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Global Transfer Pricing

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BEPS Action Plan Item 13: The New Documentation Standard and Implications for the Financial Services Industry

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The Organization for Economic Cooperation and Development completed and released the *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* in an unprecedented time frame, reflecting G20 consensus and political momentum surrounding the Base Erosion and Profit Shifting (BEPS) Project, and BEPS Action Plan item 13, which calls for a reexamination of transfer pricing documentation, in particular.

The immediate implication of the new guidance is that it will transform Chapter 5 of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* from broad recommendations to specific, prescriptive standards for documentation and reporting. The OECD has not recommended a specific effective date for the changes to Chapter 5. The effective date of the changes will depend on the domestic law of the adopting states.

This article outlines the specifics of the new guidance, the uncertainties, the general implications for multinational enterprises (MNEs), and specific implications for financial services MNEs.

Specific guidance

The OECD has adopted a three-tiered documentation approach that includes: (1) a country-by-country (CbC) report to provide a global financial snapshot of an MNE; (2) a master file to provide a high-level view of a company's business operations and important information on a company's global transfer pricing policies on intragroup services, intangibles, and financing; and (3) a local file to provide an entity- and transaction-level transfer pricing analysis to demonstrate the appropriateness of specific arrangements and pricing.

CbC reporting is a new concept for the international tax world, and it represents the biggest change in the revised Chapter 5. The CbC template includes eight items:

- revenues (broken out into unrelated-party and related-party revenues),
- profit(loss) before tax;
- cash income tax paid;
- accrued income tax;
- capital;
- accumulated earnings;

- number of employees; and
- tangible assets.

The template requires disclosure of only the total amount of each item for each country for entities consolidated in the MNE's financial statements. The template requires that each separate company in each country in the group be listed, along with its activity code and effective place of management.

In preparing the CbC template, each MNE may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, regulatory financial statements, or internal management accounts. Each MNE is required to provide a short description of the sources of data that it used in CbC reporting. The MNE should use the same data source year after year (any changes in the source data must be explained). If statutory financial statements are used as the basis for reporting, all amounts should be translated to the stated functional currency of the reporting company at the average exchange rate for the year. No accounting adjustments or reconciliations are required.

The master file is intended to provide a high-level blueprint of the MNE's transfer pricing practices in its economic, legal, financial, and tax context. The information required in the master file goes significantly beyond what is currently included in transfer pricing documentation for any given country. It must include descriptions of profit drivers and functions that contribute to value creation, as well as descriptions (graphic or written) of the supply chain for the five largest products and services, plus other products or services exceeding 5 percent of an MNE's turnover. It requires the provision of a list of important intangibles and which entities own them. It also requires disclosure of transfer pricing policies for intragroup services, intangibles-related transactions, sources of unrelated-party funding, intragroup financing entities, and intragroup financing policies. Finally, it requires the disclosure of an MNE's consolidated financial statements, unilateral income allocation rulings, and unilateral advance pricing agreements (APAs).

The master file can be prepared either on an overall company basis or a products group basis. However, the OECD provides that if the master file is prepared on a product group basis, all product groups must be submitted to all tax authorities, even if the local subsidiary is part of only one product group.

The local file will contain much of the same information traditionally included in transfer pricing documentation reports. Although the local file will be centered on a traditional functional and economic analysis, the new guidelines are more prescriptive than the documentation rules in many countries, and require additional details not required or contained in many documentation reports. For example, the new guidance calls for the disclosure of local management reporting lines and the locations of those reporting managers, as well as copies of any APAs and other tax rulings the local jurisdiction is not party to and that are related to the controlled transactions covered in the local file in question.

The new guidelines state that for local file economic analysis searches for comparable companies need be completed only every three years if the functional profile of the company has not changed, although the data on the comparable companies must be updated annually. The new guidelines support the use of local comparables when local comparables are reasonably available.

Uncertainty

The major uncertainties surrounding the new guidance relate to implementation, harmonization, and materiality.

There are at least two dimensions to the implementation issues regarding the new guidance. One dimension involves the coordination and dissemination of CbC reports and master files. Many taxpayers have expressed a preference that these two tiers of documentation be provided to headquarters location tax administrations, which in turn would be responsible for ensuring the

confidentiality and proper dissemination of the documents to other countries' tax administrations. The OECD has noted that it will provide guidance on this option for coordination and dissemination, and possibly others options, in January 2015.

The second dimension involves the implementation of the guidance at the country level. This involves consideration of the priority countries place on changing their local transfer pricing regimes and the means to make such changes, such as through bilateral tax treaties, regulatory or administrative rule changes that can be handled outside of legislative or parliamentary procedures, and legal changes requiring legislative or parliamentary action. Many commentators suggest that 2016 would be the earliest possible year for country implementation; however, there have already been anecdotal reports of tax examiners requesting the type of information contained in the CbC report and master file as a part of local tax examinations.

