Transfer Pricing Implications of the BEPS Action Plan

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Determined to eliminate so-called double non-taxation as well as no or low taxation associated with practices that are perceived to segregate taxable income from the activities that generate them, the Group of Twenty ("G20") and the Organization for Economic Co-operation and Development ("OECD") released their *Action Plan on Base Erosion and Profit Shifting* ("BEPS Action Plan") in 2013. Included in the *BEPS Action Plan* are several provisions related to transfer pricing:

- Action 4: Limit base erosion via interest deductions and other financial payments;

- Action 8: Assure that transfer pricing outcomes are in line with value creation – Intangibles;

- Action 9: Assure that transfer pricing outcomes are in line with value creation – Risks and capital;

- Action 10: Assure that transfer pricing outcomes are in line with value creation – Other high-risk transactions; and

- Action 13: Re-examine transfer pricing documentation.

The OECD has since delivered a number of reports and recommendations related to these actions, including revisions to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("Transfer Pricing Guidelines"), and it continues to perform additional work on deliverables scheduled for later this year.

While it is difficult to project exactly what final form the BEPS actions will take, it appears certain that a number of the recommendations will be implemented in whole or in part. The U.S. Treasury Department has joined other fiscal authorities and indicated that it will develop a form to implement the country-by-country ("CbC") report, which lists profits by jurisdiction among other information, under the revisions to Chapter V ("Documentation") of the Transfer Pricing Guidelines.

As such, it is now time for multinational enterprises ("MNEs") to move on from considering where the OECD is heading to determining how they can best operate within a radically changed regulatory environment. Based on the agreed draft language in the policy documents and discussion drafts provided by the OECD, we have identified some of the implications of these changes. These implications may seem obvious; what taxpayers can do to best manage the transition to the new regulatory framework and hopefully ameliorate their impact may be less clear.

Several potential implications of the *BEPS Action Plan* are as follows:

1. Revenue bodies will seek to tax a greater share of an MNE's worldwide income;

2. Transfer pricing disputes will increase;

3. Profits splits will become more prevalent;

4. Taxpayers will need to revise their transfer pricing documentation;

5. Taxpayers will need to evaluate their existing transfer pricing structures; and

6. Taxpayers may need to reconsider the use of related parties versus third parties;

We discuss each of these implications further and provide some practical advice regarding how they might best be managed below.

Revenue Bodies Will Seek to Tax a Greater Share of an MNE's Worldwide Income

This development will come as little surprise as it is a fundamental goal of the BEPS initiative. But the methods likely to be used by tax authorities may surprise taxpayers. For example, the discussion draft on revisions to Chapter I ("The Arm's Length Principle") of the Transfer Pricing Guidelines sets out circumstances in which transactions between related parties could be disregarded for transfer pricing purposes.

While non-recognition, or recharacterization, of a transaction is intended primarily to address arrangements that are not considered to have arm's length attributes (that is, third parties would be unlikely to enter such arrangements), it could, in practice, be subject to overreach by tax authorities. And any move away from the arm's length principle by a jurisdiction on one side of a transaction is bound to increase transfer pricing disputes and potential double taxation. Recharacterization will likely make ultimate resolution of transfer pricing disputes more difficult as the fundamental basis for discussion and agreement among the taxing authorities will have changed.

To help avoid such difficulties, taxpayers should consider carefully any intercompany transactions that might be challenged on their arm's length attributes and consider ways to strengthen those arrangements in a tax-efficient manner. For example, if a taxpayer believes it may be unsustainable to have a related party operating as a commissioned agent, the taxpayer may wish to consider converting that entity to a fully fledged buy-sell distributor. Consistent with the arm's-length standard in such a conversion, the entity might purchase the rights to the customer relationships from the related party that had previously sold directly to those customers. The value of those intangibles and the subsequent amortization of the purchase price may mitigate adverse tax consequences associated with higher operating margins generally attributable to buy-sell distribution.

