Insights: Transfer Pricing

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OECD's 2014 BEPS deliverables

On Tuesday, September 16, the Organisation for Economic Co-operation and Development (OECD) **released** its first set of reports and recommendations to address seven of the actions in the base erosion and profit shifting (BEPS) Action Plan it published in July 2013. The seven "deliverables" will be presented to the G20 Finance Ministers in Cairns, Australia on September 20–21, 2014 for political endorsement.

A number of these actions were addressed in detail in previous discussion drafts and, in general, the deliverables do not contain any significant new material. Some retrospective changes may also be needed to align them with the remaining eight deliverables to be finalized in 2015. However, the seven documents, agreed with the consensus of OECD and G20 countries, will have a significant impact immediately. Tax administrations can be expected to apply the measures set out in the documents in earnest and as soon as possible. Indeed, many will consider that they are already able to apply the transfer pricing measures, without any change in tax law or treaty.

The seven deliverables comprise three reports and four "instruments", i.e., model tax legislation and treaty provisions, together with new guidance to be incorporated into the OECD transfer pricing guidelines. The deliverables will help countries to:

- ensure coherence of corporate income taxation at the international level, through new model tax and treaty provisions to neutralize hybrid mismatch arrangements (**Action 2**);
- realign taxation and relevant substance to restore the intended benefits of international standards and to prevent the abuse of tax treaties (**Action 6**);
- assure that transfer pricing outcomes are in line with value creation, through actions to address transfer pricing issues in the key area of intangibles (**Action 8**);
- improve transparency for tax administrations and increase certainty and predictability for taxpayers through improved transfer pricing documentation and a template for country-by-country reporting (**Action 13**);
- address the tax challenges of the digital economy (**Action 1**);
- facilitate swift implementation of the BEPS actions through a report on the feasibility of developing a multilateral instrument to amend bilateral tax treaties (**Action 15**); and
- counter harmful tax practices (**Action 5**).

We comment below on three deliverables of particular relevance to transfer pricing, though it should be noted that all of the areas covered have transfer pricing aspects to them.

Transfer pricing documentation and country-by-country reporting

The transfer pricing documentation deliverable maintains the three-tier approach that was discussed at the OECD public consultation in May, i.e., a master file that provides a high-level overview of a Multinational Enterprise's (MNE) business, a local file that provides detailed information on the MNE's specific intra-group transactions relevant to a jurisdiction, and a separate country-by-country (CbC) data reporting template. The content needed for the three reports is now final, though how they will be implemented, especially the filing and dissemination mechanisms for the master file and CbC report, is not expected to be finalized until January 2015.

The final documentation guidance aims to provide local tax administrations with a better understanding of a group than they may have been able to previously obtain. The master file includes, for example, requirements to describe the main profit drivers for the MNE, its strategy for developing, owning, and exploiting intangibles (including location of principal R&D facilities and management), and how the group is financed, including identifying any group entities that provide a central financing function and where these are effectively managed.

The CbC report is intended to help tax administrations make a high-level transfer pricing risk assessment. The report will provide a tax administration with comprehensive data on an MNE's global allocation of profits and taxes paid and indicators of the location of its economic activity. It will enable a tax administration to make a simple judgment as to whether the allocation of profits around the group aligns (or not) with the distribution of employees. The report requires the following information:

By jurisdiction:

- Revenues (related party/unrelated)
- Profit (loss) before income tax
- Income tax paid (cash basis) and accrued
- Stated capital and accumulated earnings
- Number of employees
- Tangible assets other than cash/cash equivalents

By constituent entity:

- Country of organization/incorporation (if it differs)
- Main business activity

Transfer pricing aspects of intangibles

Some of the guidance on the transfer pricing aspects of intangibles must be treated as interim guidance and is dependent on the completion of the 2015 deliverables on risk, recharacterization, capital, and special measures, which could apply in certain circumstances and effectively override the arm's length principle.

Finalized guidance includes the (broad) definition of intangibles and the use of valuation techniques, such as discounted cash flow analyses. The sections on location savings and other local market features, assembled workforce, and MNE group synergies are also final.

The long section relating to the ownership of intangibles remains interim guidance. However, during the press conference and technical presentation accompanying the launch of the deliverables, it was mentioned a number of times that the issue of “cash-box” entities would be firmly addressed. These are entities that legally own and/or fund the development of intangibles, but have “low functionality.” The “mere contractual allocation of risk” will certainly be dealt with, though recommendations on how capital alone should be remunerated and which special measures should be introduced, for example commensurate with income rules, are yet to be provided.

The digital economy

Due to the ubiquity of the digital economy, the position remains that it is not possible to ring fence it for tax purposes, but that it should be possible to address associated BEPS risks via the existing work streams, mainly those that will be completed in 2015. In particular, transfer pricing guidance might go further to address simple distinctions between routine and entrepreneurial activities, with profit splits being a potential solution. The Permanent Establishment (PE) article might be developed to address when activities may no longer be considered preparatory or auxiliary and also address the effect of concluding contracts ex-territory. CFC rules might also be developed to target certain types of relevant income. An option is also preserved for brand new solutions in case any of the deliverables from the existing work streams are ultimately considered insufficient to tackle digital economy issues.

For more information on the OECD/G20 Base Erosion and Profit Shifting Project, including an explanatory note, a background document, FAQs, and the first deliverables to the G20, go to: **www.oecd.org/tax/beps-2014-deliverables.htm**

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