

Transfer pricing documentation and country-by-country reporting

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The revised Chapter V of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* contains new standards for transfer pricing documentation. The guidelines recommend that individual jurisdictions adopt a three-tiered approach to transfer pricing documentation:

- A master file with global information about a multinational corporation group, including specific information on intangibles and financial activities, that is to be made available to all relevant country tax administrations;
- A local file with detailed information on all relevant material intercompany transactions of the particular group entity in each country; and
- A country-by-country (CbC) report of income, earnings, taxes paid, and certain measures of economic activity.

The new guidance will change the documentation process fundamentally and significantly increase MNEs' transfer pricing compliance burden, because it requires most MNEs to gather and provide to the tax authorities substantially more information on their global operations than they have previously provided.

Three-tiered approach to documentation

Master file

The master file should provide an overview of an MNE's global operations, its overall transfer pricing policies for the creation and ownership of intangibles and its financial activities, and its global allocation of income and economic activity to place the MNE's transfer pricing practices in their global economic, legal, financial, and tax context.

In preparing the master file, MNEs should use sound judgment to determine the appropriate level of detail, taking into consideration that the guidelines indicate it is not necessary for the master file to include exhaustive details. Nonetheless, there is some concern that an individual tax authority's view of prudent business judgment could be affected by the information on local transactions.

The required information can be grouped into five categories:

- The MNE's organizational structure
- A description of the MNE's business or businesses
- The MNE's intangibles
- The MNE's intercompany financial activities
- The MNE's financial and tax positions

MNEs could present the information for the group as a whole, or by line of business, as long as centralized group functions and transactions between business lines are properly described. In addition, if the master file is prepared by line of business, all product groups will have to be submitted to all tax authorities, even if the local entity is part of only one line of business.

The new requirements are relatively prescriptive and will require MNEs to collect a considerable amount of information that has not been collected by either the headquarters or the group members in the past. The new requirements include:

- A supply chain chart for the five largest products and service offerings, plus other products or services amounting to more than 5 percent of an MNE's sales;
- A list and brief description of important service arrangements between members of the MNE group, 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 intragroup services;

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- A description of the main geographic markets for the group's products and services that are referred to in the bullet immediately above;
- A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, such as 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;
- Important intangibles or groups of intangibles, and which entities own them;
- A general description of how the group is financed, including important financing arrangements with unrelated lenders;
- The MNE's annual consolidated financial statement for the fiscal year in question, if otherwise prepared for financial reporting, regulatory, internal management, tax, or other purposes; and
- Advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

The new information required will likely necessitate new processes to obtain, collect, validate, analyze, and refresh data.

Master file information was not previously available to tax authorities, except possibly to the extent it had a direct impact on a local entity's transactions. This increased level of global transparency may result in tax authorities focusing on broader aspects and structure. For example, the additional information could result in inquiries about the development of intangibles by one group member, funding or ownership of the intangibles by another group member, and exploitation by yet another group member. Similarly, the general description of the MNE's transfer pricing policies related to financing arrangements between group members, as well as the description of important financing arrangements with unrelated lenders might highlight non-arm's-length interest rates, overcapitalization of low-tax finance companies, and inadequate debt capacity. Therefore, it would be prudent to analyze the impact of the new requirements on current transfer pricing policies and processes.

Local file

The guidance requires that the local file contain much of the same information that was traditionally found in transfer pricing documentation related to the local entity, including its controlled transactions and financial data. 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. While the master file provides a high-level overview, the local file should provide more detailed information relating to specific material intercompany transactions.

One of MNEs' major concerns regarding the local file may be 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 entity's tax liability. The guidelines recommend that individual country transfer pricing documentation requirements include specific materiality thresholds. As a practical matter, the guidelines are unlikely to reduce the current proliferation of materiality standards and the burden on business that they impose.

A positive feature of the guidelines is that they state that searches for comparable companies need be completed only every three years if the company's functional profile has not changed, although the data on the comparable companies must be updated annually. However, the guidelines still generally support the use of local comparable companies over regional comparable companies when local comparable companies are reasonably available. This requirement may increase the number of sets of comparable companies an MNE must obtain and update.

The guidelines indicate that the local file must contain a breakdown of the intragroup payments and receipts for each category of controlled transactions involving the local entity (that is, payments and receipts for products, services, royalties, and interest) by tax jurisdiction of the foreign payor or recipient. It is also a requirement that various types of agreements be reported, including all material intercompany agreements concluded by the local entity and copies of existing unilateral and bilateral or multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and that are related to controlled transactions described in the local file. The key issue for the future is whether local jurisdictions will impose additional requirements for the local file that will require additional costs to prepare locally tailored documentation reports.

