.[105] The OECD approach begins with the starting point that all members of an MNE should receive an appropriate compensation (i.e. a compensation consistent with the arm's length standard) for the functions they perform, the assets they use and the risks they assume in connection with the intangibles. The approach then presumes that important DEMPE functions contribute to the creation of the intangible's value.[106] The OECD approach concludes that in order for the legal owner of an intangible to be entitled to the returns from the intangible, it must perform important DEMPE functions. It is, therefore, intended to prevent companies with little functional substance and minimal operational activity from earning high intangibles related returns. As a result, the DEMPE functions constitute the substance test in order for an entity within the MNE to be able to claim a share of the intangibles related returns.

It should be noted that the DEMPE functions vary from industry to industry, or even from company to company. The important step to identify the key functions, which are decisive when posing the substance question, is to conduct a detailed functional analysis, namely (i) interviewing the key personnel; (ii) reviewing the entity's organizational structure; (iii) identifying the key intangibles; and (iv) reviewing human resources functions and, most importantly, employees' locations and roles.

More specifically, the Annex to the revised Chapter VI contains 29 examples that provide more detailed guidance on attributing value to the DEMPE of the intangible, since, as noted, legal ownership does not in itself confer any right to retain the returns from exploiting the intangible.[107]

The 2017 Guidelines underline that risk management (Chapter I) and DEMPE (Chapter VI) should not necessarily be seen as encompassing different functions. Under a reasonable interpretation, these chapters prescribe the same principles for delineating the actual transaction between associated enterprises. Both chapters also come to the conclusion that only an entity performing key decision-making functions related to the key income genera-

96. *See* HM Treasury, *Corporate tax and the digital economy: position paper* (2017), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661458/corporate_tax_and_the_digital_economy_position_paper.pdf (accessed 5 Dec. 2019).
97. Available at https://www.oecd.org/ctp/oecd-releases-new-guidance-on-the-application-of-the-approach-to-hard-to-value-intangibles-and-the-transactional-profit-split-method-under-beps-actions-8-10.htm (accessed 18 Apr. 2020).
98. C.J.E.A. Sporken & P. Visser, *BEPS Guidance on Transfer Pricing Aspects of Intangibles and the Need for Substance and Transfer Pricing Documentation*, 22 Intl. Transfer Pricing J. 1, p. 12 (2015), Journal Articles & Papers IBFD.
99. The new definition identifies six specific categories of intangibles, namely (i) patents; (ii) know-how and trade secrets; (iii) trademarks, trade names and brands; (iv) rights under contracts and government licenses; (v) licenses and similar rights in intangibles; and (vi) goodwill and going-concern value.
100. *BEPS Actions 8-10 Final Reports*, *supra* n. 83, at para. 6.16.
101. *BEPS Actions 8-10 Final Reports*, *supra* n. 83, at para. 15.
102. Id., at para. 103.
103. Id., at D.4.
104. Id., at p. 38 et seq.
105. Id., at p. 63 et seq.
106. *OECD Guidelines* (2017), *supra* n. 31, at para. 6.32.
107. Sporken & Visser, *supra* n. 98, at p. 12.



Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

tors for the MNE – be it risk assumption or the DEMPE of intangibles – could earn excess or residual income related to those key income generators.

The revised guidance on assets regards mainly Chapter VI on the intangibles, as analysed above, and Chapter VIII on cost contribution arrangements (CCAs). Regarding the former, a challenging transfer pricing issue since the introduction of the BEPS Project is determining the level of substance required to support the economic ownership of an asset, especially when it pertains to intangibles, since intangible assets represent a constantly growing part of the value created in an MNE.[108] Regarding Chapter VIII, following the introduction of the BEPS Project and in accordance with the provisions on substance introduced according to the BEPS Project, CCAs continue to be evaluated based on the substance of the arrangement, rather than the contractual form expressed. Therefore, while the delineation of the transaction begins by dividing the economic relevant risks, responsibilities and beneficial interests (as indicated in the contractual agreement) ultimately, only the actual risks, responsibilities and expected benefits arising from the economic activity are taken into account when valuing the contributors. Moreover, under the new guidelines, all parties must be reasonably expected to benefit from the CCA activity and have a clearly defined interest therefrom. In light of the amendments to the BEPS Project, all parties to the CCA should be able to exercise management and control functions on the financial risk associated with the CCA's economic activity and possess the financial capacity to bear the risk undertaken. Failure to satisfy those requirements could allow tax authorities to disqualify a party from the agreement or even disregard the CCA in case it lacks commercial rationale.

