

# Tax Analysis

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## OECD Release on Transfer Pricing Documentation: The New Global Standard

The OECD's final revisions to Chapter V of the transfer pricing guidelines, issued September 16, materially reduce the documentation burden on businesses contemplated in the January 30, 2014, discussion draft on transfer pricing documentation and CbC reporting, and clarify many of the issues that had concerned businesses. However, the full impact of the additional requirements the new Chapter V imposes will not be understood until January 2015, when the OECD releases additional guidance on implementation issues, including timing.

It is clear that the new guidance will change the documentation process fundamentally and require most companies to gather and provide to the tax authorities substantially more information on their global operations than they have previously provided. Although implementation dates have not been set, companies should begin to consider the process to compile the information. For some companies, the implementation processes may require substantial lead times and commitment of resources.

The new guidance will provide tax authorities with unprecedented transparency regarding the financial results of a company's global transfer pricing policies. Companies may want to consider how the new documentation guidance will impact their current transfer pricing policies and their process for implementing, monitoring, and defending those policies.

### Three-Tiered Approach to Documentation

With the release of the revised Chapter V, the OECD has adopted a three-tiered approach to documentation that includes: (1) the country-by-country (CbC) reporting template, which is intended to provide a financial picture of a company's global operations; (2) the master file, which is intended to provide a high-level view of a company's business operations, along with important information on a company's global transfer pricing policies on intangibles and financing; and (3) the local file, which is intended to provide information and support of the intercompany transactions that the local company engages in with related parties. The CbC template and the requirements for the master file and local file are reproduced as annexes to this newsletter.

### Annex 1 – Master File

<http://newsletters.usdbriefs.com/2014/Tax/ALS/AnnexI.pdf>

### Annex 2 – Local File

<http://newsletters.usdbriefs.com/2014/Tax/ALS/AnnexII.pdf>

### Annex 3 – Country-by-Country Report

<http://newsletters.usdbriefs.com/2014/Tax/ALS/AnnexIII.pdf>

## Country-by-Country Template

The CbC template was the subject of most debate after the January 30, 2014, release of the discussion draft, because the requirement was completely new and would have increased substantially the documentation burden on businesses.

After wide-ranging consultation, the OECD has significantly reduced the amount of information required, and provided more flexibility on how businesses could provide the information. The number of items that must be reported has been reduced from 14 to eight, and business has been given the flexibility to use a wide variety of organized source of information, as long as the information is used consistently from year to year. The original template contemplated that the required information would have to be disclosed for each “constituent entity” operating in a country, and then the totals added up for each country. The final template requires only disclosure of the total amount of each item for each country. The revised template retains the requirement to list each separate company in the group, along with its activity code and effective place of management.

However, the OECD notes that eight countries, primarily those from emerging markets (Argentina, Brazil, China, Colombia, India, Mexico, South Africa, and Turkey), considered that they needed additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Accordingly, it is mandated that countries participating in the BEPS project will carefully review the implementation of these new standards and will reassess no later than the end of 2020 whether modifications to the content of these reports should be made to require reporting of additional or different data.

The January 30, 2014, discussion draft used a broad definition of the term constituent entity that would be subject to the compliance requirements, which caused some concern that the required information would not be readily available. The new guidance eliminates that concern by defining a constituent entity as an entity whose income and balance sheet are consolidated in the company’s consolidated financial statements. Entities excluded from financial statements only on size or materiality grounds should be included in the country-by-country as Constituent Entities.

Many companies had hoped that entities with limited operations or dormant companies would not have to be included in the CbC template. However, the OECD has adopted an inclusive approach that requires all companies, including dormant companies, to be included in the template. The final draft even includes an activity code for dormant companies.

In preparing the CbC template, the reporting company should use the same sources of data from year to year (if there is a change, the company should explain the reason for that change). The reporting company may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, regulatory financial statements, or internal management accounts. The reporting company is required to provide a short description of the sources of data that it used in completing the CbC template. It is not necessary to reconcile the revenue, profit, and tax reporting in the template to the consolidated financial statements. 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. Companies need not make adjustments for differences in accounting principles applied in different tax jurisdictions. In many cases, companies will not know exactly where to obtain all the required CbC information, and a CbC data blueprinting exercise will have to be undertaken to identify where the CbC information is found in the company’s systems, and how to retrieve it most efficiently.

Even with the reduced information burden and increased flexibility provided to companies in the final version of the revised Chapter V, the CbC report will still pose a significant challenge to companies trying to comply with the new documentation guidance. Some of the items requested are not centrally collected by most companies on an entity or country basis. For example, the template requires disclosure of current-year cash taxes, including withholding taxes paid and accrued taxes for tax purposes (that is, not including reserves or deferred items). For many companies, the sheer volume of information that must be collected to complete the template will substantially increase their compliance burden.

