OECD Releases Guidance on Transfer Pricing Issues

The Organization for Economic Cooperation and Development on September 16 released guidance on seven of the 15 items in the Base Erosion and Profit Shifting Action Plan issued July 2013. Of the seven deliverables the OECD released, two relate to transfer pricing topics: Action 8 on the transfer pricing aspects of intangibles, and Action 13 on transfer pricing documentation and country-by-country reporting. The guidance released by the OECD amends Chapters I, V, and VI of the Transfer Pricing Guidelines. The three articles in this special issue of the Arm’s Length Standard provide in-depth analysis of the changes to each chapter.

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OECD Chapter I Release: Important Guidance on Location-Specific Advantages and Passive Association

The OECD’s revised guidance in Chapter VI of the transfer pricing guidelines defines intangibles as assets other than physical or financial assets that are capable of being owned or controlled by a single enterprise. Under this definition, location-specific characteristics and workforce in place are not considered intangibles, because they are not capable of being owned or controlled; rather, they should be considered comparability factors to be taken into account in a transfer pricing analysis. The revisions to Chapter I issued September 16 as part of the release of Base Erosion and Profit Shifting (BEPS) deliverables provide important guidance on location-specific characteristics, workforce-in-place, and synergy benefits as comparability factors.
Location Savings

The topic of location savings is discussed in Chapter IX of the transfer pricing guidelines on business restructuring. The additional guidance in Chapter I on location savings generally follows the principles laid out in Chapter IX. Location savings may be derived by an MNE group that relocates some of its activities to a place where costs (such as labor and real estate costs) are lower than in the location where the activities were initially performed or other locations, considering the possible costs involved in locating or relocating the activities.

To determine how location savings are to be shared between two or more members of an MNE group, the following factors should be considered:

- Whether location savings exist;
- The amount of any location savings;
- The extent to which location savings are either retained by a member of the MNE or are passed on to independent customers or suppliers; and
- Where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar conditions would allocate any retained net location savings.

The new guidelines indicate that if reliable local market comparables are available and can be used to determine arm’s length prices, specific comparability adjustments for location savings should not be required. However, when reliable local market comparable companies are not present, the guidance suggests that comparability adjustments for location savings should be driven by a full analysis of the underlying facts and circumstances, including the functions performed, risks assumed, and assets deployed by the relevant associated enterprises. Mere differences in salary costs should not be the sole basis for determining the existence or allocation of location savings.

Other Local Market Features

Other local market features that may affect comparability include the following:

- Relevant characteristics of the geographic market in which products are sold;
- Purchasing power and product preferences of local households in that market;
- Whether the market is expanding or contracting;
- Degree of competition in the market;
- Relative availability of infrastructure in the market;
- Relative availability of trained and educated workforce;
- Proximity to profitable markets; and
- Similar features in a geographic market that create market advantages/disadvantages.

In determining whether comparability adjustments for such local market features are required, the most reliable approach is to examine data on comparable uncontrolled transactions in that geographic market. If the comparable data indicate that transactions are carried out under the same market conditions as the controlled transaction, then the need for making specific adjustments for local market features would not arise.

In cases when reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should be based on the underlying facts and circumstances. The same factors for determining the allocation of location savings should be considered.

In some markets, the tax authorities argue that local market comparables do not exist to determine the existence or allocation of location savings or location-specific advantages. The absence of comparables may lead to a profit split analysis. The OECD guidance suggests a detailed functional and factual analysis would be required to determine the most appropriate method.
Impact of Government Licenses on Location-Specific Advantages

A government-issued license is an intangible. If the license restricts the number of entrants into the market, it may affect how location-specific characteristics are shared. In such a case, it is necessary to determine each affiliated party’s contribution to obtaining the license to determine the allocation of the profit attributable to the license intangible. In assessing the impact of the government license, the contribution by the local member of local market intangibles and other group members of intangibles such as skills, experience, and knowledge should be considered, consistent with the guidance under the draft Section B of the proposed new Chapter VI of the OECD guidelines on intangibles.

If the government-issued licenses are readily available to a large number of qualified applicants, then the license requirement would not serve as a deterrent to entry into the local market. Therefore, the possession of that license would not have a material impact on the allocation of location-specific characteristics.

Impact of New Guidance on Specific Countries

This additional guidance on location-specific advantages is likely to affect transfer pricing issues that have emerged in countries like India and China. These countries have specific market features that could potentially impact transfer prices pursuant to the new guidance.

For example, India’s 2013 Circular 6 on R&D outlines the appropriate methodology for transfer pricing purposes based on the functional profile of “Indian Development Centers,” entities that provide contract R&D services. Different functional profiles may entail different benchmarking methodologies, including a profit split analysis. The new guidance may help provide a clearer and more nuanced framework for discussions between taxpayers and tax authorities, but it is unlikely to reduce the number of instances in which the Indian tax authorities consider comparability adjustments for location-specific characteristics.

In China, the tax authorities believe that Chinese businesses benefit from a number of location-specific advantages, including lower operating costs and unique market features. Chinese tax officials have been pursuing discussions with taxpayers regarding location-specific characteristics, including location savings and market premiums. The OECD’s new guidance on location-specific characteristics is likely to increase the number of instances in which comparability adjustments for location-specific characteristics are considered, and may require taxpayers to undertake a more broad-based and exhaustive analysis of the issue.

Group Synergies

Current OECD guidelines provide that no compensation should be paid for incidental benefits received by an MNE group member solely because it is a member of the larger MNE group. The new guidance provides additional clarification regarding the concept of group synergies, and provides important examples that apply the principles in the context of intragroup loans and centralized purchasing groups.

