ACTION ITEM 13:
GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING

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Tags
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INTRODUCTION

On July 19, 2013, the Organization for Economic Cooperation and Development ("O.E.C.D.") released its full *Action Plan on Base Erosion and Profit Shifting* (the "B.E.P.S. Action Plan"), with expectations to roll out specific items over the subsequent two years. According to the O.E.C.D., the B.E.P.S. Action Plan will allow countries to draft coordinated, comprehensive, and transparent standards that governments need to prevent B.E.P.S., while at the same time updating the current rules to reflect modern business practices. Of the 15 action items listed in the B.E.P.S. Action Plan, four relate specifically to transfer pricing and several others indirectly address this area, as well. The four with direct impact on transfer pricing are Action Items 8, 9, 10, and 13:

- **Action Items 8, 9, and 10 (Assure that Transfer Pricing Outcomes are in Line with Value Creation)** develop rules to prevent B.E.P.S. by (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles, capital, or other high-risk transactions are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

- **Action Item 13 (Re-examine Transfer Pricing Documentation)** develops rules regarding transfer pricing documentation to enhance transparency for tax administrations, taking into consideration the compliance costs for multinationals.

With these and the 11 other Action Items, the O.E.C.D. aims to foster (i) coherence of corporate income taxation at the national level; (ii) enhanced substance, through bilateral tax treaties an in transfer pricing; and (iii) transparency and consistency of requirements.

Further guidance on the transfer pricing Action Items 8-10 is not expected until September of 2015. On September 16, 2014, however, the Centre for Tax Policy and Administration, part of the O.E.C.D., released its first round of recommendations under the B.E.P.S. project (the "B.E.P.S. recommendations"), including for Action Item 13 (as well as 6 other Action Items discussed in this issue). Though these deliverables are not finalized, the recommendations are perceived to represent the consensus of 44 countries (O.E.C.D., G20, plus Columbia and Latvia).[47]

TRANSFER PRICING DOCUMENTATION & COUNTRY-BY-COUNTRY REPORTING

In keeping with the third pillar of the B.E.P.S. initiative listed above – transparency and consistency – Action Item 13 calls for a revamp of transfer pricing documentation. The new guidance calls for a three-tiered approach to global transfer pricing documentation, including:

1. A Master File – a high-level overview of the multinational group business;

2. A Local File – detailed information on specific group transactions for a given country; and

3. A Country-by-Country ("CbC") report – a matrix of specific data for each jurisdiction, ostensibly to be used as a risk assessment tool by tax authorities (as well as, potentially, taxpayers).

Each of these proposed documentation elements is described below.

Master File

The Master File is meant to provide tax authorities with high-level information about a multinational's global business and transfer pricing policies. The latter can include entity characterizations (*e.g.*, distributors, manufacturers, service companies), nature of intercompany transactions, and data used to benchmark remuneration.

This recommendation endorses a practice already being followed by many multinationals concerned with efficiently presenting a consistent "story" to any tax authority that may institute a tax audit or otherwise challenge transfer pricing arrangements.

In general, the Master File should include:

- An organization chart;
- A description of the multinational's business operations;
- A description of primary intangible assets;
- A description of intercompany financial activities (*e.g.*, loans, guarantees, cash pools); and
- Relevant financial and tax information.

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47 There is overlap between O.E.C.D. and G20 member countries.

- The B.E.P.S. recommendation includes specific requirements for each of these items.

Local File

In addition to the Master File, multinationals would be required to prepare local-country transfer pricing reports that would describe business operations and intercompany transactions relevant to entities operating in that country. These reports would describe the transfer pricing method(s) applied to evaluate each transaction, the benchmarks used (comparable companies or transactions), and the conclusions reached as to the arm's length nature of the related-party dealings. (Depending on the country, the Local File may need to be prepared in the local language.)

"The Master File… recommendation endorses a practice already being followed by many multinationals."

The Local File should include:

- An organization chart for the local entity(ies), along with a description of the management structure;
- A description of the local business(es) and key competitors;
- A description of material intercompany transactions, including corresponding intra-group payments;
- Identification of affiliates involved;
- Copies of all relevant intercompany agreements;
- Detailed functional analysis of the local multinational(s) and relevant affiliates;
- A description of the transfer pricing methods applied for each transaction and the financial information utilized;
- A description of the economic/benchmarking analysis, including key assumptions and adjustments made to market benchmarks;
- Conclusions as to the arm's length nature of the intercompany transactions;
- Local entity audited or unaudited financial accounts and their links to the financial information used in the transfer pricing analysis; and
- Information on any existing Advance Pricing Agreements or other tax rulings not involving the local entities that may impact the pricing of the controlled transactions under review.

In practice, the detailed information provided in the Local Files should be entirely consistent with the more general information provided in the Master File.

CbC Report

Among the three recommended documentation elements, the CbC report has garnered the most attention. It would include the following items to be listed by jurisdiction:

- Revenues;
- Profit/loss before tax;
- Income tax (paid & accrued);
- Capital and accumulated earnings;
- Number of employees;
- Tangible assets;
- Main business by activity; and
- Country of organization/incorporation.

The information can come from any source (statutory accounts not a priority), as long as it is consistent across the relevant jurisdictions.