If any entity within a multinational group were recharacterized as a more robust operation, consideration would need to be given regarding whether compensation must be paid to provide that entity the tangible assets or the rights to any intangible assets necessary to operate in such a fashion. Taxpayers may consider proactive planning to restructure current operations that are considered at risk for recharacterization under the BEPS framework.

Transfer Pricing Disputes Will Increase

As revenue bodies expand their taxation of an MNE's worldwide income, the volume of transfer pricing disputes is certain to increase. The OECD even recognizes that "the need for more effective dispute resolution may increase as a result of the enhanced risk assessment capability following the

adoption and implementation of a CbC reporting requirement."[1] Although the countries participating in the BEPS project have agreed that they should not use data in the CbC report to propose income adjustments, the increased transparency into the distribution of profits within an MNE may lead to the deployment of audit resources on matters that could lead to the greatest transfer pricing adjustments. Indeed, an explicit object of the new transfer pricing documentation requirements is to "provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction."[2]

To help manage transfer pricing disputes, taxpayers will want to make sure their counterparties are governed by a good treaty network. Having access to a mutual agreement procedure ("MAP") under a tax treaty will be important for preventing double taxation. The MAP process is largely effective in resolving transfer pricing disputes and the OECD is working to improve access to the MAP under Action 14 (make dispute resolution mechanisms more effective) of the *BEPS Action Plan*. Without such a resolution process in place, efforts to reduce double taxation in a tightened regulatory environment will be limited.

Taxpayers should review their intercompany transactions and consider those between entities in countries without a tax treaty and an effective MAP process. Further, as we discuss in more detail below, they should consider restructuring transaction flows to ensure that any tax-advantaged entity has the functional, asset and risk profile necessary to withstand the more critical scrutiny of intercompany transaction pricing that is certain to come.

Profit Splits Will Become More Prevalent

Another method for tax authorities to potentially tax a greater share of an MNE's worldwide profits is to employ a profit split. Traditionally, most taxpayers have relied largely on profitability-based methods, such as the comparable profits method or transactional net margin method, to support their transfer prices. These methods are typically applied in a manner in which the profitability outcome of the simpler entity is evaluated - rather than how the profit is split between the counterparties. The OECD's discussion draft on the use of profit splits in global value chains considers and seeks comment on scenarios where "one-sided" profitability-based methods might not produce an outcome in line with value creation and a profit split may be more appropriate.[3]

To protect against the arbitrary application of a profit split as the most appropriate method, taxpayers will need to be prepared to explain and support both sides of a transaction, even if they have applied a one-sided transfer pricing method. That is, even if a single member of the group is the "tested party" and earns only a routine return, with the residual profit accruing to the counterparty, it will be important to explain the functions performed, assets used, and risks borne by both entities to support the income earned in each jurisdiction. Otherwise, with increased visibility into profits earned by an MNE in different jurisdictions, tax authorities may be encouraged to split profit between entities using a factor of the tax authority's choice. Thus, a profit split could essentially provide tax authorities with a means of applying a variant of formulary apportionment. In order to avoid such a result, taxpayers should make sure that the result from any one-sided analysis is consistent with value creation.

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[1] OECD, *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* (2015), p. 3.
[2] OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (2014), p. 14.
[3] OECD, *Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (2015), p. 1.

Taxpayers who have separated the trading principal entity – likely operating in a low-tax country with a good treaty network - from the entity that owns intangible assets – often in a no-tax jurisdiction - may want to consider combining these operations. Ensuring that the low-tax principal has a robust functional, asset and risk profile will help blunt the impact of the application of profit splits with related counterparties with lesser functionality.

Taxpayers will also want to consider carefully their third-party arrangements to determine whether such arrangements are comparable to their related-party arrangements and can provide support of arm's-length dealings. Such internal comparables are likely to receive greater attention by tax authorities seeking to apply profit splits so it will be important for taxpayers to review them in detail. Likewise, they may prove invaluable to taxpayers in supporting their transfer pricing with actual third-party evidence of the manner in which they value certain functions.