An additional transfer pricing topic identified in the BEPS Action Plan considers the overcapitalization of low-function entities (often located in low-tax jurisdictions) and the use of that excess capital by such cash-box entities to provide financing or funding to other entities of the MNE, thus resulting in income shifting. This is the case, for example, when an MNE group that overcapitalizes an entity in a low-tax jurisdiction then lends money to group members in high-tax jurisdictions, thus shifting income out of high tax locations and into low-tax locations through interest payments. Such entities might also invest their excess capital in valuable income-producing assets or, of particular concern in the BEPS Project, use that capital to fund the development of high-value intangibles.[109] In order to address this issue, the BEPS Report requires an appropriate arm's length remuneration to an entity providing funding ("cash-box"), this being achieved by accurately analysing risks (*see* above) when determining the proper reward for funding.[110] According to the level of risk and the respective return, the BEPS Actions 8-10 determine three categories of funding entities (from lower to higher risk and, therefore, from lower to higher resulting returns):[111] (i) the low-function cash box not bearing any risk and not making decisions on the funding arrangements that should be remunerated at a "risk-free rate" of return of its funding;[112,113] (ii) the entity with independent capacity in controlling its financing risks, i.e. taking decisions on its funding arrangements, for which the determination of an arm's length return should be calculated depending on its cost of capital and alternative investments realistically available to it; and (iii) the entity that controls both the financing risk *and* the underlying activity for which the lending capital is used, which is undoubtedly exposed to a higher level of risk and, therefore, entitled to a higher return.

In this regard, the recently released OECD/G20 Transfer Pricing Guidance on Financial Transactions (2020 TP Report),[114] which will be included in the 2017 Guidelines as new Chapter X and an addition to the current Chapter I, further clarifies the substance requirements analysed above when it comes to intra-group financing transactions. More specifically, this report provides clarifications regarding intercompany loans by indicating that the arm's length principle is relevant in determining not only whether the interest rate provided for in a loan contract is at arm's length but also whether a prima facie loan can be regarded as a loan or should be recharacterized as a contribution to equity capital.[115] In this respect, the 2020 TP Report follows a substance-over-form approach by stating that "particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis",[116] and by listing the respective economically relevant characteristics – such as the presence or absence of a fixed repayment date, the obligation to pay interest, the right to enforce payment of principal and interest, the ability of the funds recipient to obtain loans from unrelated lending institutions and to repay on the due date – that could serve as indicators to determine whether a purported loan should be regarded as debt or equity.[117]

Moreover, the 2020 TP Report also introduces a two-sided approach, which emphasizes the importance in analysing the arm's length nature of a financial transaction from *both* the lender's and the borrower's perspectives.[118]

108. T. Miyatake, *Transfer Pricing and Intangibles* p. 19 (IFA Cahiers vol. 92a, IFA 2007), Books IBFD; and I. Verlinden & Y. Mondelaers, *Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*, 17 Intl. Transfer Pricing J. 1, p. 49 (2010), Journal Articles & Papers IBFD.
109. J. Androus & P. Oosterhuis, *Transfer Pricing after BEPS: Where are We and Where Should We Be Going* p. 93 (Wolters Kluwer 2017).
110. *BEPS Actions 8-10 Final Reports*, *supra* n. 83, at p. 65.
111. Id., at p.11.
112. The risk-free rate is not defined in the BEPS Final Reports; however, it should be defined as the return of an independent investor running no risk of losing the capital invested (e.g. a high-grade bond issued by a strong government).
113. OECD, *Transfer Pricing Guidance on Financial Transactions Final Report* paras. 1.109-1.110 (OECD 2020), available at https://www.oecd.org/tax/beps/oecd-releases-transfer-pricing-guidance-on-financial-transactions.htm (accessed 14 Nov. 2020).
114. OECD/G20, *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10* (OECD 2020), Primary Sources IBFD.
115. *OECD Guidelines* (2017), *supra* n. 31, at para. 10.5.
116. Id., at para. 10.11.
117. Id., at para. 10.12.
118. Id., at para. 10.51 et seq.

 © IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

On the one side, the lender needs to (i) consider whether to provide a loan or not; (ii) determine which amount it should lend and on what terms; and (iii) perform a credit assessment of the potential borrower to evaluate the risks involved, since the assessment shall determine whether the borrower may fail to meet its payment obligations. On the borrower's side, the ORA should be considered by taking into account that an independent borrower always seeks the most cost-effective solution with regard to the business strategy it has adopted.

Furthermore, the 2020 TP Report mentions the possibility to use an interest rate setting approach based on the costs incurred by the lender in raising the funds to lend (these costs are increased by expenses incurred by the lender with respect to arranging the loan and relevant costs of servicing the loan) and a risk premium that reflects various economic factors inherent in the proposed loan and a profit margin.[119] The guidance stipulates that if such an approach is used, it should be based on the lender's costs of funds relative to other market lenders' costs of funds, as lenders in a competitive market may seek to price at the lowest possible rate in order to win business. The 2020 TP Report specifically describes the situation in which the cost of funds approach is used when external capital is passed via one or more intra-group intermediary companies to the ultimate borrower. In such cases, depending on the functionality and substance of the intermediary companies, they may be remunerated merely for the on-lending function itself or may be entitled to earn a risk premium and a profit margin.[120] By this, the report targets companies that lack the capability or actual performance of the decision-making functions to control and manage the risk associated with granting a loan, i.e. lending companies without functional substance. With regard to such companies, the 2020 TP Report underlines that they would not be entitled to the respective interest income but only to a risk-free return. The remainder would be allocable to the party exercising control over the risk.

