TRANSFER PRICING IMPLICATIONS OF THE B.E.P.S. ACTION PLAN

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Determined to eliminate so-called "double non-taxation," as well as no or low taxation, associated with practices that are perceived to segregate taxable income from the activities that generate them, the Group of Twenty ("G20") and the Organisation for Economic Co-operation and Development ("O.E.C.D.") released their *Action Plan on Base Erosion and Profit Shifting* ("B.E.P.S. Action Plan") in 2013. Included in the B.E.P.S. Action Plan are several provisions related to transfer pricing:

- Action 4: Limit base erosion via interest deductions and other financial payments;
- Action 8: Assure that transfer pricing outcomes are in line with value creation – Intangibles;
- Action 9: Assure that transfer pricing outcomes are in line with value creation – Risks and capital;
- Action 10: Assure that transfer pricing outcomes are in line with value creation – Other high-risk transactions; and
- Action 13: Re-examine transfer pricing documentation.

The O.E.C.D. has since delivered a number of reports and recommendations related to these actions, including revisions to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("Transfer Pricing Guidelines"), and it continues to perform additional work on deliverables scheduled for later this year.

While it is difficult to project exactly what form the B.E.P.S. actions will finally take, it appears certain that a number of the recommendations will be implemented in whole or in part. The U.S. Treasury Department has joined other fiscal authorities and indicated that it will develop a form to implement the country-by-country ("CbC") report, which lists profits by jurisdiction, among other information, under the revisions to Chapter V ("Documentation") of the Transfer Pricing Guidelines.

As such, it is now time for multinational enterprises ("M.N.E.'s") to move beyond consideration of where the O.E.C.D. is heading and to determine how best to operate within a radically changed regulatory environment. Based on the agreed draft language contained in the policy documents and discussion drafts provided by the O.E.C.D., we have identified some implications of these foreseeable changes. While the implications themselves may seem relatively obvious, what taxpayers should do to best manage the transition to the new regulatory framework and to hopefully ameliorate the impact of these changes may be less clear.

Several potential implications of the B.E.P.S. Action Plan are anticipated:

1. Revenue bodies will seek to tax a greater share of an M.N.E.'s worldwide income;
2. Transfer pricing disputes will increase;
3. Profits splits will become more prevalent;
4. Taxpayers will need to revise their transfer pricing documentation;
5. Taxpayers will need to evaluate their existing transfer pricing structures; and
6. Taxpayers may need to reconsider the use of related parties versus third parties.

We discuss each of these implications further and provide some practical advice regarding how they might best be managed below.

REVENUE BODIES WILL SEEK TO TAX A GREATER SHARE OF AN M.N.E.'S WORLDWIDE INCOME

This development will come as little surprise, as it is a fundamental goal of the B.E.P.S. initiative. Although, taxpayers may be surprised by the methods tax authorities are likely to use. For example, the discussion draft on revisions to Chapter I ("The Arm's Length Principle") of the Transfer Pricing Guidelines sets out circumstances in which transactions between related parties could be disregarded for transfer pricing purposes.

While nonrecognition, or "recharacterization," of a transaction is intended primarily to address arrangements that are not considered to have arm's length attributes (*i.e.*, third parties would be unlikely to enter into such arrangements), it could, in practice, be subject to overreach by tax authorities. Additionally, any move away from the arm's length principle by a jurisdiction on one side of a transaction is bound to increase transfer pricing disputes and potential double taxation. Recharacterization will likely make the ultimate resolution of transfer pricing disputes more difficult, as the fundamental basis for discussion and agreement among the taxing authorities will have changed.

To help avoid such difficulties, taxpayers should carefully consider intercompany transactions that are likely to be challenged on their arm's length attributes and consider ways to strengthen those arrangements in a tax-efficient manner. For example, if an entity operating as a commission agent on behalf of a related-party were to be recharacterized as a fully-fledged buy-sell distributor, the taxpayer could consider having that entity purchase the rights to the customer relationships from the related-party principal. The value of that intangible asset and the subsequent amortization of the purchase price may mitigate adverse tax consequences associated with higher operating margins generally attributable to buy-sell distribution. Of course, the proper amount of the purchase price of the intangible will be another transfer pricing issue that is in play.

If any entity within a multinational group were upgraded to a more robust operation, consideration would be needed regarding the compensation required to provide that entity with the tangible assets or the rights to any intangible assets necessary to operate in an upgraded fashion. Taxpayers may consider proactive planning to restructure current operations that are considered at risk for recharacterization under the B.E.P.S. framework. Moving responsibility while leaving the service providers in place may be problematic in the home country.