Larger companies may want to consider technology solutions to collect, store, analyze, and prepare the CbC template. The time and effort necessary to manually locate, collect, validate, and assemble the required data in a spreadsheet or template is likely to be significant for large companies, and the process will have to be repeated at least annually. A technology solution can utilize the company’s enterprise resource planning (ERP), consolidation, human resources, and other systems to facilitate the collection, validation, and presentation of the information required to be reported in the CbC template. In addition, technology solutions will enable companies to better manage their transfer pricing

compliance by providing functionality that allows for regular monitoring of their transfer pricing results. Some software solutions will provide comparisons to budgets or expectations; others can provide sophisticated analytics, including drill down, root cause, and sensitivity-testing analyses, to help a company understand the causes of any unanticipated deviations, potential adjustments, and the impact of those adjustments on taxes paid in relevant countries, the overall effective tax rates, and other items such as customs duties.

Adoption of the CbC report as part of the OECD's transfer pricing guidelines was one of the key goals of OECD member countries, because it may provide most local tax authorities, for the first time, an organized picture of where a company earns income and pays taxes. The report may highlight gaps and inconsistencies in a company's transfer pricing policies or its implementation of those policies. In addition, the report may highlight potential inconsistencies in the place where revenue is recognized and the place where "value" is created. Companies may want to consider addressing any potential gaps or inconsistencies before they file their first CbC template.

The CbC template is intended to be a risk assessment tool for the tax authorities, and should not be used as a substitute for a proper functional and risk analysis. The OECD Commentary specifically notes "It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income." This is intended to meet concerns from some countries and companies that the CbC template might lead more frequently to allocations of income on the basis of people and tangible assets, whether by way of greater use of the profit split method or by other means.

#### Master File

The master file is intended to provide tax authorities a better view of a company's global operations and its global policies for the creation and ownership of intellectual property and financing. Much of the information that will be contained in the master file was not previously available to tax authorities, except possibly to the extent it had a direct impact on a local unit's transactions.

Under current documentation rules, some companies prepared a master file that contained required business and other information that was common to most units. The new master file will be, in many cases, substantially different than the older version of master files. The new master file requirements are relatively prescriptive and will require companies to collect a considerable amount of information that has not been collected by either headquarters or local companies in the past. For example, the new master file will require companies to provide a chart of the supply chain for the five largest products and service offerings, plus other products or services amounting to more than 5 percent of a group's turnover. In addition, the new master file will require a company to provide a list of important intangibles or groups of intangibles and which entities own them. The requirement to disclose bilateral advance pricing agreements (APAs) and rulings that was originally included in the master file has been moved to the local file, but disclosure is required only if necessary to understanding local transactions. The requirement to disclose Mutual Agreement Procedures was removed, while the requirement to disclose unilateral income allocation rulings and APAs was retained. Importantly, the OECD eliminated the requirement that the master file contain the title and location of the company's 25 highest paid individuals.

The guidance states that the master file is intended to provide a high-level blueprint of the MNE group to place the group's transfer pricing practices in their economic, legal, financial, and tax context. In keeping with this high-level view, it is not necessary to provide exhaustive detail of the group's operations or provide comprehensive lists of required items. Rather, companies can use prudent business judgment to determine the appropriate level of detail. These statements in the guidance are helpful, because the breadth of some of the requirements could require companies to provide mountains of minutiae that would clearly be burdensome and require undue resources and as a practical matter may not be useful to the tax authorities. Nonetheless, there is some concern that an individual tax authority's view of prudent business judgment could be colored by the impact of the information on local transactions.

The new master file can be prepared either on an overall company basis or a products group basis. Large companies with multiple dissimilar product lines may find it easier to prepare the master file on a product group basis. However, the OECD has added the requirement in this version of the guidance that if the master file is prepared on a product group basis, all product groups will have to be submitted to all tax authorities, even if the local subsidiary is part of only one product group.

#### Local File

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 guidelines are more prescriptive than the documentation rules in many countries and require additional details not required or contained in many documentation reports.

One of the major concerns of MNEs is the varying thresholds of what constitutes a material transaction that must be documented. Some countries require, under domestic rules, that virtually all transactions be documented, whereas other countries are more concerned with major transactions that have a significant impact on the local subsidiary's tax liability. The guidelines do not adopt a standard definition of materiality. Rather, they recommend that each country adopt "specific materiality thresholds that take into account the size and nature of the local economy, the importance of the MNE group in that economy, and the size and nature of the local operating entities, in addition to the overall size and nature of the MNE group." Thus, the guidance is unlikely to reduce the current proliferation of materiality standards and the burden on business that they impose.

