



Arm's Length Standard

February 3, 2014 (Special Edition)

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The OECD's Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting: A work in progress

The Organization for Economic Cooperation and Development on January 30 released a discussion draft on transfer pricing documentation and country-by-country reporting as part of its work on base erosion and profit shifting (BEPS). The discussion draft sets out revised guidance on transfer pricing documentation requirements in the form of a new draft Chapter V of the OECD's transfer pricing guidelines, and includes a common template for the reporting of detailed global information to tax authorities on a country-by-country (CbC) basis, focusing on the global allocation of income, economic activity, and taxes paid.

The discussion draft addresses Action 13 in the July 2013 BEPS Action Plan, which promised to "[d]evelop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into account the compliance costs for business." However, many of the proposed requirements need further refinement and balancing to achieve this goal. The proposed rules, if implemented, will likely increase the cost of compliance for multinationals.

Interestingly, the introduction to the discussion draft states that it does not reflect consensus views of either the OECD's Committee on Fiscal Affairs or Working Party 6 undertaking the work. Given the lack of consensus in the document, it is an open issue whether the OECD's recommendations will receive broad acceptance and be implemented by a sufficient number of G20 countries to increase consistency in documentation requirements.

The OECD has invited stakeholders to submit written comments on the draft. Comments are due February 23, 2014, and should be submitted to TransferPricing@oecd.org. For a list of all the questions on which the OECD has specifically requested comments, see Appendix I.

Objectives

The discussion draft has three stated objectives:

1. To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment;
2. To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and in reporting the income derived from such transactions in their tax returns; and
3. To provide tax administrations with the information they require to conduct an appropriately thorough audit of taxpayers' transfer pricing practices.

The discussion draft responds to the views of some of the OECD's constituent members that the existing tools – the tax return and the transfer pricing documentation report – are insufficient for purposes of identifying and evaluating transfer pricing risks of taxpayers and transactions. The discussion draft recommends the preparation of a far-reaching and detailed master file (including a CbC template) so that tax administrations have ready access to detailed information at an early stage to enable an accurate and informed transfer pricing risk assessment.

Two-Tiered Approach

At the heart of this paradigm shift in documentation is the recommendation that countries should adopt a standardized approach to transfer pricing documentation that has a two-tier structure consisting of (i) a master file containing standardized information “relevant for all [multinational enterprise] MNE group members” including a CbC reporting template; and (ii) a “local file referring specifically to material transactions of the local taxpayer.” These reporting requirements call for significantly more documentation than is normally prepared today by most MNEs. This amount of information may create information overload and misdirection for many tax authorities, possibly resulting in more drawn out audits.

Master File

The information required in the master file is supposed to provide a “blueprint” of the MNE group and must contain the following five categories of information:

1. The MNE group's organizational structure;
2. A description of the MNE's business or businesses;
3. The MNE's intangibles;
4. The MNE's intercompany financial activities; and
5. The MNE's financial and tax positions.

The draft indicates that the master file should be prepared in English, whereas the local file should be prepared in the language of the relevant local country.

The draft also recommends that the master file be “completed under the direction of the parent company of the MNE group” and then shared with each country in which the MNE has an affiliate subject to tax. The draft acknowledges that not all transactions that occur between associated enterprises are sufficiently material to require full documentation, so it recommends that documentation requirements should include “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.” At this point, the threshold for what is “material” is left to individual countries.

For almost all MNEs, these rules will require significant changes in documentation processes and transfer pricing governance. The master file and global template may increase the scrutiny of transfer pricing audits as examiners may focus on broader aspects of the taxpayer's business activities and structure beyond the related-party transactions currently reported. This will require more central control of international tax and transfer pricing policies.

CbC Template

The discussion draft calls for detailed CbC reporting of financial and tax information. In particular, for each constituent entity organized in the country, or permanent establishment maintained in the country, the CbC template requires the following information:

- Place of effective management
- Important business activity codes:
 - A = Research & Development;
 - B = Holding intellectual property;
 - C = Purchasing and procurement;
 - D = Manufacturing and production;
 - E = Sales, marketing, and distribution;
 - F = Administrative and support service;

- G = Finance;
 - H = Insurance;
 - I = Holding company;
 - J = Other.
- Revenues
 - Earnings before income tax
 - Income tax paid on a cash basis (a) to the country of organization and (b) to all other countries
 - Total withholding tax paid
 - Stated capital and accumulated earnings
 - Number of employees
 - Total employee expense
 - Tangible assets other than cash and cash equivalents
 - Royalties paid to (and received from) constituent entities
 - Interest paid to (and received from) constituent entities
 - Service fees paid to (and received from) constituent entities

The CbC template incorporates a “bottom up” approach to reporting financial data based on local-country financial statements using local-country functional currency and accounting standards (IFRS vs. GAAP). This may require less effort than a “top down” approach whereby the MNE group’s consolidated income would be allocated among all countries in which it operates. The OECD has requested comments from taxpayers as to whether this “bottom up” approach would be more burdensome than a “top down” approach.