The revised guidelines recognize that MNE groups may benefit from group synergies that do not exist for smaller, independent enterprises. These synergies may stem from economies of scale, combined or integrated computer and communication systems, integrated management, and elimination of duplicative expenses. Such synergies are often favorable, but may be unfavorable if they impose bureaucratic impediments that smaller, nimbler enterprises do not face, or as a result of additional burdens and requirements placed on units because they are part of a large organization.

Incidental benefits that arise merely because an associated enterprise is part of a larger group should not require a payment in the absence of “deliberate concerted action” by another member. The term incidental refers to benefits that arise solely from membership in a group, not to the quantum of benefit received.

However, if the benefit arises from the deliberate concerted action of the group, then it is necessary to determine:

- The nature of the advantage or disadvantage;
- The amount of the benefit or detriment; and
- How the benefit or detriment should be allocated among group members.
The revised guidelines state that benefits arising from deliberate concerted group actions should be shared in proportion to the members’ contribution to the benefit.

**Intragroup Loans**

The guidance on group synergies addresses the issue of passive association/implicit support with respect to financial transactions using two examples.

Example 1 recognizes the impact of group synergies on the credit rating of a subsidiary that is a member of an MNE group. In Example 1, P is the parent company of an MNE group engaged in the financial services business. The strength of the consolidated group’s balance sheet enables P to maintain a Aaa credit rating. On a standalone basis, the strength of S’s balance sheet would support a credit rating of only Baa. Nevertheless, because of S’s membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating. S borrows simultaneously from a third party lender and P at an interest rate that reflects S enhanced credit rating as part of the P group.

**Chart 1 – Illustration of OECD Example 1 – No contractual credit guarantee**

The example states that no payment or comparability adjustment is required for the group synergy benefiting S because the benefit arises solely from S’s group membership, rather than from any deliberate concerted action of members of the MNE group.

A similar principle is applied in Example 2, which distinguishes between incidental benefit and deliberate concerted action. Example 2 considers a similar situation as Example 1, but the parent company provides an explicit guarantee (legal obligation), an example of a concerted group action. The example concludes that S should be required to pay a guarantee fee, but only on the enhancement of its credit standing from A to AAA, rather than from Baa to AAA, because the leap from Baa to A is attributable to S’s passive association in the group, whereas the enhancement from A to AAA is directly attributable to deliberate concerted action – the provision of the guarantee by Parent.
These examples appear to be premised on a number of facts that may not be present in all situations. The examples conclude that the willingness of the MNE group to provide financial assistance in the future in the event of default is not a "deliberate concerted group action." However, if the parent company undertakes deliberate steps to maintain its credit rating at a certain level to enable it to borrow at a rate lower than its competitors, the examples do not address whether that action constitutes a "deliberate concerted group action" for which S may be required to compensate P.

Similarly, the examples assume that large independent lenders are willing to lend to the subsidiary at an interest rate reflecting a higher credit rating than the subsidiary’s standalone rating. This may not be the case in all situations. For example, credit rating agencies consider implicit support only under specified circumstances. The International Basel II framework issued by the Bank for International Settlements Basel Committee on Bank Supervision in assessing a bank’s risks generally considers only legally enforceable guarantees, which implicit support would not satisfy. These OECD examples could affect whether a bank would consider implicit support, because implicit support would affect its risk rating. Banks generally do not publish their approach to implicit support, and experience suggests those approaches vary.

Finally, Example 1 assumes that there are no contractual differences between the unrelated-party loan and the related-party loan. Implicit support would not appear to impact loan-specific contractual differences. For example, if the related-party loan were subordinate to third-party creditors, the subordination may affect the standalone credit rating of the specific loan.

**Centralized Purchasing**

The new guidance states that a group that takes affirmative action to centralize purchasing in a single group entity to take advantage of volume discounts has taken deliberate concerted action, which generally requires the members to share the benefits of consolidation regardless of whether the centralized purchasing company buys and resells the purchase items or simply negotiates master purchase contracts for the group. However, no affirmative action occurs if a vendor simply offers an additional discount to a group company in the hope of obtaining additional orders from other group members. In that
case, the company receiving the discount is receiving an incidental benefit for being part of the group and should retain the entire benefit.

The guidance contains three examples that illustrate the view that when a centralized purchasing company is able to take advantage of volume discounts, the volume discounts must be shared among the group companies, and the centralized purchasing company is entitled only to a return on the functions it performs and the assets it uses in the purchasing activity. The examples imply that, in those cases, the purchasing activity is a routine activity for which the purchasing entity should receive a routine return. Any benefit received for aggregating the group’s purchasing volume should be shared among group members.

The examples appear to be premised on a number of facts that may not be present in all situations. If the centralized purchasing entity engaged in additional functions and employed additional assets or resources, such as by developing a sophisticated software algorithm to track and predict price movements more efficiently, the examples do not appear to dictate that this incremental value attributable to the purchasing services should be shared by the group companies.

**Assembled Workforce**

The additions to Chapter I provide guidance on the potential impact of an assembled workforce in a transfer pricing analysis. The guidance indicates that a uniquely qualified or experienced workforce may be a comparability factor that may impact transfer prices.