The new guidelines state that 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 statement in the January 30, 2014, discussion draft on the use of local vs. regional comparables has been softened, but still generally supports the use of local comparables over regional comparables when local comparables are reasonably available. This requirement may increase the number of sets of comparables an MNE must obtain and update.

#### Language

Local law will determine the language in which the documentation must be submitted. Countries are encouraged to permit filing in commonly used languages and request translation after submission. Several countries objected to the clause in the January 30, 2014, discussion draft that permitted the master file to be prepared in English or the company's primary business language. Their objections ultimately prevailed.

#### New governance policies

The new documentation guidance may accelerate the trend toward centralized management and documentation of a company's transfer pricing policies and the monitoring of transfer price implementation, as taxpayers may strive for more consistency in light of the new transparency of their financial results. This increase in global transparency is likely to mean that deviations from a company's transfer pricing policy or the implementation of that policy will become more apparent to tax authorities around the world. For these reasons, companies that currently do not establish and monitor transfer pricing policies on a global basis may find a need to do so in the near future. For some companies, the new guidance could require an increase in authority and resources to establish and implement transfer pricing policies, and new systems and procedures to regularly and proactively monitor transfer pricing results on a global basis.

#### Preparation of documentation

The CbC template and the master file are likely to be prepared by the headquarters company. As a practical matter, it is likely that only the headquarters company will be able to obtain the information necessary to prepare those documents. For companies that do not prepare their transfer pricing documentation on a global basis, the new files will require a substantial change. Even if companies do prepare their documentation on a global basis, the new guidance is likely to require companies to compile and explain substantially more information than was traditionally included in documentation reports. The new requirements are likely to require new processes to collect, validate, analyze, and prepare transfer pricing documentation.

Companies are also likely to find that it is necessary to centrally prepare or coordinate all of their global documentation. Companies will need to ensure that the CbC template, master file, and the local files provide consistent information about their global and local operations and their transfer pricing policies. For companies that took a decentralized approach to their transfer pricing documentation, the additional preparation or coordination requirements will likely necessitate the allocation of additional resources at headquarters.

#### Implementation

The OECD will provide additional guidance on the process for filing and sharing documentation and the process to encourage consistent application of the new guidance in January 2015.

The OECD has had and will continue to have extensive discussions on how to share the CbC template and the master file. Businesses, and some countries, want the CbC and master file to be shared under the terms of bilateral tax treaties, tax information exchange agreements or the OECD's Convention on Mutual Administrative Assistance in Tax Matters (which has more than 60 country signatories to date). Advocates for government-to-government exchanges believe that type of exchange would provide greater protection of confidential information, as well as greater certainty of

obtaining information. Other countries have argued that the local subsidiary should obtain the information from the parent and provide it to the local tax authorities. Countries advocating for this position are concerned that it would take too long to obtain the information through government-to-government exchanges, thereby hindering the timely completion of the local audit process.

In deciding how to share the information found in the CbC template and the master file, one consideration should be that the CbC template and master file information may be only within the possession and control of a parent company. In the event that a parent company does not provide global country-by-country and master file information to its subsidiaries, a local tax authority may be limited in its power to compel the local subsidiary to provide the information. The guidance states that local documentation-related penalties should not be levied if the information is not in the possession of the multinational company, but expressly sets out that the assertion that other group members are responsible for transfer pricing documentation is not sufficient reason to preclude the local subsidiary with being charged documentation-related penalties.

Although the guidance does not provide any exemptions from the documentation requirements in the revised Chapter V, Marlies de Ruiter, head of the Tax Treaty, Transfer Pricing, and Financial Transactions division of the OECD's Centre for Tax Policy and Administration mentioned during a September 16, 2014, webcast that the OECD is considering adopting such an exemption for small businesses.

The OECD may provide additional guidance on the process that countries can use to adopt the guidance. The OECD has stated clearly that the CbC template and the master file are intended to be implemented in their standard form by all countries without deviation, to encourage consistency and efficiency of compliance for taxpayers. It remains to be seen whether similar consistency can be achieved in the approach to local files, given the variability in current requirements. It is clear that for businesses, such an agreement among countries to standardize the information required will substantially reduce the burden to compile the new reports. The OECD recognizes that from a business perspective, the end of the proliferation of different documentation requirements around the world would provide welcome relief.