Possible risk exists that in practice tax authorities may misuse the global template by seeking to apply formulary apportionment principles in contravention to the discussion draft’s stated goal of reinforcing the arm’s length standard. This risk may be heightened by the template’s request for the three components (numbers of employees, tangible assets, and sales in the local country) used in the application of formulary apportionment.

In addition, the reporting of financial data for entities that do not directly engage in transactions with the affiliate under review may lead examiners to investigate possible indirect base eroding transactions, thereby making it more difficult to conclude audits in a timely manner.

Local File

The discussion draft calls for the local file to include:

- A description of the management structure of the local entity, a local organizational chart, and a description of the individuals to whom local management reports and the country or countries in which those individuals maintain their principal offices; and
- An indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the current or immediately past year, and an explanation of those aspects of such transactions that affect the local entity.

The draft also requires that taxpayers report the following financial information in the local file:

- Annual local entity financial accounts for the fiscal year concerned;
- Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements; and
- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.

The local file would also include information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries that are material in the context of the local country’s tax system, including:

- A description of the controlled transactions and the context in which they are taking place;
- Aggregate amount of intercompany charges for each category of transactions;
- Identification of associated enterprises involved in each category of controlled transactions, and the relationship among them;
- A detailed functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions;
- Identification and description of other controlled transactions of the taxpayer that can directly or indirectly affect the pricing of the controlled transactions being documented;
- Indicate the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method;
- Indicate which entity is selected as the tested party, if applicable, and explain why;
- Summarize the important assumptions made in applying the transfer pricing method;
- If relevant, explain the reasons for performing a multi-year analysis;
- List and description of comparable uncontrolled transactions (internal or external) (if any), including a description of the comparable search methodology and source of the information;
- Describe any comparability adjustments performed;
- Describe the reasons for concluding that the relevant transactions were conducted on an arm's length basis based on application of the selected transfer pricing method; and
- A summary of financial information used in applying the transfer pricing method.

The draft indicates that, in performing the above analysis, reliability requires that taxpayers use local comparables over regional comparables when such local comparables are reasonably available.

Many of the above requirements for the local file are not currently included in local-country documentation, so these requirements may create additional compliance burdens for MNEs. Additionally, most issues open to interpretation in the above requirements are left for local jurisdictions to determine, further complicating any centralized preparation of the global documentation.

Timing, Updates, and Other Aspects of the Proposal

The discussion draft calls for a "best practice" to require that both the master file and the local file be prepared no later than the due date for filing of the tax return for the fiscal year in question. It concedes that in some situations the financial information relevant for the CbC reporting may not be finalized until after the due date for income tax returns. In those situations, it recommends extending the deadline for the CbC documentation to "one year following the last day of the fiscal year of the ultimate parent entity of the MNE group." The draft recommends that "both the master file and the local file should be reviewed and updated annually," but it also acknowledges that in many situations business descriptions, functional analyses, and descriptions of comparables may not change significantly from year to year. Accordingly, it recommends that if operating conditions have remained unchanged, then the searches for comparables supporting the local file need only be updated every three years (but financial data for the comparables must be updated every year). Updating comparables in the local file every three years is consistent with the policy followed by most MNEs.

The draft states that it would be unfair to impose penalties on taxpayers that make a reasonable good faith effort to comply with the documentation requirements. The draft also acknowledges that tax authorities must ensure no public disclosure of trade secrets, scientific secrets, or other confidential information. There is no indication of what protections will be put in place to safeguard such secrets, although the OECD specifically asks for comments on this issue. This question may be particularly troublesome to MNEs, as many believed (or hoped) the global template would be available only through information exchange treaties, rather than be given to any jurisdiction that asked for it.

The mechanism for sharing the master file, including the CbC template, is also open for discussion, and the draft lists three possibilities:

- Direct local filing of the information by MNE group members subject to tax in a given jurisdiction;
- Filing of information in the parent company's jurisdiction and then sharing it under treaty exchange of information provisions; or
- A combination of the above.

Relying on the treaty network seems a sensible approach, given the requirements imposed on tax authorities by tax information exchange agreements (as well as the OECD Model Treaty) to maintain taxpayer confidentiality.

Important Considerations for Taxpayers

The introduction to the discussion draft states a goal of reasonableness in the documentation process from both taxpayers' and tax authorities' perspectives, and avoiding excessive documentation compliance burden.

The introduction to the discussion draft states that the overarching consideration in updating the transfer pricing guidelines on documentation is the need to balance the usefulness of the data requested to the tax authorities with any increased compliance burden on taxpayers. However, in almost every instance, the draft suggests increased documentation burdens and selects fairly difficult data options; thus, tax authorities' needs seem to outweigh concern for taxpayers' burden. In addition, much of the language describing the documentation in the master file leaves significant room for interpretation and potential differences between the tax authorities and the taxpayer.

The OECD's goal of more transparent documentation requirements will be achieved only if all OECD countries and observers adopt common standards, but there has been no commitment from OECD countries that they will adopt common standards. The United States has been silent to date on whether it will revise its rules to be consistent with the proposed standard.

