SEPTEMBER 2014
BEPS ACTION 13:

The implications on transfer pricing documentation

BDO

INTRODUCTION

On September 16, 2014 the OECD released the first seven action plans of its Base Erosion Profit Shifting (BEPS) Project. Among those released were two that are particularly relevant for transfer pricing: Action 8 – Guidance on Transfer Pricing Aspects of Intangibles and Action 13 – Guidance on Transfer Pricing Documentation and Country-by-Country reporting (CBCR) template.

This bulletin focuses on Action 13, with particular emphasis on:

- The practical differences between the transfer pricing documentation created to satisfy the previous OECD Transfer Pricing Guidelines and what Multinational Enterprises (MNEs) will need to do under the new Guidelines.
- Steps MNEs should be taking now to be ready for the new documentation requirements.

SECTION 1
Old versus new Chapter V

The BEPS Guidance in Action 13 replaces Chapter V and the annexes of the OECD's original Transfer Pricing Guidelines. With the new Guidelines, the OECD has taken a very different approach. Until now, the OECD never specified the type or nature of the transfer pricing documentation MNEs should create. Indeed, in earlier Guidelines the OECD simply emphasised the need for reasonableness and the intention of avoiding excessive documentation burdens.

Given the tremendous growth in volume and complexity of international intra-group trades and the increased number of countries requiring transfer pricing documentation and reporting, it's clear that MNEs are facing significant compliance costs. But, at the same time, many tax authorities have felt the documentation they receive is often inadequate. So, to address this situation, the OECD has reversed course and the new Guidelines specify three tiers of documents taxpayers should include in their transfer pricing documentation.

The new documentation requirements are intended to:

- Help foster a "culture of compliance" within organisations by providing an incentive to taxpayers to give appropriate consideration to transfer pricing in establishing prices and by requiring them to "articulate convincing, consistent and cogent transfer pricing positions".
- Provide tax authorities with useful information so they can assess transfer pricing risks.
- Provide information to help tax authorities determine the most effective way to deploy audit resources.

The three tiers of documentation required under the new Guidelines are:

Master File

This will provide a high-level overview of the MNE group's global business operations and transfer pricing policies. The Master File will be available to each country so that tax authorities have an appropriate overview of the MNE's global business.

Local File(s)

This will be provided to individual jurisdictions and will include detailed information on specific group transactions that are considered material under the local country's tax system. The purpose of the information provided in the local file(s) is to show the taxpayer has complied with the arm's length principle.

Country-by-Country Report (CBCR)

This will provide aggregate jurisdiction-wide information on the global allocation of the MNE's income, taxes paid, stated capital and accumulated earnings, the number of employees, and other information showing the location of the economic activity within the MNE. The information will have to be provided by jurisdiction. As well, the CBCR must include all tax jurisdictions where the MNE has an entity resident for tax purposes, regardless of the size of the business operations in a country.

New Chapter V includes annexes that provide a fair bit of detail regarding the specific documentation required for each tier, as well as a model template for the CBCR. The OECD hopes that having clear and widely adopted documentation will help ensure tax administrators get useful information and, at the same time, will help minimise compliance costs for MNEs.

SECTION 2
The consequences of the changing landscape

Under the old Guidelines, taxpayers sometimes prepared documentation that was sufficient for one jurisdiction, and relied on that documentation in the event other jurisdictions inquired into their transfer pricing policies. This approach will no longer be effective because with the new requirements, if one jurisdiction that an MNE reports to has adopted the OECD Guidelines, the taxpayer must prepare all three tiers of documentation.

MNEs face two potential types of risks as they try to satisfy the new documentation requirements:

- Visibility risk – which relates to unintended consequences that result from the MNE's transfer pricing policy decisions; and
- Delivery risk – which relates to unexpected consequences that result from the MNE's ability to meet the new reporting requirements.

Visibility risk

Visibility risk relates to transfer pricing policy decisions and issues related to implementation of those policies. Visibility risk can occur if an MNE's transfer pricing policy is not current or up-to-date, or is not followed in any of the jurisdictions the MNE operates in. For example, unintended consequences can result if the policy no longer represents the substance of activities. As well, visibility risk can arise if the policies do not fit within the enterprise's risk profile.