#### Timing

The OECD has not provided any information on the expected date that individual countries should implement the new documentation requirements. As part of its work on the implementation of the new guidance, the OECD is expected to provide guidance to countries on effective dates, including the phasing in of the requirements. Given the global nature of the new guidance, a consistent global effective date or dates is clearly desirable. Given the burden that the new guidance for the CbC template and the master file will impose on companies to obtain the relevant information, the earliest practical effective date for the new reporting requirements would be a company's fiscal year 2016. In light of the political pressure for action in this area, it seems unlikely that the effective date for providing the CbC template and the master file would be pushed beyond that date.

#### Comments from China State Administration of Taxation

On September 17, 2014, the State Administration of Taxation (SAT) issued a press release related to the deliverables of G20 BEPS actions in which it acknowledges BEPS initiatives' unavoidable and practical impacts to tax administration in China and that tax authorities in China will face pressure of fulfilling its corresponding obligation regardless of the final output of the various BEPS actions. In the release, the SAT observes that such global initiatives allow for a more equitable result by aligning taxation with value creation in a fair and transparent way. As such, it concludes that it is important for China to continue to actively participate in this development to ensure a fair transfer pricing enforcement through appropriate legislative and administrative frame work as well as international cooperation.

From a technical perspective, revised Chapter V is also largely consistent with recent release of commentary from Jiangsu Tax Bureau regarding BEPS Initiatives in terms of transparently documenting financial results, value creations, role of intangibles, etc. and that the new transparency will also mean that companies are expected to have well thought out and appropriate governance structure and internal control around their transfer pricing policies in addition to the more structured approach to documentation. It is also expected that the SAT will provide further comments regarding its view of the various BEPS Actions in the upcoming revised Circular 2.

#### Comments from Hong Kong Inland Revenue Department

Whilst Hong Kong is not a member of the OECD or G20, nor is it an observing party to the BEPS initiative, it has been playing close attention to the development and has continued to fast track conclusions of more Double Taxation Agreements and Tax Information Exchange Agreements. In light of the recent development of BEPS, the Inland Revenue Department (IRD) is actively reviewing the 15 action points under BEPS but has not decided on whether to issue any specific guidance notes at this point.

Hong Kong generally follows the OECD Transfer Pricing Guidelines, as per DIPN46 "Transfer Pricing Guidelines – Methodologies and Related Issues" (except where they are incompatible with the domestic tax laws), and the IRD has no imminent plan to change the current practice and will continue to follow the OECD Transfer Pricing Guidelines when dealing with transfer pricing issues. It will nonetheless closely monitor international development in this respect, including OECD's discussions, with a view to assessing the need for introducing corresponding measures in response to the BEPS development.

### What does it mean for China and Hong Kong headquartered companies?

Subject to the SAT's further instructions on threshold, it is understood that ultimate parent entities of Chinese state owned enterprises with overseas investments and private owned enterprises with overseas investments will need to prepare a master file and CbC report. Potentially, some ultimate parent entities of MNE groups incorporated under foreign countries' laws (e.g. BVI companies, Cayman companies, etc.) but with their place of effective management situated in China may also need to prepare such documents. As the reporting companies are required to provide important information in their master files and CbC reports, including but not limited to the groups' transfer pricing policies in certain business arrangements, constituent entities' function and risk profiles, constituent entities' performances and business operation elements, tax authorities of China and overseas countries are able to leverage such information to assess whether the reporters' adopted transfer pricing policies are in line with the arm's length principle.

Therefore, the reporting companies do need to evaluate, more frequently, the appropriateness of their adopted transfer pricing policies and make necessary improvement to mitigate transfer pricing risks in China and foreign countries, taking the latest transfer pricing related development and how these additional risk assessment driven information now readily available to tax authorities into consideration. As discussed earlier, companies may not know exactly where to obtain all the required CbC information and thus a data blueprinting exercise will have to be undertaken. And once these are identified, the company will need to determine how to retrieve them efficiently and effectively. Lastly, depending on the company's particular circumstances, it may also need to consider whether such additional information can be disclosed in relation to its obligation with other (non-tax) regulators or administrators.

Most of above-noted issues will also be similarly faced by Hong Kong headquartered companies. Many MNCs also have Hong Kong based regional headquarters. Although these companies may not be ultimately responsible for the CbC or the master file, they may nevertheless be in possession of much of these additional required information and thus have a critical role to play in the new compliance processes.

### Conclusion

The OECD has proposed a new paradigm for transfer pricing documentation that may cause many companies to rethink their current procedures to set, implement, monitor, and document their global transfer pricing policies. The new guidelines will require a company's headquarters to implement new procedures that will allow them to locate, collect, store, validate, and assemble the information to meet the new requirements. The increase in transparency and the greater need for global consistency may require many companies to increase the resources devoted to transfer pricing issues.

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