Regarding intra-group financial guarantees, the 2020 TP Report reiterates that they should only be remunerated where they provide measurable benefits, such as a more favourable interest rate, beyond those that derive from implicit support (i.e. passive association).[121] Where a financial guarantee also permits a company to borrow a greater amount of debt, this additional borrowing may be, taking into account the facts and circumstances, recharacterized as an equity contribution by the guarantor to the borrower and the guarantee fee limited on the portion that has been accurately delineated as a loan.[122]

Finally, with regard to cash pooling, the 2020 TP Report states that, in general, a cash pool leader performs no more than coordination or agency functions and that, given the low level of functionality, the cash pool leader's remuneration as a service provider should be relatively limited. However, where a cash pool leader is, in reality, carrying on activities other than coordination or agency functions, its arm's length remuneration should be determined based on its control over the risks and financial capacity to bear the economically significant risks linked to the cash pool (e.g. credit risk, liquidity risk, interest rate risk or currency risk).[123]

The concept of substance has been impacted also by the recent guidance on recognizing the accurately delineated transactions that has also changed after the release of BEPS Actions 8-10. Although transactions should still only under exceptional circumstances be disregarded, the description of when this exceptionality materializes has been amended. More specifically, the OECD replaced the two former circumstances under which a transaction could be disregarded (i.e. (i) economic substance of the transaction differing from its form; and (ii) diverging characterization of the transaction from the one that would have been adopted by unrelated third parties) with the following:

> The transaction as accurately delineated might be disregarded… where the arrangements made in relation to the transaction differ from those which would have been adopted by independent enterprises *behaving in a commercially rational manner* in comparable circumstances...taking into account the parties' perspectives and the options realistically available to them at the time of entering the transaction. [Emphasis added][124]

Therefore, in order for a transaction to be disregarded, relevance is placed on its commercial rationality. Moreover, the BEPS package (particularly Action 7) seeks to readapt the PE definition through a substance-over-form approach that prioritizes the economic substance of MNEs' businesses instead of their legal qualifications.[125] Hence, the forms implemented by entities are disregarded in order to focus more on where activities are carried out and where value is created. This means that the PE rules should, in principle, reconcile its definition with the existence of significant economic allegiances in the source state. The changes introduced both in the MLI and the revised OECD Model, with regard to PEs, focus on the three following points: (i) exceptions of the PE definition; (ii) changes to agency PE rules; and (iii) changes to the construction PE rule.

More specifically, the BEPS package updated the PE exceptions of article 5(4) of the OECD Model, stating that subparagraphs (a)-(f) are only applicable if those activities are of a preparatory or auxiliary nature. BEPS Action 7 highlights the need to assess such activities in conjunction with the foreign entity's business. Therefore, for example, an internet trading company only possessing a warehouse in the source state for the purposes of storage and delivery

119. *OECD Guidelines* (2017), *supra* n. 31, at para. 10.97 et seq.
120. EY, *OECD releases final transfer pricing guidance on financial transactions* (2020), available at https://taxnews.ey.com/news/2020-0350-oecd-releases-final-transfer-pricing-guidance-on-financial-transactions (accessed 29 Apr. 2020).
121. *OECD Guidelines* (2017), *supra* n. 31, at para. 10.156 et seq.
122. Id., at para. 10.161.
123. *OECD Guidelines* (2017), *supra* n. 31, at para. 10.129 et seq.
124. Id., at para. 1.122.
125. V. Dhuldhoya, *The Future of the Permanent Establishment Concept*, 72 Bull. Intl. Taxn. 4a/Special Issue, p. 17 (2018), Journal Articles & Papers IBFD.



Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

of products purchased online by its client might constitute a PE, given that this warehouse is an integral part of the foreign entity's business.[126]

Moreover, the BEPS package lowers the agency PE threshold of article 5(5) of the OECD Model by establishing that a person acting on behalf of the foreign entity can be deemed as a PE, not only by concluding contracts on behalf of the foreign entity (which was the requirement of the former article 5(5)) but also by habitually playing a principal role in their conclusion. Such contracts may include, inter alia, the transfer of ownership of the foreign entity's property or the provision of services.[127] These updates give priority to activities carried out in the source state with the purpose of concluding contracts for the foreign enterprise instead of the authority of the person carrying out such activities for the foreign entity, as indicated by the substance principle.[128] Moreover, the new aggregation rule of article 5 para 4.1 dictates that a combination of activities, which may be of a preparatory or auxiliary nature, may (when considered together) be regarded as a PE when they constitute a part of the foreign entity's business. Therefore, this anti-fragmentation rule could be considered as the "other side of the coin" of the exceptions established in the OECD Model.[129] Last but not least, the BEPS Action Plan modified the construction PE rules. The update included in the Commentaries as an optional provision and in article 14 of the MLI provides that whenever a construction, assembly or installation project or site does not last more than 12 months (whereby connected activities that are carried out in the same project or site, either by the same entity or by one or more enterprises closely related to this entity, and last more than 30 days), this time shall be added to the time spent in the main project for the purposes of applying article 5(3).[130]