An assembled workforce may be transferred as part of a business restructuring. In such a case, the guidance states, the value of the workforce can be estimated by a replacement cost analysis. In some instances, the transfer of an assembled workforce would entail time and cost savings that should be reflected in the arm’s length price charged for the transferred assets. Conversely, in some cases, the workforce may come with termination, pension, or other liabilities that would reduce the value of the workforce or even create a negative value. In those cases, the price paid in the restructuring should reflect those potential liabilities. Importantly, the guidance does not suggest that an assembled workforce is an intangible, presumably because it cannot be owned or controlled by a single enterprise.

The guidance indicates that in most situations the mere secondment of an employee would not require any additional compensation other than for the services of the employee.

If the transfer of a workforce or a secondee results in the transfer of valuable know-how, then the transfer of that valuable know-how should be valued in accordance with the guidelines in Chapter VI on intangibles. Similarly, access to a trained and experienced workforce may enhance the value of a transferred intangible, which could affect the value of the intangible or could be a comparability factor affecting the value of the services to be provided by the workforce in the future.

**Effective Dates**

The OECD has not recommended a specific effective date for the changes to Chapter I. The effective date of the changes will depend on the domestic law of the adopting states. Some states have not enacted specific transfer pricing rules, and generally follow the OECD’s transfer pricing guidelines. For those countries, the changes to Chapter I will be automatically incorporated into domestic law when final. Conversely, those countries that do have specific transfer pricing legislation, rules or guidance will have to either enact new legislation adopting the rules or formally amend their existing rules or guidance.

Whether the changes to Chapter I will apply prospectively or retroactively will also be determined under local law. It is possible that final agreements at the end of the BEPS project in 2015 could include effective dates for the new OECD guidelines to apply.

**Conclusion**

The additional guidance added to Chapter I regarding location-specific advantages, group synergies, and workforce-in-place provides important new guidance for tax administrators and companies. Companies that have taken positions on these issues should consider this new guidance when analyzing their transfer pricing positions.
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 alert.

Annex 1 – Master File

Annex 2 – Local File
URL: http://newsletters.usdbriefs.com/2014/Tax/ALS/AnnexII.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.

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 polices. 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.

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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Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

ACTION 13: 2014 Deliverable
Annex I to Chapter V

Transfer pricing documentation – Master file

The following information should be included in the master file:

Organisational structure

- Chart illustrating the MNE’s legal and ownership structure and geographical location of operating entities.

Description of MNE’s business(es)

- General written description of the MNE’s business including:
  - Important drivers of business profit;
  - A description of the supply chain for the group’s five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5 percent of group turnover. The required description could take the form of a chart or a diagram;
  - A list and brief description of important service arrangements between members of the MNE group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services;
  - A description of the main geographic markets for the group’s products and services that are referred to in the second bullet point above;
  - A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks
assumed, and important assets used;

- A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

**MNE’s intangibles (as defined in Chapter VI of these Guidelines)**

- A general description of the MNE’s overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.

- A list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities legally own them.

- A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and licence agreements.

- A general description of the group’s transfer pricing policies related to R&D and intangibles.

- A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

**MNE’s intercompany financial activities**

- A general description of how the group is financed, including important financing arrangements with unrelated lenders.

- The identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organised and the place of effective management of such entities.

- A general description of the MNE’s general transfer pricing policies related to financing arrangements between associated enterprises.
MNE’s financial and tax positions

- The MNE’s annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.

- A list and brief description of the MNE group’s existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.
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### Annex II to Chapter V

**Transfer pricing documentation – Local file**

The following information should be included in the local file:

#### Local entity

- A description of the management structure of the local entity, a local organisation chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.

- A detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity.

- Key competitors.

#### Controlled transactions

For each material category of controlled transactions in which the entity is involved, provide the following information:

- A description of the material controlled transactions (e.g. procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licences of intangibles, etc.) and the context in which such transactions take place.

- The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e. payments and receipts for products, services, royalties, interest, etc.) broken
down by tax jurisdiction of the foreign payor or recipient.

- An identification of associated enterprises involved in each category of controlled transactions, and the relationship amongst them.

- Copies of all material intercompany agreements concluded by the local entity.

- A detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, including any changes compared to prior years.1

- An indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method.

- An indication of which associated enterprise is selected as the tested party, if applicable, and an explanation of the reasons for this selection.

- A summary of the important assumptions made in applying the transfer pricing methodology.

- If relevant, an explanation of the reasons for performing a multi-year analysis.

- A list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information.

- A description of any comparability adjustments performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both.

- A description of the reasons for concluding that relevant transactions were priced on an arm’s length basis based on the application of the

---

1 To the extent this functional analysis duplicates information in the master file, a cross-reference to the master file is sufficient.
selected transfer pricing method.

- A summary of financial information used in applying the transfer pricing methodology.

- A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to controlled transactions described above.

## Financial information

- Annual local entity financial accounts for the fiscal year concerned. If audited statements exist they should be supplied and if not, existing unaudited statements should be supplied.

- Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements.

- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.
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Annex III to Chapter V

A model template for the Country-by-Country Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

<table>
<thead>
<tr>
<th>Tax Jurisdiction</th>
<th>Revenues</th>
<th>Profit (Loss) Before Income Tax</th>
<th>Income Tax Paid (on cash basis)</th>
<th>Income Tax Accrued – Current Year</th>
<th>Stated capital</th>
<th>Accumulated earnings</th>
<th>Number of Employees</th>
<th>Tangible Assets other than Cash and Cash Equivalents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unrelated Party</td>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Related Party</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

<table>
<thead>
<tr>
<th>Tax Jurisdiction</th>
<th>Constituent Entities resident in the Tax Jurisdiction</th>
<th>Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence</th>
<th>Main business activity(ies)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Research and Development, Holding or Managing intellectual property, Purchasing or Procurement, Manufacturing or Production, Sales, Marketing or Distribution, Administrative, Management or Support Services, Provision of Services to unrelated parties, Internal Group Finance, Regulated Financial Services, Insurance, Holding shares or other equity instruments, Dormant, Other²</td>
<td></td>
</tr>
</tbody>
</table>

1. 
2. 
3. 