Many MNEs are uncertain whether they will need to prepare the three-tier documentation to meet the foreign jurisdiction requirements before their own home country imposes new requirements. To the degree a foreign jurisdiction's requirements are based on its domestic regulations or law, the answer may be yes. So, for example, if a foreign jurisdiction requires entities to comply with the CbC reporting requirement under its domestic laws but the entities' home country does not, taxpayers will somehow need to meet the foreign jurisdiction's requirement.

One key objective the OECD emphasized in undertaking Action item 13 was the desire to provide MNEs with a more consistent, harmonized documentation framework across countries. However, the revised Chapter 5 sends mixed signal about harmonization, as early as the executive summary. It notes that eight countries -- Argentina, Brazil, China, Colombia, India, Mexico, South Africa, and Turkey -- expect that they will need information the OECD requires in the templates. Specifically, these countries appear to want transactional data regarding related-party interest payments, royalty payments, and service fees. Thus, the hope that OECD transfer pricing documentation guidance would create a "one size fits all" template must be tempered with the reality that one size may fit many, but that differences in country-specific requirements will not disappear. Thus, on a prospective basis, some uncertainty remains as to what data MNEs will ultimately need to gather, validate, collate, and explain in, or as a supplement to, the CbC reports.

Another consideration the OECD emphasized with Action item 13 was the balancing of taxpayer burden against tax administrations' need for information. As prescriptive as the new guidelines are regarding content requirements, they lack concrete advice geared toward reducing the myriad materiality thresholds MNEs face.

General Implications

MNEs should expect that the greater transparency associated with CbC reporting and the master file may create new risk management challenges, that the availability of CbC reporting data may influence tax administrators' preference for two-sided analysis of transfer pricing economic results, and that the data requirements of CbC reporting may result in more emphasis on manual or technology-driven data processing capabilities.

The worrisome aspect of increased transparency is tax administrators' visibility into data that may have only a limited bearing on a specific transaction, but may still provide tax administrators with new arguments leading to formal adjustments or taxpayer-initiated amended returns. Arguments focused on consistency of arrangements and pricing may be more prevalent even when seemingly valid economic arguments exist for differences in arm's length transfer prices across locations.

From a risk management perspective, MNEs may need to replicate the thinking of tax administrators reviewing CBC reports, and may need to find ways to manage the risk posed by CbC reporting results and master file presentation of policies, compared to local file analysis of actual transfer

prices. One critical success factor for this is likely to be the governance and control of transfer pricing, so that tradeoffs between policies and outcomes and policies and exceptions are addressed at the appropriate level in MNEs.

There is also a concern that the CbC template might lead more frequently to the allocation of taxable income on the basis of headcount and/or tangible assets. In the past, an MNE may have felt reasonably confident that a rigorous demonstration of the arm's length nature of related-party pricing could be based on an evaluation of the functions performed and risks assumed by the entity located in a country (in other words, a one-sided test of transfer prices) the latest OECD guidance suggests that tax authorities are increasingly likely to focus on multilateral analyses (such as revenue or profit splits) as a primary or corroborative test of transfer pricing policies.

The concern that tax authorities may be more likely to assert the need for revenue or profit splits is likely to be exacerbated by the OECD's new guidance on comparability factors such as location-specific advantages and the broader definition of intangibles as articulated in the new Guidance on Transfer Pricing Aspects of Intangibles, issued under BEPS Action Item 8. By according location-specific characteristics the status of a comparability factor, the OECD has put tax authorities on firmer footing when using location-specific arguments as a basis for rejecting the taxpayer's transfer pricing method. When viewed in concert with a broader definition of intangibles; the OECD's view that economic ownership of intangibles can be split among multiple entities; and CbC reporting that will provide tax authorities significantly more information about the amount and location of taxable income, it is reasonable to expect that in the future, the adjustments proposed by tax authorities are more likely to be based on profit split methods.

For many MNEs, the process of locating, collecting, validating, and presenting the data necessary for the CbC report is likely to involve significant manual effort and to be very time consuming. Accordingly, many MNEs will have to evaluate their CbC report production capabilities and the cost and benefits of technology-driven solutions, much the same way they would when dealing with other data-heavy, time-constrained, operationally risky finance processes. This inflection point for transfer pricing management may offer opportunities to leap ahead in overall transfer pricing data management capabilities, which can have beneficial effects in areas other than CbC reporting, such as risk monitoring, escalation, and remediation.

Implications for Financial Services MNEs

Some of the foreseeable implications for financial services MNEs include the following.