Regarding the role of substance in tax compliance, BEPS Action 13 (on transfer pricing documentation and Country-by-Country (CbC) reporting)[131] aims to re-examine TP documentation and develops rules in order to enhance transparency for tax administrations by introducing the three-tiered approach in TP documentation (i.e. Master File, Local File and CbC reporting), also taking into consideration the substance requirements provided for in the other OECD BEPS Actions, as well as compliance costs for business. More specifically, BEPS Action 13 provides – among other things – a template for MNEs to report annually and, for each tax jurisdiction in which they do business, aggregate information such as the tax jurisdiction of incorporation (if different from the tax jurisdiction of residence) and the nature of the main business activities carried out by that constituent entity.[132] The OECD also released, in BEPS Action 13, an Implementation Package for Country-by-Country Reporting (CbCR).[133] The package consists of model legislation that requires the ultimate parent entity of an MNE to file the CbC report in its jurisdiction of residence, including backup filing requirements when that jurisdiction does not require filing. The package also contains three model competent authority agreements to facilitate the exchange of CbC reports among tax administrations. Therefore, BEPS Action 13, apart from introducing coherence in the domestic rules that affect cross-border activities, also contributed to reinforcing substance requirements in the existing international standards and improving transparency as well as certainty (since the inclusion of key information in an MNE's Master File and CbCR contributes to acquiring deeper insights in its global operations, understanding its global value chain and observing where value is truly created). MNEs must address local substance requirements in all the countries in which they conduct business, or they might be confronted with a higher effective tax burden on their business activity.

## 4. Recent Relevant Case Law

The shift toward the substance requirement since the implementation of the OECD BEPS Actions into the 2017 Guidelines had also a significant impact on relevant case law in various countries.

This effect was already apparent by 2017 in the renowned Australian *Chevron* case, which concerns a cross-border financing agreement that resulted in reducing Chevron Australia's taxable profits.[134] In this case, the Chevron group had set up a US company (Chevron Texaco Funding Corporation), whose sole purpose was to borrow money in US dollars at an interest rate of 1.2% and then grant a loan to Chevron Australia denominated in Australian dollars at an interest rate of 8.9%. This excessive interest rate resulted in an increase of Chevron Australia's deductible interest costs. The interest income of the US company, which was not taxed in the United States, then returned to Chevron Australia in the form of tax-exempt dividends. From the facts of the case, it became apparent that the US entity was, in fact, a shell company created for the sole purpose of raising funds in the commercial paper market and then lending those funds to the Australian company. The Australian Taxation Office went on to disregard certain elements of the loan agreement, arguing that had Chevron Australia sought funding from external sources (i.e. unrelated third parties), it would need to provide a guarantee or other security and, therefore, borrow at a lower interest rate than 8.9%, which was, in fact, an interest rate for an intra-group loan where no guarantee was

126. OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report* p. 31 (OECD 2015), Primary Sources IBFD [hereinafter *BEPS Action 7 Final Report*].
127. R. Ekkehart, *Permanent Establishment in the OECD Model Tax Convention*, in *Permanent Establishments – A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* p. 116 (6th ed., R. Ekkehart et. al, Kluwer Law International 2018).
128. Dhuldhoya, *supra* n. 125, at p. 12.
129. Art. 5.4 *OECD Model* (2017), *supra* n. 21, at sub-para. f.
130. *BEPS Action 7 Final Report*, *supra* n. 126, at pp. 43-44.
131. OECD/G20, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: 2015 Final Report* (OECD 2015), Primary Sources IBFD.
132. Id., at para. 24.
133. OECD/G20, *Action 13: Country-by-Country Reporting Implementation Package* (OECD 2015), available at https://www.oecd.org/ctp/transfer-pricing/beps-action-13-country-by-country-reporting-implementation-package.pdf (accessed 12 Nov. 2020).
134. AU: FCA, 21 Apr. 2017, *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation Australia*, [2015]FCA 1092, Case Law IBFD.


© IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

provided. In this respect, the Australian Federal Court emphasized that there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer when entering into a controlled transaction. The first circumstance arises where the economic substance of the transaction differs from its form, and the second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction (viewed in their totality) differ from those that would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price.[135] Therefore, it becomes apparent how the outcomes of the OECD BEPS Actions started being considered upon evaluation of transfer pricing models and, particularly, how the notion of substance has become the main focus of tax administrations.

This approach was followed by subsequent court decisions, the most prominent being the *Glencore* case.[136] The transfer pricing lesson emerging from this case reaffirmed many key principles articulated in the *Chevron* case. More specifically, the Commissioner of Taxation amended assessments for income years 2007, 2008 and 2009, on the grounds that the pricing (according to a price sharing agreement) at which Cobar Management was providing copper concentrate to its parent, Glencore International AG, was an agreement that unrelated third parties would never have entered into. The notable outcome of this case was that, unless the terms of arrangements are such that either the substance does not match the form or contracting parties acting independently would not have entered into them, the arrangements should be respected by tax authorities and no reconstruction should be attempted.[137]

In this respect, additional prominent cases in the international tax landscape include the US *Santander Holdings* case[138] and the *Switzerland vs R&D Pharma* case.[139] In the former case, Santander Holdings USA was using a scheme (so-called STARS transaction)[140] developed and promoted by Barclays in order to claim foreign tax credits in the United States on taxes paid in the United Kingdom and simultaneously recouped a substantial portion of its UK paid tax. In order to obtain this, Santander Holdings USA, which was a financial services company and a US taxpayer, diverted income into and out of a wholly owned Delaware trust, which had a nominal UK trustee. The circulation of income through the trust was only a paper transaction, and no income was actually engaged in any productive activities or put at risk. Though, since the trustee was a UK tax resident, the income became taxable in the United Kingdom even though, in reality, the assets and respective income deriving therefrom (e.g. loans to US borrowers) never left the United States. The respective tax paid in the United Kingdom was then claimed by the US taxpayer at its full amount as foreign tax credit. In addition to this, Barclays acquired a formal interest in the Delaware trust. That interest allowed Barclays to claim, under UK law, certain UK tax benefits, ultimately permitting Barclays to recover almost the full amount (in this case, up to 85%) of the taxes paid in the United Kingdom. As remuneration for the STARS strategy, Barclays agreed to return only a percentage of the amount earned to the US taxpayer, keeping the rest as its fee. As a result, the US taxpayer received 50% of its UK taxes as a refund from Barclays and 100% of its UK taxes through a foreign tax credit claim by the US Internal Revenue Service.