2 Please specify the nature of the activity of the Constituent Entity in the “Additional Information” section.
### Table 3. Additional Information

<table>
<thead>
<tr>
<th>Name of the MNE group:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal year concerned:</td>
</tr>
</tbody>
</table>

*Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the country-by-country report.*
**General Instructions for Annex III to Chapter V**

**Purpose**

This Annex III to Chapter V of these Guidelines contains a template for reporting a multinational enterprise’s (MNE) allocation of income, taxes and business activities on a tax jurisdiction-by-tax jurisdiction basis. These instructions form an integral part of the model template for the country-by-country report.

**Definitions**

*Reporting MNE*

A Reporting MNE is the ultimate parent entity of an MNE group.

*Constituent Entity*

For purposes of completing Annex III, a Constituent Entity of the MNE group is any separate business unit of the MNE group (company, corporation, trust, partnership etc.) that is included in the consolidated group for financial reporting purposes. Entities excluded from financial statements only on size or materiality grounds should be included in the country-by-country report as Constituent Entities.

*Treatment of Branches and Permanent Establishments*

The term Constituent Entity also includes permanent establishments of a member of the MNE group conducting business in a tax jurisdiction, provided such permanent establishment prepares a separate income statement for regulatory purposes, financial reporting, internal management or tax purposes. The permanent establishment data should be reported by reference to the tax jurisdiction in which it is situated and not by reference to the tax jurisdiction of residence of the Constituent Entity of which the permanent establishment is a part. Residence tax jurisdiction reporting for the Constituent Entity of which the permanent establishment is a part should exclude financial data related to the permanent establishment.
Period covered by the annual template

The template should cover the fiscal year of the Reporting MNE. For Constituent Entities, at the discretion of the Reporting MNE, the template should reflect on a consistent basis either (i) information for the fiscal year of the relevant Constituent Entities ending on the same date as the fiscal year of the Reporting MNE, or ending within the 12 month period preceding such date, or (ii) information for all the relevant Constituent Entities reported for the fiscal year of the Reporting MNE.

Source of data

The Reporting MNE should consistently use the same sources of data from year to year in completing the template. The Reporting MNE may choose to use data from its consolidation reporting packages, from separate entity statutory financial statements, regulatory financial statements, or internal management accounts. 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 MNE at the average exchange rate for the year stated in the Additional Information section of the template. Adjustments need not be made, however, for differences in accounting principles applied from tax jurisdiction to tax jurisdiction.

The Reporting MNE should provide a brief description of the sources of data used in preparing the template in the Additional Information section of the template. If a change is made in the source of data used from year to year, the Reporting MNE should explain the reasons for the change and its consequences in the Additional Information section of the template.
Specific instructions for Annex III to Chapter V

Overview of allocation of income, taxes and business activities by tax jurisdiction (Table 1)

Tax Jurisdiction

In the first column of the template, the Reporting MNE should list all of the tax jurisdictions in which Constituent Entities of the MNE group are resident for tax purposes. A tax jurisdiction is defined as a State as well as a non-State jurisdiction which has fiscal autonomy. A separate line should be included for all Constituent Entities in the MNE group deemed by the Reporting MNE not to be resident in any tax jurisdiction for tax purposes. Where a Constituent Entity is resident in more than one tax jurisdiction, the applicable tax treaty tie breaker should be applied to determine the tax jurisdiction of residence. Where no applicable tax treaty exists, the Constituent Entity should be reported in the tax jurisdiction of the Constituent Entity’s place of effective management. The place of effective management should be determined in accordance with the provisions of Article 4 of the OECD Model Tax Convention and its accompanying Commentary.

Revenues

In the three columns of the template under the heading Revenues, the reporting MNE should report the following information: (i) the sum of revenues of all the Constituent Entities of the MNE group in the relevant tax jurisdiction generated from transactions with associated enterprises; (ii) the sum of revenues of all the Constituent Entities of the MNE group in the relevant tax jurisdiction generated from transactions with independent parties; and (iii) the total of (i) and (ii). Revenues should include revenues from sales of inventory and properties, services, royalties, interest, premiums and any other amounts. Revenues should exclude payments received from other Constituent Entities that are treated as dividends in the payor’s tax jurisdiction.
Profit (Loss) Before Income Tax

In the fifth column of the template, the Reporting MNE should report the sum of the profit (loss) before income tax for all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The profit (loss) before income tax should include all extraordinary income and expense items.

Income Tax Paid (on Cash Basis)

In the sixth column of the template, the Reporting MNE should report the total amount of income tax actually paid during the relevant fiscal year by all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. Taxes paid should include cash taxes paid by the Constituent Entity to the residence tax jurisdiction and to all other tax jurisdictions. Taxes paid should include withholding taxes paid by other entities (associated enterprises and independent enterprises) with respect to payments to the Constituent Entity. Thus, if company A resident in tax jurisdiction A earns interest in tax jurisdiction B, the tax withheld in tax jurisdiction B should be reported by company A.