TRANSFER PRICING DISPUTES WILL INCREASE

As revenue authorities expand the scope of taxation of an M.N.E.'s worldwide income, the volume of transfer pricing disputes is certain to increase. The O.E.C.D. recognizes that "the need for more effective dispute resolution may increase as a result of the enhanced risk assessment capability following the adoption and implementation of a CbC reporting requirement."[1] Although the countries participating in the B.E.P.S. project have agreed that they should not use data in the CbC report to propose income adjustments, increased transparency with regard to the distribution patterns for profits within an M.N.E. may lead to the deployment of tax examination resources on matters that could lead to even greater transfer pricing adjustments. Indeed, an explicit object of the new transfer pricing documentation requirements is to "provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction."[2]

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To help manage transfer pricing disputes, taxpayers will want to make sure their counterparties are covered by a broad treaty network. Having access to a mutual agreement procedure ("M.A.P.") under a tax treaty will be important for preventing double taxation. The M.A.P. process is largely effective in resolving transfer pricing disputes and the O.E.C.D. is working to improve access to the M.A.P. under Action 14 (Make dispute resolution mechanisms more effective) of the B.E.P.S. Action Plan. Without such a resolution process in place, efforts to reduce double taxation in a tightened regulatory environment will be limited.

Taxpayers should review intercompany transactions to identify those between entities based in countries not having a tax treaty in effect. The goal would be to identify partner countries and to move transactions to entities in those countries in order to promote an effective M.A.P. process. Additionally, operating management should take necessary steps to ensure that any tax-advantaged entity has the functional, asset and risk profile necessary to withstand the more critical scrutiny of intercompany transaction pricing that is certain to come. Headcount and facilities will be key factors in determining the substance of the entity in a tax-advantaged jurisdiction.

PROFIT SPLITS WILL BECOME MORE PREVALENT

Another method for tax authorities to potentially tax a greater share of an M.N.E.'s worldwide profits is to employ a profit split. Traditionally, most taxpayers have relied

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[1] O.E.C.D., *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* (2015), p. 3.

[2] O.E.C.D., *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (2014), p. 14.

largely on profitability-based methods, such as the comparable profits method or the transactional net margin method, to support their transfer prices. These methods are typically applied in a manner by which the profitability outcome of the simpler entity is evaluated - rather than how the profit is split between the counterparties. The O.E.C.D.'s discussion draft on the use of profit splits in global value chains considers and seeks commentary on scenarios in which "one-sided" profitability-based methods might produce outcomes that are not in line with value creation.[3] In such cases, the discussion draft suggests that the profit split method may be more appropriate. At the same time, the O.E.C.D. adamantly refuses to acknowledge the validity of formulary apportionment as a driver to appropriate taxation.

To protect against arbitrary application of a profit split as the most appropriate method, taxpayers should be prepared to explain and support both sides of a transaction, even if they have applied a one-sided transfer pricing method. That is, even if a single member of the group is the "tested party" and earns only a routine return with the residual profit accruing to the counterparty, it will be important to explain the functions performed, assets used, and risks borne by both entities to support the income earned in each jurisdiction. Otherwise, with increased visibility into profits earned by an M.N.E. in different jurisdictions, tax authorities may be encouraged to split profit between entities using a factor that produces the most revenue for the tax authority undertaking the examination. As previously alluded, a profit split could essentially provide tax authorities with a means of applying a variant of formulary apportionment. In order to avoid such a result, taxpayers should make sure that the result from any one-sided analysis is consistent with value creation.

Taxpayers who have separated the trading principal entity – likely operating in a low-tax country with a good treaty network – from the entity that owns intangible assets – often in a no-tax jurisdiction – may want to consider combining these operations. Ensuring that the low-tax principal has a robust functional, asset and risk profile will help blunt the impact of the application of profit splits with lesser functionality related counter-parties.

Taxpayers will also want to consider carefully their third-party arrangements to determine whether such arrangements are comparable to their related-party arrangements and can provide support of arm's-length dealings. Such internal comparables are likely to receive greater attention from tax authorities seeking to apply profit splits, so it will be important for taxpayers to review them in detail. Likewise, they may prove invaluable to taxpayers in supporting their transfer pricing with actual third-party evidence of the manner in which they value certain functions.