The question raised before the Supreme Court was whether the economic substance of a transaction for which a taxpayer claims foreign tax credits on its federal tax return depends, in part, on whether the transaction was profitable after all foreign taxes were paid. Similar to other provisions of the Internal Revenue Code (IRC), foreign tax credits are subject to the economic substance doctrine. According to the doctrine, a transaction shall not be allowable if it does not have economic substance or it lacks a business purpose. The doctrine reflects the principle that the IRC does not intend for sham transactions to produce tax benefits, even if the transactions would otherwise trigger tax benefits under the pertinent statutory and regulatory provisions.[141]

In the *Switzerland vs R&D Pharma* case, a Swiss company was making royalty payments to its parent in the Netherlands for the research and development (R&D) of certain molecules. However, in reality, the latter had neither the substance nor the technical expertise to carry out this activity. In practice, the R&D of the group was conducted by the Swiss company, which subcontracted some of the tasks to a French company that was also a subsidiary of the Dutch parent. Despite the group's claims that the Dutch parent company assumed important financial, regulatory and operational risks that needed to be compensated, the Supreme Court held that the Dutch parent was a mere shell company that did not hold the required substance to be entitled to royalty payments. More specifically, the Dutch parent was actually not involved in the group's R&D activity and had no/very few employees, whereas the Swiss company had 60 employees, made all the strategic decisions regarding the R&D functions and was also the legal owner of the group's registered patents. As a result, the amount of royalties paid by the Swiss company to the parent company, after deducting the costs of subcontracting incurred by the Swiss company, were found to constitute unjustified expenses on a commercial basis and were disregarded.[142]

135. *Chevron Australia* ([2015]FCA 1092), at para. 89.
136. AU: FCA, 3 Sept. 2019, *Glencore Investment Pty Limited v. The Commissioner of Taxation of the Commonwealth of Australia*, [2019]FCA 1432, Case Law IBFD.
137. *Glencore Investment* ([2019]FCA 1432), at para. 89.
138. US: United States Court of Appeals, 16 Dec. 2016, *Santander Holdings USA, Inc. v. United States*, Case No. 16-1130, available at https://law.justia.com/cases/federal/appellate-courts/ca1/16-1282/16-1282-2016-12-16.html (accessed 3 May 2020).
139. CH: Tribunal Fédérale Suisse, 10 Dec. 2018, *Switzerland v. R&D Pharma*, 2C_11/2018.
140. Structured trust advantaged repackaged securities (STARS).
141. *Santander Holdings* (No. 16-1130).
142. *Switzerland vs R&D Pharma* (2C_11/2018).

© IBFD


Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

Moreover, in the *South Africa vs Sasol Oil* case,[143] the Court of Appeal upheld the decision of the Tax Court, which considered that certain contractual arrangements were simulated and, therefore, should be disregarded. The Court of Appeal found that when the contracts were first concluded in 2001, the witnesses had proposed them not in order to avoid the residence-based tax (introduced in mid-2001) but because they had a commercial justification.[144]

Finally, in the *Japan vs Denso Singapore* case,[145] the Supreme Court of Japan stated that the controlled foreign corporation rules do not apply when the subsidiary has substance and it makes economic sense to conduct business in the low-tax jurisdiction. Total revenue, number of employees and fixed facilities are relevant factors in determining the existence of substance at the level of the subsidiary.[146]

From the above cases concerning the new substance requirements introduced by the BEPS Action Plan, it becomes apparent that international tax practice has quickly implemented the substance doctrine and confirmed its relevance in a post-BEPS world.

## 5. The Future Ahead: Substance between Digitization, Digitalization and Digital Transformation

As analysed above, the concept of substance in transfer pricing finds its roots in the delineation and recognition of the actual transactions, where functions performed, assets employed and risks assumed play a key role. Most importantly, under the post-BEPS guidance, the OECD has provided a stronger link between the notions of functions and control over risk. Consistent with what was implied in Chapter IX, the substance requirement is now considered to be the competence of the personnel performing the functions, the authority that such personnel has to make decisions and the internal performance of such competence.[147]

However, businesses are extremely dynamic and constantly evolving in order to survive. Therefore, in the past years, terms such as "digitization", "digitalization" and "digital transformation" have pervaded the common language, including the one used by international tax and transfer pricing topics. For a shared understanding of these terms:[148]

- "digitization" refers to "taking analogue information and encoding it into zeroes and ones so that computers can store, process, and transmit such information",[149] implying that the information is no longer paper based but, rather, digitized. The result of the increasing digitization of information is the availability of more data;
- "digitalization" refers to "the use of digital technologies to change a business model and provide new revenue and value-producing opportunities", indicating the processes and businesses operations that use more digital means (e.g. from postal mail and typewriters to emails and computers). A result of the increasing digitalization of processes is the implementation of new procedures and roles that make up the operations of a business;
- "digital transformation" refers to "customer-driven strategic business transformation that requires cross-cutting organizational change as well as the implementation of digital technologies". An effect of the increasing digital transformation is the proliferation of new business models and strategies that emphasize the role of customers.