Visibility risk can also occur as a result of how the MNE implements its transfer pricing policy. For example, the MNE's transfer pricing policy should be easy to understand so that there's no misinterpretation of what needs to be put in place and maintained after the initial implementation. As well, intercompany agreements and documentation should to be in line with the stated policy and with existing advance pricing agreements (APAs), mutual agreement procedures (MAPs), or rulings the taxpayer has received.

Delivery risk

Delivery risk relates to the processes in place to facilitate compliance with the reporting requirements. Delivery risk can occur if the MNE's reporting processes and systems are lacking. Such systems can be inadequate in a variety of ways. For example, the level of disclosure might be less than needed or inefficient. Alternatively, the disclosure generated, or the method by which the disclosure is delivered, could be problematic because it breaches confidentiality standards within the organisation.

Delivery risk can also arise if the results generated by the reporting process are different than those expected. For example, if the transfer pricing policy states that all distribution entities should earn an operating margin between 3% and 5%, there is a delivery risk if some of those entities earn well in excess of 5% and the reason(s) for those results are not known and documented.

SECTION 3
Take action now

Though some details are yet to be worked out regarding implementation of the new transfer pricing documentation requirements, the OECD expects to reach agreement on the appropriate means of filing the required information over the next several months. So, given that MNEs will be expected to file a CBCR annually, enterprises should begin taking steps to ensure they will be ready to meet the new requirements.

To prepare, we recommend that enterprises do a dry run in which they prepare a preliminary CBCR to test their transfer pricing policies and reporting mechanisms. Given that one of the goals of the CBCR is to ensure enterprises have a robust transfer pricing policy, a dry run will provide critical information MNEs can use to assess their transfer pricing policies and their implementation and documentation capabilities.

The purpose of the dry run is to assess the current state of the MNEs transfer pricing environment, rather than focusing on a narrow functional analysis and benchmarking. The dry run also provides an opportunity to explore potential planning and optimisation opportunities; for example, taking advantage of lower tax rates in jurisdictions where there is enough substance to justify higher profits being earned there.

A well-designed transfer pricing system should include a framework that provides for central reporting, including appropriate reporting tools. The system should ensure:

- A consistent approach to transfer pricing across the enterprise based on a clear vision;
- Consistency between outputs (whether it's the Master File, Local File, or CBCR); and
- Stakeholders have a means to assess the strengths and weaknesses of the transfer pricing policy and its effectiveness.

Assessing your transfer pricing environment

There are a series of steps we recommend MNE's take to assess their transfer pricing environment:

- Conduct a transfer pricing policy review
- Prepare a draft CBCR
- Test risks using financial analyses
- Conduct a gap analysis based on identified transfer pricing risks
- Address risks and assess opportunities

Transfer pricing policy review

When conducting a transfer pricing policy review, gather information from a variety of sources, such as: tax returns, existing transfer pricing documentation, questionnaires and information gathered from staff in each jurisdiction, management reports, tax and transfer pricing audits borne by group's companies and the tax positions taken in the financial statements. Remember that information from outside sources may also be relevant, such as patent information concerning intellectual property rights, securities analyst reports, commercial databases, press reports, and so on. In reviewing this information, assess and evaluate the appropriateness of the existing transfer pricing policy. Consider how the various tax authorities may view this information when considered in conjunction with the information presented in the CBCR.

Prepare a draft CBCR

Once you have gathered all the relevant information, prepare a draft CBCR using the OECD template. Actually filling in the columns in the template will help focus attention on the information needed regarding the MNE and Constituent Entities. Preparing the draft will help you assess the reporting systems and processes used, as well as the robustness of the transfer pricing policy based on the results being generated under the policy.