Potentially significant challenges with revenue reporting for CbC - The OECD template requires that an MNE's revenues in a particular jurisdiction be split between related- and unrelated-party revenues. This may prove difficult for MNEs in the financial sector. In other industries, third-party revenues are likely to be attributed to the entity performing sales/distribution functions. This is not always true for financial services firms. In a global trading transaction, the entity that is credited with third-party revenues is frequently the entity into which the transaction is booked. The decision about which entity should book a transaction is frequently determined by client preference (for example, which entity has an International Swaps and Derivatives Association (ISDA) agreement with the client) rather than by reference to what functions an entity performed or risks assumed in a transaction. Thus, the extent to which an entity has or does not have significant third-party revenue might not be a good indicator of value.

Misinterpretation of CbC summary statistics on number of employees - One possible misinterpretation of CbC results by tax administrators could be the correlation between profits and the number of employees. In some countries, companies with relatively low numbers of front office employees but high profits may find that to be a risk assessment factor that draws unwarranted attention. Whereas the correlation between value creation and number of employees in a manufacturing or other service industry context may be high,

this is often not the case in a commercial and institutional financial services setting. To reduce the possibility of misinterpretation, it is important for financial services MNEs to avoid generic descriptions of their supply chains and value drivers, and to contextualize the company's value drivers fully in the local files.

Misinterpretation of CbC summary statistics on tangible assets – Tax administrations sometimes deem the presence of tangible assets other than cash an indicator of value creation. Financial services firms typically have relatively low levels of tangible assets on the balance sheet. In fact, when looking at the consolidated balance sheets of five large banks and five large insurance companies, tangible assets (not including cash) made up less than 2 percent of the balance sheet. Thus, tangible assets appear to be a poor indicator of value creation for the financial services industry.

Increased focus on treasury and intercompany finance - The master file is the point of convergence of factors to put pressure on financial services MNEs to articulate and support consistent intercompany finance arrangements and pricing. Other BEPS factors that affect this are the OECD's position on passive association in a credit support context (part of Action Item 8) and hybrid instruments (Action Item 2), as well as the OECD work on interest (Action Item 4) to take place in 2015. To address this, financial services MNEs transfer pricing and treasury functions will have to work in an even more coordinated manner to determine approaches to harmonizing policies globally and determining ex post transfer pricing test for real time pricing set by treasury departments.

Increased focus on intangibles - Depending on the sector and the level of the market, intangibles may play a relatively small role in the conduct of financial services business. By contrast, the potential for abnormal returns the OECD seems to attribute to intangibles in a general way, in the financial services industry may more accurately represent returns for the assumption of risk. But despite the fact that intangibles may not be significant value drivers for financial services firms, the master file and Action Item 8 covering intangibles converge to obligate financial services MNEs to identify intangibles and attribute ownership of the key intangibles to companies within the group. Many institutional financial services businesses involve technology cost sharing and/or intragroup services, including technology, and these should be examined carefully for policy and local file positioning. Indeed, this is what China's State Administration of Taxation is beginning to focus on during its discussions with and examinations of banks. Other types of intangibles such as licenses, brands, client relationships, and contracts should also be clearly identified, and clear positions on their contribution to value should be articulated. Failure to do so poses the risk that tax administrators may take the initiative in defining intangibles' value contribution.

Need to examine regulatory driven policy exceptions - In the financial services industry, situations can arise whereby regulatory constraints drive businesses to operate outside their normal value chain in a particular market. These situations can then drive exceptions to global transfer pricing policies. These types of exceptions are likely to be more problematic from a tax and regulatory perspective going forward. When these exceptions cannot be avoided, consideration should be given to the value of bilateral APAs (which must be reported only in the local files, rather than the master file) as means of mitigating the tax risk and providing a level of credibility in dealing with regulators.

Scope and design of master files - Compared to MNEs that trade in goods, the scope of what financial services MNEs will have to cover in the master file under the category of intragroup services will be very expansive in many cases. Additionally, determining annually which products must be presented in what detail is likely to create a good amount of variance from year to year in master file content for, say, a universal bank. Accordingly, the design of the master file should be carefully considered to address issues of granularity, completeness, flexibility over time, clarity, and conciseness. In many cases the historical global or regional files in place may provide content, but it should not be assumed that the structure of those files is best for OECD master file purposes.

Local file requirements - The prevalence in the financial sector of branch structures and product line reporting (as opposed to legal entity reporting) is likely to mean that MNEs in this sector may find the local file requirement to provide schedules that show how financial data used in transfer pricing reports reconciles to the annual financial statements particularly challenging.

Conclusion

The new chapter 5 of the OECD's transfer pricing guidelines will drive significant change in transfer pricing compliance, but more than that, it will change transfer pricing governance, risk management, and operations. While many of the drivers for this change are common across all industries, as has been noted by the OECD in prior transfer pricing and permanent establishment guidance, specific aspects of the financial services industry require particular attention. As financial services MNEs begin to prepare for a new era in global transfer pricing, they should carefully consider and address industry-specific transfer pricing management points and not just consider the new three-tier documentation a compliance exercise.

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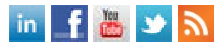

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