The definitions above are of key relevance in understanding how the concept of substance in transfer pricing is currently evolving.

As for the digitization of the economy, an increasing number of countries have recently emphasized the idea that "data is the new oil",[150] the most valuable asset in the world. Although this might be true to some extent, it should be recognized that businesses have always collected and used data, especially regarding their customers' preferences. However, the growing digitization of these data has allowed businesses (as well as governments) to collect an exponentially higher amount of data, with the resulting effect that the value associated to such data is perceived to be significantly greater. Therefore, when analysing the concept of substance in transfer pricing, the relevant question in this regard will be whether – considering that data are nowadays perceived as an important asset and that, as mentioned before, assets are relevant indicators of substance – data will become indicators of substance in transfer pricing. At first glance, the answer to this question seems to be affirmative. However, when considering the conceptual and practical implication of this conclusion, it should be noted that data, in itself, have no value. For example, a picture taken with a smartphone and stored in such a smartphone, in itself, is just raw data that have no value. It is only when data is collected, elaborated and exploited by a company that it starts (potentially) generating value, depending on the business model of that company. For instance, when that picture is collected, elaborated and used by Facebook on its website (e.g. if someone uses that picture as her own profile picture),

143. ZA: Supreme Court of Appeal, 9 Nov. 2018, *Sasol Oil Proprietary Limited v Commissioner for the South African Revenue Service*, Case No. 923/2017, available at http://www.saflii.org/za/cases/ZASCA/2018/153.html (accessed 3 May 2020).
144. *See* https://tpcases.com/south-africa-vs-sasol-oil-november-2018-supreme-court-of-appeal-case-no-923-2017/ (accessed 3 May 2020).
145. The third court ruling of October 24, 2009 on the request for correction of corporate tax treatment and cancellation of the 224th tax on Heisei 28.
146. *See* https://tpcases.com/japan-vs-denso-singapore-november-2017-supreme-court-of-japan/ (accessed 3 May 2020).
147. OECD, *BEPS Actions 8-10 Final Reports*, *supra* n. 83, at para. 1.66.
148. OECD, *Going Digital: Making the Transformation Work for Growth and Well-Being* para. 14 et seq. (7-8 June 2017), available at https://www.oecd.org/mcm/documents/C-MIN-2017-4%20EN.pdf(accessed 13 Nov. 2020).
149. *See* https://www.igi-global.com/dictionary/digital-convergence-cybersecurity-policy/7751 (accessed 13 Nov. 2020).
150. *See* European Parliamentary Research Service, *Is data the new oil? Competition issues in the digital economy*, (2020), available at https://www.europarl.europa.eu/thinktank/en/document.html?reference=EPRS_BRI(2020)646117 (accessed 13 Nov. 2020).


© IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

that data might potentially generate value; however, the same picture might not generate value for another business with a different business model (e.g. if someone uses that picture as her own profile picture of her online bank account). Moreover, it should be also considered that collecting, elaborating and exploiting data is a demanding exercise (requiring, initially, a business behind it) that might generate considerable losses (as any other business). Furthermore, data are not the same for every business, with some being more relevant and some less so (e.g. internal data versus external data), and not all useful data have the same value. Finally, data might not only generate value but also destroy it (e.g. concerning instances of "fake news" for businesses like Facebook and Twitter).[151]

Considering the OECD definition of intangibles as "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances",[152] it is doubtful that data is, in every circumstance, an intangible asset. Therefore, it could be reasonably concluded that data, per se, cannot be considered indicative of substance in transfer pricing (for this reason, a server or data storage also cannot be considered indicative of substance in transfer pricing); however, as for any other asset, when connected to relevant functions and risks (*see* above in this section), this might be the case.

Concerning the digitalization of the economy, this can have a more relevant impact on the concept of substance in transfer pricing. The above mentioned new processes and roles that constitute the operations of a business allow functions to be remotely performed and risks to be remotely managed by employees. This implies that more MNEs are (and will continue to do so) delocalizing many employees. Consequently, a significant number of entities are reducing their functional profile and, consequently, their substance. In this regard, a relevant question in the future will be whether, from a transfer pricing perspective, these effects of digitalization will yield an increasing number of business restructurings and, if so, how the movement of profit potential will be allocated between different countries. In general, business restructurings can potentially trigger symptoms of base erosion, either when commercially rational transactions fail to meet arm's length criteria or when restructurings lack commercial rationality in themselves and are purely tax motivated. In both cases, the tax consequences significantly impact taxpayers and tax administrations.[153] It has been observed that digitalization also leads to both deliberate and unintended business restructurings, and such transactions are required be at arm's length.[154]

Another implication of the digitalization of the economy is that MNEs are shifting their focus from people to processes. The relevant question nowadays is not only "who does what" but also "how something is done". Therefore, going forward, the concept of substance should be focusing much less on functions and more on processes.