Income Tax Accrued (Current year)

In the seventh column of the template, the Reporting MNE should report the sum of the accrued current tax expense recorded on taxable profits or losses of the year of reporting of all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The current tax expense should reflect only operations in the current year and should not include deferred taxes or provisions for uncertain tax liabilities.

Stated capital

In the eighth column of the template, the Reporting MNE should report the sum of the stated capital of all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. With regard to permanent establishments, the stated capital should be reported by the legal entity of which it is a permanent establishment unless there is a defined capital requirement in the permanent establishment tax jurisdiction for regulatory purposes.

Accumulated earnings

In the ninth column of the template, the Reporting MNE should report the sum of the total accumulated earnings of all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction as of the end of the
year. With regard to permanent establishments, accumulated earnings should be reported by the legal entity of which it is a permanent establishment.

**Number of Employees**

In the tenth column of the template, the Reporting MNE should report the total number of employees on a full-time equivalent (FTE) basis of all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The number of employees may be reported as of the year-end, on the basis of average employment levels for the year, or on any other basis consistently applied across tax jurisdictions and from year to year. For this purpose, independent contractors participating in the ordinary operating activities of the Constituent Entity may be reported as employees. Reasonable rounding or approximation of the number of employees is permissible, providing that such rounding or approximation does not materially distort the relative distribution of employees across the various tax jurisdictions. Consistent approaches should be applied from year to year and across entities.

**Tangible Assets other than Cash and Cash Equivalents**

In the eleventh column of the template, the Reporting MNE should report the sum of the net book values of tangible assets of all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. With regard to permanent establishments, assets should be reported by reference to the tax jurisdiction in which the permanent establishment is situated. Tangible assets for this purpose do not include cash or cash equivalents, intangibles, or financial assets.
List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction (Table 2)

Constituent Entities resident in the Tax Jurisdiction

The Reporting MNE should list, on a tax jurisdiction-by-tax jurisdiction basis and by legal entity name, all the Constituent Entities of the MNE group which are resident for tax purposes in the relevant tax jurisdiction. As stated above with regard to permanent establishments, however, the permanent establishment should be listed by reference to the tax jurisdiction in which it is situated. The legal entity of which it is a permanent establishment should be noted (e.g. XYZ Corp – Tax Jurisdiction A PE).

Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence

The Reporting MNE should report the name of the tax jurisdiction under whose laws the Constituent Entity of the MNE is organised or incorporated if it is different from the tax jurisdiction of residence.

Main business activity(ies)

The Reporting MNE should determine the nature of the main business activity(ies) carried out by the Constituent Entity in the relevant tax jurisdiction, by ticking one or more of the appropriate boxes.

<table>
<thead>
<tr>
<th>Business activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research and Development</td>
</tr>
<tr>
<td>Holding or managing intellectual property</td>
</tr>
<tr>
<td>Purchasing or Procurement</td>
</tr>
<tr>
<td>Manufacturing or Production</td>
</tr>
<tr>
<td>Sales, Marketing or Distribution</td>
</tr>
<tr>
<td>Administrative, Management or Support Services</td>
</tr>
<tr>
<td>Provision of services to unrelated parties</td>
</tr>
<tr>
<td>Internal group finance</td>
</tr>
<tr>
<td>Regulated Financial Services</td>
</tr>
<tr>
<td>Insurance</td>
</tr>
<tr>
<td>Holding shares or other equity instruments</td>
</tr>
<tr>
<td>Dormant</td>
</tr>
<tr>
<td>Other(^3)</td>
</tr>
</tbody>
</table>

\(^3\) Please specify the nature of the activity of the Constituent Entity in the “Additional Information” section.
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OECD Release on Intangibles: Many Issues Unanswered

The OECD on September 16 issued revisions to Chapter VI of the transfer pricing guidelines, Special Considerations for Intangibles, as part of the release of base erosion and profit shifting (BEPS) deliverables. This release is a work in progress, as several important sections remain in draft form and will only be finalized as part of the 2015 BEPS deliverables. However, the release provides important guidance in the many areas that are final, and for those that are not, it provides insight into the likely direction of future guidance.

Definition of Intangibles

The OECD has adopted a broad definition of intangibles in the revised guidance to preclude arguments that valuable items fall outside the scope of the definition. The expansive approach adopted by the OECD is similar to that of many countries.

The revised guidance defines an intangible as something (1) that is not a physical asset or a financial asset; (2) is capable of being owned or controlled for use in commercial activities; and (3) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

In identifying intangibles for transfer pricing purposes, the OECD focuses on what would be agreed upon between unrelated parties in a comparable transaction. The broad definition is not dependent on accounting or legal definitions or characterizations, and is not dependent on or intended to be used for any other tax purposes. The OECD notes that a transfer pricing analysis should carefully consider whether an intangible exists and whether an intangible has been used or transferred. For example, not all research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible.

The availability and extent of legal, contractual, or other forms of protection is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes, although it may affect the value of an item and the returns that should be attributed to it. Likewise, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.