A key concern for MNEs may be the lack of guidance in terms of post-transaction adjustments that are required to prepare a compliant local file. Most countries allow only upward adjustments. This means that if an entity needs to make an upward adjustment to be in compliance, but is prohibited from making a downward adjustment in the counterparty's country, it would be subject to double taxation. This suggests a need for close monitoring of transfer prices to reduce the potential for post-transaction adjustments.

CbC report

As set forth in the guidelines, the final piece of the three-tiered documentation package—the CbC report—should contain aggregate information (without any intercompany adjustments or eliminations) for all entities and for each tax jurisdiction on the following eight items:

- Revenue by related and unrelated party and the sum, including royalties, service fees, interest income premiums, and any other amounts derived from transactions with related or unrelated persons, excluding dividends;
- Profits before income tax;
- Income tax paid, including withholding taxes;

- Income tax accrued, that is, the sum of the accrued current tax expense recorded on taxable profits of the year of reporting, excluding reserves or deferred taxes or provisions for uncertain tax liabilities;
- The number of employees on a full-time equivalent basis;
- Stated capital;
- Retained earnings; and
- Tangible assets other than cash and cash equivalents.

The CbC report should provide information on each group member (company, corporation, trust, or partnership) by tax jurisdiction, along with an indication of the jurisdiction of organization or incorporation, and relevant business activity codes for each entity, including dormant entities.

The CbC report requirement applies to MNEs with annual consolidated group revenue in the immediately preceding fiscal year of €750 million or more (or a near equivalent amount in domestic currency). The monetary threshold does not apply to the master file or local file. Individual countries may adopt different thresholds for those documents.

In preparing the CbC report, the reporting entity 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. Reporting entity is defined as an entity that is required to file a CbC report in its jurisdiction of tax residence on behalf of the MNE.

The reporting entity may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, regulatory financial statements, or internal management accounts. The reporting entity is required to provide a short description of the sources of data that it used in completing the CbC report. If statutory financial statements are used as the basis for reporting, all amounts should be translated to the stated functional currency of the reporting entity at the average exchange rate for the year. If information is used from consolidated financial statements, upon audit, the tax authority may ask for that information to be reconciled to the statutory or regulatory financial statements and then reconciled again to the tax return although the guidance specifically does not require that the information be reconciled. For this reason, some companies are considering using separate entity statutory financial statements or regulatory financial statements for purposes of preparing the CbC report.

In many cases, MNEs may not know where to obtain all the required CbC information, and a CbC data-blueprinting exercise may need to be undertaken to identify where the CbC information is found in the MNE's systems, and how to retrieve it most efficiently. Larger MNEs should perform reporting systems readiness assessments and address potential gaps. Some of the items requested may not be centrally collected on an entity-by-entity or country-by-country basis. For many MNEs, the sheer volume of information that must be collected to complete the report will substantially increase their compliance burden.

Larger MNEs may want to consider technology solutions to collect, store, analyze, and prepare the CbC report. The time and effort necessary to manually locate, collect, validate, and assemble the required data in a spreadsheet or report

is likely to be significant for large MNEs, especially because the process will have to be repeated annually. Technology solutions may enable MNEs to better manage their transfer pricing compliance by providing functionality that allows for regular monitoring of their transfer pricing results. Some software solutions may provide comparisons to budgets or expectations; others may 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 VAT and customs duties.

Adoption of the CbC report as part of the OECD's transfer pricing guidelines was one of the key goals of the BEPS project, because it may provide most local tax authorities, for the first time, an organized picture of where a company earns income and pays taxes. The report may highlight gaps and inconsistencies in a company's transfer pricing policies or its implementation of those policies. In addition, the report may highlight potential inconsistencies in the place where revenue is recognized and the place where "value" is created. MNEs should be ready to provide counterarguments, especially in situations where seemingly similar functions and risks have resulted in different profits for their affiliates in different countries. Such analysis should focus on the location of the decision-makers and the location of unique, high-value assets, including technical and marketing intangibles. MNEs should consider addressing any potential gaps or inconsistencies before they file their first CbC report.

The CbC report is intended to be a risk assessment tool for the tax authorities, and "should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis." The guidelines state that "It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income." The OECD has indicated that if such adjustments are made by the local tax administration, the jurisdiction's competent authority will be required to promptly concede the adjustment in any relevant competent authority proceeding.

Notwithstanding the OECD's admonishments, some countries and MNEs are concerned that the CbC report 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.

Other key elements

Language

Local law will determine the language in which documentation must be submitted. The guidance encourages countries to permit the filing of transfer pricing documentation in commonly used languages when the usefulness of the documents will not be compromised. If tax administrations believe that translation of documents is necessary, the guidance suggests that tax administrations make specific requests for translation and provide sufficient time to complete the task.