TAXPAYERS WILL NEED TO REVISE THEIR TRANSFER PRICING DOCUMENTATION

Under the new Transfer Pricing Guidelines related to documentation, M.N.E.'s with revenues over €750 million will be required to complete a CbC report containing certain information by jurisdiction, including revenues, profit before income tax, number of employees, and amounts of tangible assets. While the report itself will create additional documentation, the greatest burden comes from the obligation to explain

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[3] O.E.C.D., *Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (2015), p. 1.

value creation within the overall group and to match the levels of functionality, risks and assets to the allocation of income. As mentioned in the discussion of the profit split, increased transparency with regard to profits earned within the group will require taxpayers to explain both sides of a transaction.

The master file and local file approach embodied in the new documentation chapter of the Transfer Pricing Guidelines provides taxpayers with opportunities to re-evaluate and strengthen their documentation position. The master file, which provides information on the group as a whole, offers the taxpayer an opportunity to develop the factual analysis, describe the important drivers of business profit, and explain how those are aligned with the overall structure of the group and its transfer pricing arrangements. The local file further allows the taxpayer to explain the extent of the local affiliate's contribution to overall group profit. Recognizing that business considerations are the drivers in the structure, prudence dictates that operating management's story should be translated into the language of the transfer pricing adviser in order to promote the likelihood of a successful outcome.

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Much will likely depend on the quality and depth of this documentation. It is vitally important that tax departments have a full grasp on what is communicated in these documents and that documentation should be prepared carefully and consistently to present the group's transfer pricing in the best possible light. Where consistency does not exist, well developed reasons justifying those differences should be prepared in advance. As transfer pricing practices and outcomes become fully transparent to all tax authorities, taxpayers must control all aspects of the facts on the ground and create the narrative to support their decisions and results.

TAXPAYERS WILL NEED TO EVALUATE THEIR EXISTING TRANSFER PRICING STRUCTURES

A large focus of the work of the O.E.C.D. has been on the transfer pricing aspects of intangibles. The work in this area completed to date has helped to clarify the definition of intangibles under the Transfer Pricing Guidelines and to provide supplemental guidance for determining arm's length conditions for transactions involving intangibles. Work continues on the most thorny issues such as recharacterization and the valuation of intangibles based on ex-post results versus ex-ante forecasts (essentially a commensurate with income approach). But whatever final form the recommendations take, there appears to be support in many jurisdictions for requiring intangible ownership within an M.N.E. to be aligned with the ability to develop, enhance, maintain, protect, and exploit such intangibles. The mere funding of intangible development may not enable a member of the group to accrue economic income associated with such intangibles beyond a return on investment that is commensurate with the risk profile of the investment.

Whereas tax planning before the B.E.P.S. initiative may have focused on shifting risks and intangible ownership between members of a group, taxpayers will wish to pay greater attention to the functions performed by the different members of the group going forward. As emphasized by the work on intangibles, the profits earned by different entities will depend on value creation, and substance through value-adding functions will be vitally important. Taxpayers should work to ensure that those members of the group earning excess profits have the necessary substance and, if they do not, work to enhance that substance. Employee headcount will be crucial and use of outside contractors – especially related contractors – should be avoided.

The traditional "Intellectual Property Company," or "IPCo," that held and funded the rights to intangible assets and often collected residual profits within the taxpayer's transfer pricing structure, may need to be restructured. As mentioned previously, a combination of intangible assets, trading and investment risks, and significant functionality likely provides the most defensible structure to centralize the profit successes and failures of the organization. For management, the key will be to place sufficient functions in the IPCo without exposing the IP to risk as a result of law suits arising from the performance of those functions.

TAXPAYERS MAY NEED TO CONSIDER THE USE OF RELATED PARTIES VERSUS THIRD PARTIES

A potential result of the B.E.P.S. initiative may be in how M.N.E.'s choose to operate globally. This risk of double taxation – particularly if it results in having excess profits attributed to a member of the group that provides what are clearly considered routine functions – may lead some M.N.E.'s to use third parties in a jurisdiction where they would have otherwise established a subsidiary.

For example, if the use of a related-party distributor or contract manufacturer means that a principal company could have a share of its profits taxed by another jurisdiction through recharacterization or another measure, then it may ultimately choose to mitigate such risk by contracting with third parties to perform such services. Hopefully, policymakers will consider distortive results such as these and their impacts on foreign investment when developing their recommendations.

CONCLUSION

Measures to eliminate B.E.P.S. will come to fruition. We are now beyond the point of academic discussion on the matter. As the regulatory implications of those measures that impact transfer pricing come into sharper focus, the ramifications for taxpayers appear to be significant. We have identified a number of these transfer pricing implications and have presented some practical approaches for potentially addressing them. With proper planning, it is likely that the impacts of these changes can be mitigated. Taxpayers should develop policies and documentation to help themselves best manage their transfer pricing risk in a post-B.E.P.S. world.