The digitalization of the economy allows more functions to be performed and risks to be managed by artificial intelligence systems rather than by people. This means that more MNEs are dismissing numerous employees while performing the same functions and undertaking the same risks. In the future, this may require a switch in focus from "significant people functions" to "significant functions" (both in the context of the 2017 Guidelines and the AOA).[155]

Finally, the digital transformation of the economy will potentially have more far-reaching consequences on the concept of substance in transfer pricing. The proliferation of new business models placing the role of their users and customers as one of the key value drivers will undoubtedly change the way substance is conceived nowadays.

The increasing digital transformation of business models results in value being created not by a company in isolation for the benefit of the customer but, in fact, by a constant flow of interaction between the company and the customer. Therefore, value creation is no longer a static eventuality at the end of a value chain but rather the result of dynamic interaction within a digital ecosystem of shops and networks. These new business models are challenging the current transfer pricing rules to consider whether the existing frameworks still apply. This issue is critical as we transition into an increasing digitalized world characterized by continuous and circular data flows, value shifts and greater functional complexity of related and unrelated parties, both across space and time.[156]

As a result, it currently appears that the concept of substance is viewed as not only as overlapping with the notion of value creation (as mentioned before, in line with the post-BEPS guidance) but also embedding elements of value consumption.[157] Countries are increasingly arguing that the market jurisdictions should gain more taxing rights, since users and customers are vital to some companies' business models. Concepts like "user participation", "marketing intangibles" and "significant economic presence" have, in recent years, reshaped the connotation of the concept of substance.[158] The final outcome of these

151. R. Petruzzi, *Transfer Pricing, Users' Participation and Profit Attribution to Digital Permanent Establishments: A Case Study*, 26 Intl. Transfer Pricing J. 2, pp. 87-90 (2019), Journal Articles & Papers IBFD.
152. *OECD Guidelines* (2017), *supra* n. 31, at para. 6.6.
153. S. Prasanna, *Digitalization of Traditional Business Models: Transfer Pricing Implications of Business Restructurings*, 25 Intl. Transfer Pricing J. 6 (2018), Journal Articles & Papers IBFD.
154. Id.
155. R. Petruzzi et al., *The OECD "Unified Approach": Have the Cards been Reshuffled?*, 2019 Transfer Pricing International 6, pp. 1-12 (2019).
156. *See* Bloomberg Tax, *INSIGHT: Transfer Pricing Challenges In the Digital Economy–Part 1: Hic Sunt Dracones?* (30 May 2019), available at https://news.bloombergtax.com/daily-tax-report/insight-transfer-pricing-challenges-in-the-digital-economy-part-1-hic-sunt-dracones (accessed 1 Dec. 2019).
157. R. Petruzzi & S. Buriak, *Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?*, 72 Bull. Intl. Taxn. 4a/Special Issue, p. 2 (2018), Journal Articles & Papers IBFD.
158. OECD/G20, *Addressing the Tax Challenges of the Digitalisation of the Economy* p. 8 et seq. (OECD 2019), Primary Sources IBFD.

© IBFD


Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

discussions has generated the OECD Unified Approach,[159] which appears to neither address BEPS issues nor resolve issues related to highly digitalized businesses.

This project suggests a revision of the tax system to be applied to various MNEs, consisting of a hybrid formulary (i.e. Amount A) and arm's length approach (i.e. Amounts B and C). The former approach (under Amount A) aims at increasing the taxing rights of the market jurisdictions by attributing to them a portion of the consolidated profits of large MNEs. However, based on the results of the impact assessment released by the OECD, this allocation of extra taxing rights might not be significant.[160] Moreover, since this approach is alien to the transfer pricing system, it will not be further analysed in this article.

The latter approach (i.e. Amounts B and C), instead, focuses on preserving the current arm's length approach (as amended by the BEPS guidance), implementing a certain level of simplification for certain types of baseline and distribution activities, as well as a system for mandatory dispute resolutions. Within this framework, the relevant question is whether the concept of substance in transfer pricing (as developed by the BEPS Project) *will* and *should* be further amended in order to consider the above mentioned developments. This is pertinent since this new system will not impact only the notorious FAANG[161] but also all large consumer-facing businesses and automated digital services businesses.

The question of whether the concept of substance in transfer pricing (as developed by the BEPS Project) *will* be further amended in order to consider the above mentioned developments will be answered by the legislations and tax administrations of the specific countries in the years to come. Indeed, in light of the previous discussions, it seems highly probable that this will happen. Most likely, countries will increasingly use topics such as "valuable data", "users participation" and "relevance of the market" in order to justify a higher amount of substance (hence, taxable profits) in their own jurisdictions.

However, the issue of whether the concept of substance in transfer pricing (as developed by the BEPS Project) *should* be further amended in order to consider the above mentioned developments is a more difficult one to address. The following considerations definitively argue against such an amendment:[162]

- corporate income taxes should be levied where value is created, not consumed;
- the idea of providing more taxing rights to the market jurisdictions cannot, per se, justify amendments to the concept of substance; any amendment to this concept should rather rely on principle-based ideas;
- the concept of substance cannot be amended only for certain types of taxpayers (e.g. highly digitalized businesses, large consumer-facing businesses, automated digital services businesses, etc.) but it should be relevant for all taxpayers with no exceptions;
- amending the concept of substance might imply the amendments of taxing rights not only in profitable situations but also in loss-making situations; and
- the role of data and users in a digitalized business model, although increasingly important, should not be overestimated.