Taxpayers Will Need to Revise Their Transfer Pricing Documentation

Under the new Transfer Pricing Guidelines related to documentation, MNEs with revenues over EUR 750 million will be required to complete a CbC report containing various information by jurisdiction including revenues, profit before income tax, number of employees, and amounts of tangible assets. While the report itself will create additional documentation requirements, the information contained in the report will require taxpayers to explain value creation within the overall group, and challenge them to match the levels of functionality, risks and assets to the allocation of income. As mentioned in the discussion of the profit split, increased transparency about the profits earned within the group requires taxpayers to explain both sides of a transaction.

The master file and local file approach embodied in the new documentation chapter in the Transfer Pricing Guidelines provides taxpayers opportunities to re-evaluate and strengthen their documentation position. The master file, which provides information on the group as a whole, offers the taxpayer an opportunity to develop the factual analysis and describe the important drivers of business profit and how those are aligned with the overall structure of the group and its transfer pricing arrangements. The local file further allows the taxpayer to explain the extent of the local affiliate's contribution to overall group profit.

Much will likely depend on the quality and depth of this documentation. It is vitally important that tax departments have a full grasp on what is being said in these documents and that the documentation be prepared carefully and consistently to present the group's transfer pricing in the best possible light. As transfer pricing practices and outcomes become fully transparent to all tax authorities, taxpayers must control all aspects of the facts on the ground and create the narrative to support their decisions and results.

Taxpayers Will Need to Evaluate Their Existing Transfer Pricing Structures

A large focus of the work of the OECD has been on the transfer pricing aspects of intangibles. The work in this area completed to date has helped to clarify the definition of intangibles under the Transfer Pricing Guidelines and to provide supplemental guidance for determining arm's length conditions for transactions involving intangibles. Work continues on the more thorny issues such as recharacterization and the valuation of intangibles based on ex-post results versus ex-ante forecasts (essentially a commensurate with income approach). But whatever final form the recommendations take, there appears to be support by many jurisdictions for requiring intangible ownership within an MNE to be aligned with the ability to develop, enhance, maintain, protect, and exploit such intangibles. The mere funding of intangible development may not enable a member of

the group to accrue economic income associated with such intangibles beyond a return on investment that is commensurate with the risk profile of the investment.

Whereas tax planning before the BEPS initiative may have focused on shifting risks and intangible ownership between members of a group, taxpayers will wish to pay greater attention to the functions performed by the different members of the group going forward. As the work on intangibles emphasizes, the profits earned by different entities will depend on value creation, and substance through value-adding functions will be vitally important. Taxpayers should work to ensure that those members of the group earning excess profits have the necessary substance and if they do not, work to enhance that substance.

The traditional "Intellectual Property Company," or "IPCo," that held and funded the rights to intangible assets and often collected residual profits within the taxpayer's transfer pricing structure, may need to be restructured. As mentioned previously, a combination of intangible assets, trading and investment risks and significant functionality likely provides the most defensible structure to centralize the profit successes and failures of the organization.

Taxpayers May Need to Consider the Use of Related Parties Versus Third Parties

A potential result of the BEPS initiative may be in how MNEs choose to operate globally. This risk of double taxation – particularly if it results in having excess profits attributed to a member of the group that provides what are clearly considered routine functions - may lead some MNEs to use third parties in a jurisdiction where they would have otherwise established a subsidiary.

For example, if the use of a related-party distributor or contract manufacturer means that a principal company could have a share of its profits taxed by another jurisdiction through recharacterization or another measure, then it may ultimately choose to mitigate such risk by contracting with third parties to perform such services. Hopefully, policymakers will consider distortive results such as these and their impacts on foreign investment when developing their recommendations.

Conclusion

Measures to eliminate BEPS are going to happen. We are now beyond the point of academic discussion of the matter. As the regulatory implications of those measures that impact transfer pricing come into sharper focus, the ramifications for taxpayers appear to be significant. We have identified a number of these transfer pricing implications and have presented some practical approaches for potentially addressing them. With proper planning the impacts of these changes likely can be somewhat mitigated. Taxpayers can develop policies and documentation to help themselves best manage their transfer pricing risk in a post-BEPS world.

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