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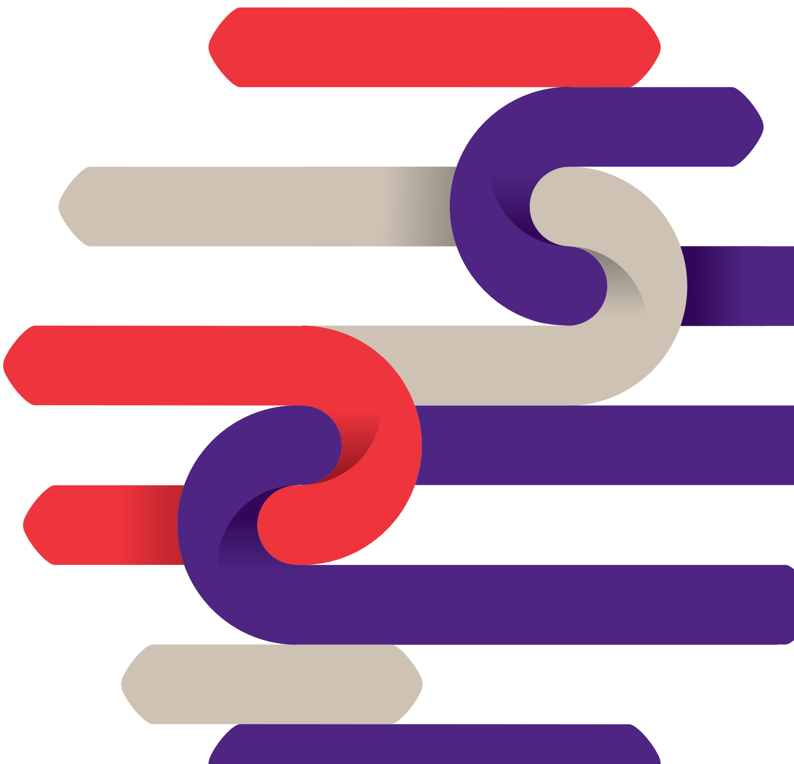
The brave new world of transfer pricing after BEPS

Nobody thought that complying with the Base Erosion and Profit Shifting (BEPS) transfer pricing (TP) analysis and documentation demands would be easy. Yet, the opening year has proved to make greater demands and has required more attention than many multinational enterprises (MNEs) had anticipated.

As MNEs find themselves swamped by multiple deadlines[1] in year two and beyond, the danger is failing to take the big picture view needed to make sure that the process is operationally sustainable and reliably compliant. A strategic view is also vital in managing the risks of disclosing such sensitive and easily misinterpreted data. So how can your business keep up with the group policy analysis and documentation demands, get on top of the risks and present a clear, consistent and well thought-through 'tax story'? Grant Thornton TP teams have been working with the OECD and many government tax authorities and groups for many years and have gained valuable experience that we are pleased to share.



[1] New transfer pricing documentation guidelines set out in the OECD's BEPS Action 13 are being progressively introduced around the world. Country-by-country reporting is one of the four minimum standards to which more than 100 countries and jurisdictions have committed.

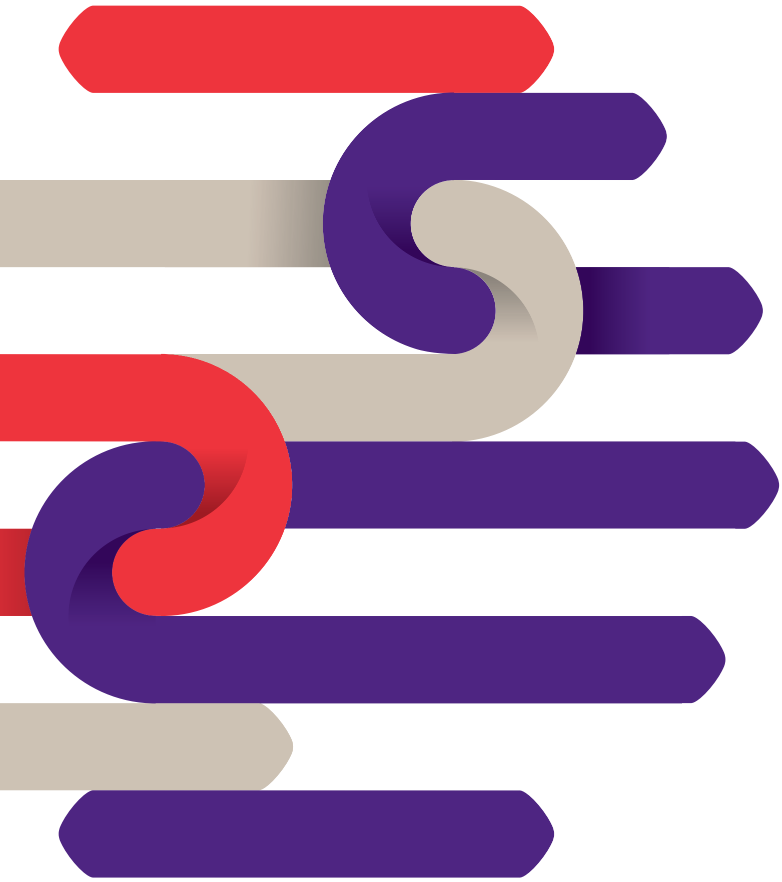
Transfer pricing minds

By opening up TP to the closest possible scrutiny and potential challenge, BEPS Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) was never going to be a narrow or straightforward compliance exercise.