Yet, in some cases, it is also true that users and customers might generate relevant value for an MNE and, as such, could be considered part of the concept of substance in transfer pricing. This should be the case only in very limited instances, i.e. when users and customers both are active and generate relevant value to the specific MNE. In these circumstances, users and customers could potentially become part of the accurate delineation of an actual transaction and, as such, be considered (together with all the other economically significant characteristics) part of the definition of "substance".

## 6. Conclusions

This article addressed the notion of substance in transfer pricing and how this has evolved since it was first introduced by the OECD in its 1979 Report until today. Specific relevance has been given to the OECD BEPS Actions Plan and how it has impacted the significance and transformed the role of substance under the transfer pricing magnifying glass and within the international tax landscape.

Although the concept of substance was first generally introduced in the 1979 Report, it was further developed by notions such as the "conduct of parties" in the 1995 Guidelines and in Chapter IX (on business restructurings) of the 2010 Guidelines.

In 2015, the OECD BEPS Project defined "substance" as one of its three core pillars in an attempt to enhance the fight against base erosion and profit shifting. Considering this, BEPS Actions 8-10 are exclusively dedicated to transfer pricing, shedding more light on substance so that income is taxed where the value is created. It should be highlighted that under the BEPS initiative, substance and value creation became one and the same. In this new context, not only does the whole value chain of an MNE have to be examined but also the notions of "commercial rationality" and "other options realistically available to the parties", which have been identified as critically important in defining the substance in a business transaction reality. Each transaction is viewed as part of a greater picture, in particular, concerning the digitalization of the economy. Therefore, value creation, in a post-BEPS world, is no longer a stationary outcome at the end of a value chain

159. OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One* (2019), available at https://www.oecd.org/tax/oecd-invites-public-input-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 8 May 2020).
160. OECD/G20, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy* (2020), available at www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf (accessed 16 Oct. 2020).
161. Acronym that refers to the stocks of five prominent American technology companies: Facebook, Amazon, Apple, Netflix and Google.
162. Petruzzi et al., *supra* n. 155, at pp. 1-12.


© IBFD

Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.

but rather a result of dynamic interaction within a digital ecosystem of shops and networks.[163]

Ultimately, the implementation of the BEPS Project has triggered considerable influence on the OECD countries regarding the relevance of substance, particularly in the era of economic digitalization. In the new age, the OECD is primarily focusing on the ability of digital platforms to create "size without mass" and the exploitation of data as a key component of their activity. Consequently, it can be argued that users create value for the platform businesses they are using, which may justify taxation in the location where users are located.[164]

The relevance of this topic will, therefore, inevitably increase in the upcoming years. International organizations should provide more guidance, while taxpayers and tax administration should assess whether their current understanding of this topic is aligned with its future evolution.

163. Bloomberg Tax, *Transfer Pricing Challenges In the Digital Economy—Part 2: A Case Study of the Internet of Things* (31 May 2019), available at https://news.bloombergtax.com/daily-tax-report/insight-transfer-pricing-challenges-in-the-digital-economy-part-2-a-case-study-of-the-internet-of-things (accessed 15 May 2020).

164. W. Haslehner, *Taxing where value is created in a post-BEPS (digitalized) world?* (Kluwer Tax 2018), available at http://kluwertaxblog.com/2018/05/30/taxing-value-created-post-beps-digitalized-world/ (accessed 16 May 2020). Regarding the allocation of income to the country where users are located fit into a functional model of value creation, it has been recently proposed as a solution to consider users as "unconscious employees", thereby attributing their actions as "functions" to the firm (*see* Petruzzi & Buriak, *supra* n. 157, at p. 72 et seq.).

IBFD, Your Portal to Cross-Border Tax Expertise **www.ibfd.org**

Covering over 60 countries, Global Transfer Pricing Explorer Plus is a practical guide that will assist you in making transfer pricing decisions.

- Includes practical examples, cases and diagrams.
- Chapters deal with comparability analyses, transfer pricing methods, compliance, transfer pricing audits, penalties, advance pricing agreements and litigation.
- Covers very specific issues such as intangibles, services, cost contribution arrangements, business restructuring, intra-group financing and the intricate role of transfer pricing in indirect taxes.
- Includes Transfer Pricing Tables, Transfer Pricing Documentation Tables and BEPS Country Monitor.
- Information on documentation requirements includes CbC, MF, LF and deadlines.

To see the full collection content and tools, to take a free 7-day trial or to order, please visit www.ibfd.org.

**Contact us**

**IBFD Head Office**
Rietlandpark 301
1019 DW Amsterdam

P.O. Box 20237
1000 HE Amsterdam,
The Netherlands

**Tel.:** +31-20-554 0100 (GMT+1)
**Customer Support:** info@ibfd.org
**Sales:** sales@ibfd.org

**Online:** www.ibfd.org
www.linkedin.com/company/ibfd
@IBFD_on_Tax

2020_1




Exported / Printed on 9 Nov. 2022 by fernandes@ibdt.org.br.