The OECD discusses several items that are characterized as intangibles for transfer pricing purposes, and some that are not:

<table>
<thead>
<tr>
<th>Intangibles for TP Purposes</th>
<th>Patents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Know-how and trade secrets</td>
</tr>
<tr>
<td></td>
<td>Trademarks, trade names, and brands</td>
</tr>
<tr>
<td></td>
<td>Rights under contracts and government licenses, including</td>
</tr>
<tr>
<td></td>
<td>contractual commitment to make a workforce available</td>
</tr>
<tr>
<td></td>
<td>Licenses and similar limited rights in intangibles</td>
</tr>
<tr>
<td></td>
<td>Goodwill and ongoing concern value</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Not Intangibles for TP Purposes (not owned or controlled by a single associated enterprise)</th>
<th>Group synergies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market specific characteristics (e.g., local consumer purchasing power and location savings)</td>
</tr>
<tr>
<td></td>
<td>Assembled workforce</td>
</tr>
</tbody>
</table>

The guidance provides that, in conducting a transfer pricing analysis, it is important to identify the relevant intangibles with specificity, and that vaguely specified or undifferentiated intangibles are insufficient for that purpose. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets, and with business operations to create value.

Rights to Returns for the Development and Exploitation of Intangibles

Section B of the revised guidance addresses the difficult question of how to allocate profits attributable to an intangible when ownership of the intangible is separated, in whole or in part, from activity that relates to the development, enhancement, maintenance, protection, or exploitation of that intangible. This may be the most important part of the revised guidance on intangibles, and it remains the most controversial, because it has the potential to require significant
changes to practice under the current guidelines. However, the strong point in this section is its directive to apply the arm’s length principle in accordance with Chapters I-III of the transfer pricing guidelines.

Section B is not in final form because some aspects of the guidance might be revised following consideration of risk, hard to value intangibles, and special procedures, which will take place in the next round of BEPS work. The revised guidance is scheduled to be delivered in September 2015, although early drafts – at least with respect to risk and capital – are expected before the end of 2014.

The guidance in Section B recognizes that payment for use of an intangible should be made to the party with legal ownership of that intangible. However, when another party has participated in activity leading to the development, enhancement, maintenance, protection, or exploitation of an intangible, a separate transaction dealing with that activity must also be considered. There is therefore no intention to divert the income stream arising from use of the intangible away from the legal owner, but instead to recognize that the legal owner has a transfer pricing obligation to pay for those activities it does not perform. Hence, the transfer pricing questions related to payment to the legal owner for use of an intangible are not affected by the subsequent transfer pricing question of how much the legal owner should pay to parties that have participated in the development, enhancement, maintenance, or protection of those intangibles.

In discussing the issues concerning (1) the separation of ownership from activity leading to the development, enhancement, maintenance, protection, or exploitation of intangibles; (2) the determination of the party whose profitability is to be tested; and (3) what profit ultimately is allocated to the owner and to those undertaking those activities, the guidance states that the results should be driven by a functional analysis of the functions performed, assets used, and risks assumed by all group members, in accordance with Chapters I-III of the transfer pricing guidelines. The guidance is clear that the legal owner of the intellectual property might not earn any functional profit from simply owning the intangible, after compensating other members of the group for those activities.

The guidance states that contracts may be used to describe the roles, responsibilities, and rights of associated enterprises, and may serve as a reference point for identifying and analyzing controlled transactions. Thus, associated enterprises are encouraged to express their intent in contracts. However, the guidance is clear that if the actual assumption or control of risk and the actual functions leading to the development, enhancement, maintenance, protection, or exploitation of intangibles differ from those stipulated in the contractual agreement, then it is the actual position that must be reviewed.

The guidelines contain a clear statement that the legal owner itself does not need to carry out all the functions related to the development, enhancement, maintenance, and protection of those intangibles. The guidance recognizes that independent parties sometimes engage others to perform these functions, and under the arm’s length principle, therefore, related parties could act in a similar manner. If such outsourced activity is to be considered a “service” and priced accordingly, the guidance is clear that someone in the group, other than the service provider, should exercise control over the performance of the outsourced activity. In this situation, an entity would be deemed to exercise control if it has the ability to understand the function being performed, to determine if the function is being performed adequately, and to be the final decision-maker regarding important aspects of the function. The guidance is clear that when the legal owner does not adequately control the outsourced activities, the party that in practice controls the outsourced activity, whether the party performing the outsourced activity or another, should also be appropriately compensated.

The guidance states that, in determining the prices to be paid for functions performed, some “important functions” will have, in appropriate circumstances, “special significance” because they usually make a significant contribution to intangible value. The list provided is not all-inclusive but merely illustrative. In some situations, any of the listed items might not have special significance; in others, something not listed might. The list includes:

- Design and control of research and marketing programs;
- Direction of and establishing priorities for creative undertakings, including determining the course of “blue-sky” research;
- Control over strategic decisions regarding intangible development programs;
- Management and control of budgets;
- Important decisions regarding defense and protection of intangibles; and
- Ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.
In practice, as between unrelated parties, any of these activities might be performed by another party whose specialized knowledge makes it sensible, from a business point of view, to rely on the other parties' judgment. Transfer pricing practitioners need to investigate and identify the activities of "significant importance" and show the arm's length nature of the actual arrangements. The guidance cautions that the reliability of one-sided transfer pricing methods will be substantially reduced if parties performing a significant portion of the important functions are treated as tested parties. Failure to perform or control the significant functions is likely to leave the legal owner with only a small return on the other functions it performs. If these significant functions would not have been outsourced by unrelated parties the transfer pricing consequence might be that comparables cannot be found which leads either to the application of profit split methods or, in appropriate cases, to the recharacterization of the transaction.

The release adds new guidance on when the transfer pricing analysis should be performed. The release states that compensation must be determined on the basis of anticipated or ex ante information. This could raise practical considerations, because in many cases, the individuals responsible for transfer pricing analysis will not be aware of all of the intangible-creating activity and, even if they are aware, the ex ante internal analysis many companies prepare in deciding to create intangibles may not be adequate to perform all of the required analysis.