Timing

MNEs will be required to file their first CbC reports for their first fiscal year beginning on or after January 1, 2016, and to file it no later than 12 months after the end of that fiscal year. This means that for MNEs with fiscal years ending on December 31, the first CbC report would be required to be filed by December 31, 2017. For MNEs with other fiscal years, the first CbC report would be required to be filed in 2018, 12 months after the close of the first fiscal year beginning after January 1, 2016.

The guidance recommends that the master file and local file requirements be implemented through local-country legislation or administrative procedures, and that MNEs file the master file and local file directly with the tax administration in each relevant jurisdiction under the requirements of such administrations. The guidance indicates that both confidentiality and consistent use of the framework for the content to be included in the master file and local file should be taken into account when incorporating these requirements under local law and procedures.

Implementation legislation

The OECD has released model legislation that could be used by countries to mandate the filing of the CbC reports by the ultimate parent entity of an MNE and also the exchange of this information on an automatic basis with the relevant qualifying jurisdictions in which the MNE operates. Countries with existing transfer pricing documentation rules may choose to affirmatively adopt the OECD's approach or augment their rules, and countries without existing transfer pricing documentation rules should be able to immediately adopt the OECD's approach.¹ The extent to which various countries will provide their own guidance on CbC reports is unclear.

The OECD's model legislation also provides that members of an MNE must notify their country's tax administration whether they are the reporting entity for the group no later than the last day of the MNE's fiscal year. The model legislation requires tax authorities to share the CbC information with other relevant tax authorities within 18 months of the end of the financial reporting year for the first year, and within 15 months of the end of the financial reporting year for subsequent years.

Unfortunately, the guidance does not include any provisions regarding penalties to be imposed in the event a reporting entity fails to comply with the reporting requirements for the CbC report, under the assumption that jurisdictions would wish to extend their existing transfer pricing documentation penalty regime to CbC filing requirements.

However, the guidance states that local documentation-related penalties should not be levied if the information is not in the possession of the local entity, 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 from being charged documentation-related penalties.

Implications

The new documentation guidance may accelerate the trend toward centralized management and documentation of an MNE's transfer pricing policies and the monitoring of transfer price implementation, as MNEs 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 transfer pricing policy or the implementation of that policy will become more apparent to tax authorities around the world. For these reasons, MNEs 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 MNEs, 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.

The CbC report and the master file are likely to be prepared by the headquarters company because as a practical matter, it is likely that only the MNE's headquarters will be able to obtain the information necessary to prepare those documents. For MNEs that do not prepare their transfer pricing documentation on a global basis, the new requirements will pose a substantial change. Even if they do prepare their documentation on a global basis, the new guidance is likely to require MNEs 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.

MNEs will need to ensure that the CbC report, master file, and the local files provide consistent information about their global and local operations and their transfer pricing policies. For MNEs that took a decentralized approach to transfer pricing documentation, the additional preparation or coordination requirements will likely necessitate the allocation of additional resources at headquarters.

Each MNE needs to determine the appropriate level of compliance with the soon-to-be-revised and varying global transfer pricing documentation requirements. It is likely that even though some countries, such as the United Kingdom and Ireland, will not adopt the master file and local file approach, they may nonetheless request that the MNE produce its master file upon audit. A risk-based approach will need to be adopted to balance the MNE's tolerance for risk and its available resources. Tax executives will need to identify the impact of the revised guidance on their processes, measure the impact, prioritize the actions needed, develop an approach to centralize control over transfer pricing, communicate with the key stakeholders, and develop restructuring options, if necessary. A prudent

¹ As of this writing, Australia, Canada, China, Germany, Ireland, the Netherlands, Poland, South Korea, Spain, the United Kingdom, and the United States have indicated that they would adopt the OECD's proposed CbC reporting template. Other countries such as Finland, France, India, Israel, Italy, Japan, Korea, Luxemburg, Mexico, New Zealand, Norway, Singapore, Slovakia, South Africa, Sweden, and Taiwan have announced their support for the adoption of the CbC reporting template.

action is to begin the process for the preparation of the master file and the CbC report for the most recent year to identify gaps, and to begin to make strategic decisions on, for example, classification of the group members and their jurisdiction or residence and whether to have a single master file or one for each business line.

Conclusion

The revised guidance proposes a new paradigm for transfer pricing documentation that may cause many MNEs to rethink their current procedures to set, implement, monitor, document, and report their global transfer pricing policies. The new guidelines will require an MNE's headquarters to implement new procedures that will allow it 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 MNEs to increase the resources devoted to transfer pricing issues.

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