CHALLENGES & STRATEGIES

Master & Local Files

The Master File and Local File concepts are familiar to many multinationals that have been following a similar strategy. In many cases, a Master File is prepared at the end of a transfer pricing planning analysis[48] to memorialize the relevant business information and the corresponding transfer pricing policies being implemented. That planning report can then be updated on an annual basis (reflecting any changes in business operations and incorporating new financial information) and serve as the basis for any Local Files needed. This "wheel and spokes" approach ensures consistency and maximizes efficiency in the preparation of needed documentation.

As a practical matter, a multinational will not prepare a Local File annually for each country in which it operates. Rather, potential exposure (based on audit risk, volume of intercompany flows, complexity of transactions, types of transactions) should be evaluated on a regular basis in order to decide how resources should be deployed in preparing local documentation, especially for companies that do not have relatively large tax departments containing tax lawyers, accountants, and economists. Consideration should also be given to specific country practices regarding time limits imposed by the tax authority once documentation is requested and possible requirements to translate documentation into the local language.

[48] That is, an exercise aimed at determining the proper transfer pricing structure, as opposed to justifying one already in place.

CbC Reporting

The new documentation standards, particularly the CbC reporting template, have the stated purpose of providing enough information for tax authorities to determine "whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments."[49] As such, it is intended to be used as a "risk assessment" tool by tax administrations, perhaps helping to focus attention and resources on particular transactions and jurisdictions.

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Given that CbC reporting standards have not been finalized or formally adopted by individual countries, it may be prudent for multinationals to adopt a wait-and-see approach before adjusting transfer pricing documentation strategies. On the other hand, since it is likely that something comparable to the proposed template will be put into use in a significant number of jurisdictions, internal CbC reporting may be a viable part of the risk assessment process for multinational tax departments wishing to plan ahead. Filling out the template now, *at least* for major jurisdictions in which a multinational does business, will help ascertain the ease with which the needed data can be collected. It also can be used to expose potential audit risks or, at a minimum, the business and geographic areas that are likely to invite detailed inquiries from tax authorities. Further, since broad measures in the CbC reporting template – such as total number of employees and profits broken down on a country-by-country or entity-by-entity basis – do not shed light on whether transfer pricing policies are supportable, a global group might consider augmenting the CbC template with additional information that clarifies and is consistent with its transfer pricing. Any such additional information, as with the basic CbC data provided, should be fully consistent with contents of the Master File and Local Files.

The B.E.P.S. recommendations expressly discourage tax administrations from using the CbC information "to propose transfer pricing adjustments based on a global formulary apportionment of income."[50] However, there is considerable, and perhaps reasonable, trepidation among the multinational community that use of the CbC template will move past general assessment into some sort of apportionment argument, at least in some jurisdictions. For example, some less developed countries might take the position that local taxable income should be in direct proportion to the total share of employees.[51] This or a similar approach would bypass any insights gained through a comprehensive functional analysis of the multinational enterprise, which would go beyond superficial numbers to identify the true profit-generating activities and assets of the global business.[52] Global groups will likely benefit by proactively conducting an adjusted analysis that identifies value drivers and meticulously documenting the facts and resulting transfer pricing policies under the three-tiered structure described in the B.E.P.S. recommendations.

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49 OECD/G20 Base Erosion and Profit Shifting Project, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, Action Item 13: 2014 Deliverable, pages 9-10.

50 *Ibid*., page 20.

51 This could be an indirect way for countries where routine functions are centralized, such as India or China, to capture a share of the "location savings."

52 Multinationals that have centralized ownership of valuable intellectual property might be particularly vulnerable to a simplified apportionment argument.

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NEXT STEP – IMPLEMENTATION

Though there is consensus on the content, there remains substantial uncertainty as to how the B.E.P.S. recommendations on Action Item 13, particularly CbC reporting, will be implemented by individual countries. For example, let us take a selective survey as follows:

- United States officials, while stepping up transfer pricing enforcement efforts in recent years (particularly with respect to intangibles and services), have adopted a wait-and-see attitude regarding the Action Item 13 proposed documentation standards.[53]

- France has been requesting consolidated accounts and management reports during audits and is widely expected to introduce CbC reporting in some form.

- Germany has already implemented some B.E.P.S. measures and is in favor of consistent adoption by all countries.

- The United Kingdom views its current transfer pricing audit practices as consistent with the B.E.P.S. initiative and is likely to adopt the Action Item 13 recommendations as part of a coordinated international effort.

- The “B.R.I.C.” countries (Brazil, Russia, India, China) have identified incomplete information disclosure as a primary reason for tax-base erosion and are, therefore, proponents of the CbC report.

In each country, adoption of the Action Item 13 recommendations will require consideration of such issues as confidentiality, timeliness, and usefulness of the information collected (particularly through the CbC template). Taxpayers also have concerns with respect to how the information would be disseminated. At this point, it is unclear whether there will be any thresholds (size/type) with respect to affiliates and countries that should be covered in the Master File, Local File, or CbC documentation.

Finalization of all B.E.P.S. Action Plans will focus on these implementation and coordination challenges; unilateral action by countries would be counterproductive. The O.E.C.D. has made it clear that the recently-released B.E.P.S. recommendations, including those on Action Item 13, may be impacted by decisions made with regard to the remaining eight elements of the B.E.P.S. Action Plan, which are scheduled to be presented to the G20 for final approval in 2015.

[53] Many U.S. multinationals and transfer pricing practitioners have voiced reservations.