Take action now

Test risks

You can then use the draft CBCR to test specific transfer pricing risks. There are five broad categories of transfer pricing risks you should consider:

Transaction related risks	These types of risks can be related to transaction volumes or values. They can also relate to transactions for which no payments were exchanged. Based on best practices, consider what pricing methodologies should be used when evaluating transactions and related risks.
Profit related risks	These types of risks can arise, for example, if there are sustained losses or decreasing margins. Evaluating profit related risks involves comparing group profit margins, conducting comparables testing, comparing profits to other metrics (for example, number of employees), and so on.
Geographic type	These types of risks could arise, for example, when there are transactions with tax havens, in jurisdictions where the tax authorities are known to aggressively pursue transfer pricing, and when non-OECD methodologies are used. When evaluating geographic risk, consider things like local headline tax rates and effective local tax rates.
Structural risks	These types of risk can arise, for example, when special purpose vehicles are used, where hybrid entities are included in the corporate structure, where one-off transactions occur, or where a high risk business model is used. When evaluating structural risks, check for consistent treatment across jurisdictions.
Process related risks	These risks can arise, for example, when those responsible for implementing the policy are ineffective, or when there is uncertainty as to who is responsible, whether at the head office or at constituent entities within the group. It can also arise if current documentation is not prepared. When evaluating process related risks, review process controls, as well as standard operating procedures (SOPs), the terms of advance pricing agreements (APAs), and so on.

BDO'S TRANSFER PRICING RISK REGISTER

We have developed a Transfer Pricing Risk Register tool that helps enterprises identify major transfer pricing risks by Constituent Entity and country, and quantifies the level of risk (tax, interest, and penalty exposure). The Risk Register identifies who has responsibility for managing each risk going forward and can be used to globally manage potentially offsetting items. The Risk Register can also be used to manage the enterprise's MAP and APA programs.

Contact your BDO transfer pricing specialist for information about how the Transfer Pricing Risk Register can help you manage your transfer pricing program.

Take action now

Conduct a gap analysis

Once you have identified potential risks through the CBCR dry run and have quantified those risks, it's important to analyse gaps between the actual risks and the level of risk the MNE considers acceptable. Consider quantitative outputs, such as the amount of tax at stake. Also consider qualitative outputs, like complexity and subjectivity of positions, and how supportable the enterprise's position is. Additionally, it will be advisable to take in consideration the transfer pricing case law and doctrine in risk related jurisdictions.

Low risk items can be parked, allowing you to focus on mitigating medium and high risk items. In some cases, mitigation may involve putting controls or systems in place, revising policies, modifying specific procedures, performing additional planning analyses, and so on.

Assess opportunities

Review of the CBCR may also reveal planning and optimising opportunities, for example, reducing the profits earned in jurisdictions where the profits reported in the CBCR are in excess of the profits expected under the MNE's existing transfer pricing policies.

The CBCR will also help you articulate a clear risk strategy and approach, which should help increase stakeholders' awareness, buy-in, and support for the enterprise's transfer pricing policy. This, in turn, should help ensure a consistent approach is applied to all the transfer pricing documentation (the Master File, Local File(s), and CBCR).

SECTION 4
Adoption of the Guidelines

As noted, Action 13 has been agreed on and we anticipate that countries will adopt the OECD Transfer Pricing Guidelines, though a few important issues remain to be finalised, including:

- An implementation plan and phase-in-rules;
- How concerns about commercially sensitive information will be addressed.

Also, it should be noted that because the mechanisms included in Action 13 are new and untested, the OECD has pledged to review the documentation standards and the CBCR by the end of 2020 to determine whether the standards provide an adequate basis for transfer pricing risk assessment.

CONCLUSION

Though some details are to be worked out, there's no question that many countries will adopt the Guidelines and that businesses will have to meet the new reporting requirements in the near future.

We believe enterprises should take action early to understand, address, and manage the reporting process so that there are no surprises. Though doing so might be burdensome, MNEs that develop robust systems to fulfil the documentation requirements could end up saving money by taking advantage of planning opportunities that come to light in the process of complying. As well, enterprises should keep in mind that money and effort spent complying with the Guidelines may pay off in the event of a transfer pricing dispute.

CONTACT

If you would like to discuss any aspect of this bulletin in more detail, or any other transfer pricing issue, please contact your usual BDO adviser.

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