**Valuation of Intangibles**

In selecting a transfer pricing method to value intangibles, the guidance makes it increasingly likely that the method to be applied as the most appropriate will be the transactional profit split, and the use of discounted cash flow techniques by requiring consideration of both parties' realistic alternatives. In particular, the draft specifies the difficulties, in many circumstances, of finding suitable comparables for the use of the comparable uncontrolled price (CUP) method.

**Realistically Available Options**

The guidance strongly emphasizes that the comparability analysis with respect to intangibles transactions must consider the options realistically available to each of the parties to the transaction, and that a one-sided comparability analysis is insufficient. The guidance further provides that the specific business circumstances of one of the parties should not be used to support an outcome contrary to the realistically available options of the other party. The guidance includes an example that states that a transferor of intangibles would not accept a price that is less advantageous than its other realistically available options merely because it lacks the resources to effectively exploit the transferred rights. A second example states that a transferee should not be expected to accept a price that would make it impossible to anticipate earning a profit using the acquired rights in the intangible in its business.

The guidance takes the position that an intercompany price for a transaction in intangibles can be identified that is consistent with the realistically available options of each of the parties and is consistent with the assumption that taxpayers seek to optimize their allocation of resources. The guidance cautions that in situations when there is no overlap in the prices acceptable to both parties, given their realistically available options, it may be necessary to consider whether the actual transaction should be disregarded, the parties' allocation of risk should not be recognized, or whether the conditions of the transaction should otherwise be adjusted. Similarly, if it is asserted that either the current use of an intangible or a proposed realistically available option does not optimize resource allocations, it may be necessary to consider whether such assertions are consistent with the true facts and circumstances of the case.

**Comparability Analysis**

The supplemental guidance states that it is essential to evaluate the unique features of the intangibles in conducting a comparability analysis. This is particularly important when the CUP method is applied, but is also relevant in applying other methods that rely on comparables. Important factors in determining comparability include the actual and potential profitability of potential comparables in comparison to the transferred comparable, and whether the transferred comparable can be used as a platform to shorten the development time of future generations of the product. The guidance questions whether comparable information drawn from public or private databases is sufficiently detailed to satisfy the guidance’s comparability standards.

The guidance provides that if amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, the computation of the adjustment may not be reliable, and the intangibles being compared may in fact not be sufficiently comparable to support a valid transfer pricing analysis. The guidance effectively
sets a high comparability bar in applying the CUP method to value intangibles transfers, and the OECD explicitly notes that the identification of reliable comparables involving intangibles may be difficult or impossible in many cases.

**Transfer Pricing Methods**

The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how the transferred intangibles interact with other functions, assets, and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies, among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

The OECD states that, depending on the specific facts, any of the five OECD transfer pricing methods may constitute the most appropriate transfer pricing method for the transfer of intangibles. Nevertheless, the OECD goes on to caution that one-sided methods, including the resale price method and the transactional net margin method (TNMM), are generally not reliable methods for intangibles transactions, in part because they can assume that all of the residual profit is allocated to the owner of the intangible. The OECD further notes that transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development are generally discouraged, because there rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Consequently, the guidance concludes that the transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method, and that valuation techniques can be useful tools.

As described above, the OECD guidance sets a high bar on comparability, which in practice likely will make the CUP method difficult to apply (except in cases when there is a recent acquisition from an unrelated party or a suitable internal CUP).

The guidance suggests that profit splits may be a reliable method for valuing developed intangibles in the absence of CUPs. The discussion of the profit split method is not in final form, presumably because additional guidance on the transactional profit split method will be provided as part of Action 10 on high-risk transactions due September 2015. Hopefully, the additional guidance will provide guidance on how the legal owner should share losses with entities that perform the important functions that would have permitted those entities to earn additional returns had the intangible been profitable.

The OECD further provides that it may be possible to use valuation techniques, including income-based methods such as discounted cash flow, to estimate the arm’s length price of intangibles. New guidance on the application of the discounted cash flow method is provided. In applying a valuation technique, it is essential to consider the assumptions that underlie the analysis. In particular, the OECD notes that the following issues should be considered:

- Accuracy of financial projections;
- Assumptions regarding growth rates;
- Discount rates;
- Useful life of intangibles and terminal values;
- Assumptions regarding taxes; and
- Form of payment.

**Potential Considerations with Respect to Risk and Capital**

Current OECD guidance on the allocation of risk focuses on whether the party assuming the risk has control over the risk and financial capacity to assume the risk. Current rules focus on economic substance of any purported allocation of risk (see Paragraphs 9.22-9.32 of the OECD transfer pricing guidelines).

Proposed guidance contained in Section B recognizes that funding of the development, enhancement, protection, or exploitation of intangibles and the associated business risk are often integrally related, but requires them to be analyzed separately because the allocation of risk can be affected by contract. The release recognizes that returns attributable to funding risk depend on the stage of development of the intangible, the control over intangible-related risks, and the ability to absorb losses. The proposed guidance specifically recognizes the need to reward the party that funds the intangible, but...
if the functional analysis shows no functions, risks, or assets other than funding and the funding risk, then that party is entitled only to a risk-adjusted return on capital.

BEPS Action 9 requires the OECD to develop rules to prevent base erosion and profit shifting by transferring risks among, or allocating excessive capital to, group members. As part of Action 9, the OECD is discussing new guidance for the allocation of risk and the associated returns to capital. The OECD is discussing whether related taxpayers can contractually allocate risk within a multinational group. Some commentators have argued that the true bearers of risk within a multinational group are the shareholders, not any individual entity.