Insights

The discussion draft, if adopted as is, would result in a significant increase in documentation obligations for MNEs and expanded audits. It would lead to a significant increase in documentation for MNEs because the local file and the master template (especially the CbC reporting) ask for much more information than companies currently collect and have readily available. It may lead to expanded audits (but not necessarily an increase in efficiency) because tax authorities would be overloaded with information that could lead them to pursue paths of inquiry that do not necessarily have a specific direction. This in turn may result in a significant increase in the number of Competent Authority Mutual Agreement Procedure requests by MNEs and could lead to more bilateral and multilateral advance pricing agreements (APAs). Too much information may be as burdensome for tax authorities as too little. The goal should be to have information that aids in risk assessment, but not so much that it becomes difficult for the tax authorities to reach the right conclusion.

Essential aspects of the conceptual framework for this project must be resolved to achieve standardization. In its current form, the draft does not make it clear which transactions are "material" and thus subject to the new documentation requirements, nor is it clear which companies will qualify for the small and medium-sized companies exception. These two concepts must be further defined to accomplish the OECD's recommendation that SMEs not bear costs and burdens disproportionate to the circumstances. As discussed above, the CbC template requires reporting of information on tangibles, sales, and employees, and because these are the three factors in the formula used for allocation of "taxing rights" under the formulary apportionment methodology, the possibility arises that tax authorities may misuse the CbC report by drifting away from the arm's length standard toward formulary apportionment.

Although the OECD seems focused on whether a "bottom up" or "top down" approach should be used for the CbC template, it is not clear that either of these approaches, as described, will meet the stated objective. There seems to be an inherent weakness in the conceptual structure of the CbC template, because transfer pricing analysis of an entity in a given jurisdiction is and must be an analysis that looks at the functions and transactions pertaining to *that entity* and its aggregated financials.

Lastly, the introduction states that the call "to develop a common template for country-by-country reporting ... did not specifically limit the application of country-by-country reporting to transfer pricing administration," and that "the OECD will be giving further consideration to whether information relevant to other aspects of tax administration and the BEPS Action Plan should also be included in the common template." Consequently, the draft leaves open the question whether separate countries may attempt to impose more stringent tax reporting and documentation requirements.

Conclusion

In its current form, the discussion draft presents numerous areas of concern that need further refinement. However, the document is only a draft, and the OECD seems genuinely interested in receiving feedback from taxpayers and the tax professional community. Taxpayers should take this opportunity to be part of the discussion to ensure that the new guidelines meet their needs as well as those of the tax authorities.

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APPENDIX I

The OECD has specifically requested comment on the following issues:

What other forms beyond the CbC reporting template are needed?

The circumstances in which tax authorities should share their risk assessment with taxpayers.

The scope and nature of possible rules relating to the production of information and documents in the possession of associated enterprises outside the jurisdiction requesting the information.

Should the master file be prepared on a “line of business” or “entity-wide” basis?

Should the CbC report be part of the master file, or a separate document?

Should the CbC template be compiled using “bottom-up” reporting from local statutory accounts as in the current draft, or should it require (or permit) a “top-down” allocation of the MNE group’s consolidated income among countries? What additional guidance would be required regarding source and characterization of income and allocation of costs to permit consistent CbC reporting under a top-down model?

Should the CbC template be prepared on an entity-by-entity basis as in the current draft or should it require separate individual country consolidations reporting one aggregate revenue and income number per country if the “bottom-up” approach is used?

Would a requirement for separate individual country consolidations impose significant additional burdens on taxpayers?

Should the CbC template require one aggregate number for corporate income tax paid on a cash due basis per country? Should the CbC template require the reporting of withholding tax paid? Would a requirement for reporting withholding tax paid impose significant additional burdens on taxpayers?

Should reporting of aggregate cross-border payments between associated enterprises be required? If so at what level of detail? Would a requirement for reporting intragroup payments of royalties, interest, and service fees impose significant additional burdens on taxpayers?

Should the CbC template require reporting the nature of the business activities carried out in a jurisdiction? Are there any specialist sectors that would need to be accommodated in such an approach? Would a requirement for reporting the nature of the business activities carried out in a jurisdiction impose significant additional burdens on taxpayers? What other measures of economic activity should be reported?

Whether specific guidelines are needed on what constitutes “materiality” for determining which transactions are “material” (and thus need to be disclosed and discussed in the transfer pricing documentation), and if so, what form the materiality guidance should take.

How can tax authorities simplify the process of documentation and updating documentation?

What are the most appropriate approaches for translation requirements (for translating the documentation from one language to another)?

How can tax authorities safeguard the confidentiality of taxpayers’ sensitive information?

What is the most appropriate mechanism for making the master file and CbC reporting template available to tax authorities? Direct local filing of the information by MNE group members subject to tax in the jurisdiction? Or through filing of information in the parent company’s jurisdiction and sharing it under treaty information exchange provisions?

Should reporting of APAs, other rulings, and MAP cases be required as part of the master file?

Have a question?

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