As part of Action 9, the OECD is addressing whether an allocation of risk between members reflects economic substance, since most entities in the same business line arguably share the risks associated with that business line; in other words, a proper functional analysis will show that the risks of developing, manufacturing, and marketing successful products are borne by the R&D center, the manufacturer, and the distributor. The OECD has also discussed whether there is a “natural” location for certain types of risk taking, at the location of the people involved in the risk-taking behavior. For example, the R&D group performing the R&D activity might be the natural place to allocate the R&D risk. The distributor performing marketing functions might be the natural place to allocate marketing risk. This line of reasoning, which heavily focuses on people functions, is consistent with the OECD’s direction that transfer pricing outcomes should reflect where value is created.

If the OECD were to follow this approach in relation to structured business models perhaps with central entrepreneurs, it could significantly reduce the situations in which ex-post benchmarked returns may be used to test transfer prices, because the risk position of potential comparables is unlikely to match that of a group member. In addition, it could significantly change the profitability of entities as they move away from benchmarked returns for example, manufacturing, sales, or services and lead to more frequent use of the transactional profit split method.

Potential Considerations with Respect to Hard-to-Value Intangibles

Chapter VI guidance may be further affected by the output from BEPS Action 10, which considers the transfer pricing of high-risk transactions, and by further consideration of “special measures,” such as recharacterization, both of which are due to be completed in September 2015.

Tax authorities have expressed concern that some intangibles are hard to value using traditional methods and techniques, either because the intangible is unique in nature, the transaction would not happen between unrelated parties, or because the income stream that the intangible might generate is highly speculative at the time of the transaction. The OECD’s Working Party 6 (which deals with multinational enterprises and transfer pricing) is expected to consider options to enhance transfer pricing guidance to address all of these situations, and because their review will be far-reaching, the discussion likely will consider areas where it is necessary to look at alternatives to the arm’s length principle in specific circumstances.

The release has added new sections on the impact of unanticipated ex post returns, stating that it must be determined whether the unanticipated returns were actually unanticipated. If the returns are unanticipated, then those returns should generally be earned by the entity or entities that have the control and management of the relevant risks and actually bear the risk. Additional guidance in this area is expected as part of Action 10 on high-risk transactions, in particular, additional guidance on when results reasonably should have been anticipated, which may permit tax authorities to make adjustments to transactions and when they will be considered unanticipated.

It is possible that Working Party 6 could conclude that the arm’s length principle cannot provide tax authorities with a solution in all circumstances, and that a non-arm’s-length approach may be the only option in some cases. Changing OECD guidance to ‘deem’ certain outcomes as non-arm’s length may cause significant problems for tax legislation in a number of countries that specifically require arm’s length outcomes. In addition, such a solution would be inconsistent with the business profits article of most current multinational tax treaties, which incorporates the arm’s length principle, although presumably this could be changed as part of a multilateral instrument contemplated by BEPS Action 15.

Similar problems may arise with a broadening of the circumstances in which an actual transaction may be recharacterized and an entity taxed on the basis of a fictional transaction. Current OECD rules permit tax authorities to disregard a transaction only in two circumstances: (1) when the economic substance of the transaction is different from its form; and (2) when the terms of the transaction in their totality differ from those adopted by independent parties behaving in a
commercially rational manner and the actual structure practically impedes the determination of an appropriate transfer price. The current guidance therefore provides very specific and limited circumstances in which recharacterization can be applied, and the OECD has announced that it is considering whether to clarify how/when it would be appropriate to use recharacterization to prevent base erosion and profit shifting.

A significant drawback of recharacterization is that, save in the most straightforward cases, there is no single obvious transaction to recharacterize the transaction to, and no standard against which to create a recharacterized transaction so that both parties (and their respective tax authorities) would agree. As it is highly unlikely that the two parties to the transaction, or their tax authorities, would recharacterize a transaction to precisely the same fictional transaction, such a broadened rule is very likely to lead to significant uncertainty, potential double taxation, and increases in the number of requests for mutual assistance.

Effective Date

The OECD has not recommended a specific effective date for the changes to Chapter I. The effective date of the changes will depend on the domestic law of the adopting states. Some states have not enacted specific transfer pricing rules, and generally follow the OECD’s transfer pricing guidelines. For those countries, the changes to Chapter I will be automatically incorporated into domestic law when final. Conversely, those countries that do have specific transfer pricing legislation, rules, or guidance will have to either enact new legislation adopting the rules or formally amend their existing rules or guidance.

Whether the changes to Chapter I will apply prospectively or retroactively will also be determined under local law. It is possible that final agreements at the conclusion of the BEPS project in 2015 could include effective dates for the new OECD guidelines to apply.

Conclusion

The OECD has undertaken the difficult task of providing additional guidance on the valuation of intangibles for transfer pricing purposes. Although some of the important guidance is not final, the direction of the final guidance is clear; the mere legal ownership of intangibles is unlikely to result in the legal owner receiving significant intangible returns. Companies that have entered into contracts for the development, enhancement, maintenance, protection, and exploitation of intangibles should consider reviewing those contracts in light of the new and proposed guidance.

The forthcoming guidance could have a significant impact on companies transfer pricing practices. Companies should closely monitor the forthcoming guidance and actively participate in future consultations with and present evidence of any concerns to both the OECD and their tax authorities.

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