While it's the transaction-level detail in the local file that tax authorities are likely to be most interested in, the master file provides them with a revealing blueprint of profit drivers, intercompany financing and TP policies within the group. The master file also includes a breakdown of the development, enhancement, maintenance, protection and exploitation (DEMPE) lifecycle of intangibles, through which the costs and returns from the functions performed, assets used and risks assumed can be evaluated and reviewed for TP purposes.

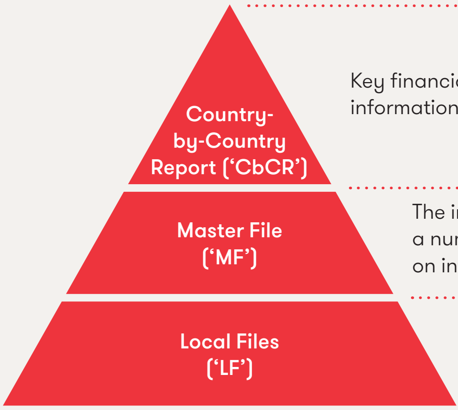
Last, but by no means least, country by country (CbC) reporting enables tax authorities to compare ratios like the size of the workforce (a proxy for value generating 'substance') against the share of the tax take in each of the MNE's operating territories.

BEPS Action 13 doesn't deal with the gathering and documentation of information in the same way as groups treat their related party transactions. Action 13 implicitly requires that groups define their TP and tax strategy, properly identifying risks and mismatches within the group. They then find measures, solutions and remedies for these before going on to set this out in the documentation to support their transfer pricing.



> " Action 13 implicitly requires that groups define their TP and tax strategy, properly identifying their risks and mismatches within the group."
>
> **Juan Martinez**
> Partner
> Grant Thornton, Spain

Three-tiered approach



Key financial information on all group members on an aggregate country basis. This includes information on income, earnings, taxes and certain measures of economic activity.

The information required in the Master File provides a 'blueprint' of the group. There are a number of additional sections and information to be included by groups. These focus on intangibles and financing.

The Local File should provide information that is more detailed and support of the intercompany transactions that the local company engages in with related parties.

The TP documentation demands open up sizeable operational challenges – meeting reporting deadlines and recording accurate and consistent information. They also raise far-reaching strategic questions – does TP reflect the substance of where and how value is created and exchanged within your business? How can you justify your TP approach? What policies and transactions could tax authorities focus on as a basis for TP audit and additional tax demands?

In March 2018, tax professionals from around the world joined leading TP specialists from Grant Thornton to explore the documentation demands, likely areas of tax authority scrutiny and associated risks for a typical MNE.[2] Drawing on the workshop discussions and case study evaluations, here we look at possible solutions for managing TP documentation in this 'brave new world'.

> "How Ireland will implement the latest OECD TP guidelines should become clearer in the coming months, following the Coffey report publication and subsequent consultation phase. Other transfer pricing changes in Ireland, such as the extension of transfer pricing to non-trading transactions, are also under consideration."

Peter Vale
Partner
Grant Thornton, Ireland

[2] The workshop formed part of TP Minds International 2018.

"Now the rules have been finalised, there may be a clearer roadmap for what's required."

Brad Rolph
Partner
Grant Thornton, Canada

Sustainable programme for generation of reports

For most MNEs, especially those with smaller and less well-resourced tax teams, the main priority has been simply getting over the line, rather than focusing on the strategic issues.

Now the rules have been finalised, there may be a clearer roadmap for what's required. However, the diverse implementation timelines worldwide are forcing MNEs to juggle multiple deadlines. Many countries have also introduced their own specific requirements (eg the additional demands with the master file in India).

Implications

Many groups were mainly concentrating on the deadlines in year one, with the result that the master file was insufficiently focused. How can your business make the process more manageable and the outputs more accessible, clear and comprehensive?

Further operational questions include whether you should start from the local files and work up to the master file or vice-versa. This question is complicated by the need to ensure full consistency between the different tiers of reporting and present the local files in national languages. Related considerations include how much of this process should be carried out in-house and how much outsourced?

Actions

1 Well-planned delivery

You need to have a clear view of the TP documentation and reporting deadlines, and how these overlap with tax returns so that resources are in place to comply on time.

A lot of the necessary data and documentation would need to be collated and prepared from scratch – who needs what, where and when? Some documentation may already be in place – how can you identify and deploy what you have?

2 Manageable length

Year two is likely to see a move towards briefer, but more strategically focused documentation and disclosure. This in turn demands a chart of where value is created, how the value is transferred through the DEMPE lifecycle and whether TP reflects the substance of value generation.

3 Central versus local

The extent to which the lead is taken centrally or locally will largely depend on the business model and how resources within the tax team are distributed. Whatever approach is taken, there should be close collaboration and adequate information exchange between local and central teams. Local teams should also retain ultimate responsibility for the details, rather than passing everything up to the centre.

Avoid 'keeping secrets' within HQ. Without collaboration and information exchange, key data can slip through the cracks or inconsistencies could emerge within the different tiers of reporting. Failure to consult and share data may also mean that tax authorities have access to sensitive information before local tax teams, leaving your people on the ground on the back foot when dealing with enquiries and investigations.

4 In-house or outsourced

TP advisors can provide valuable support for central teams, including helping to develop templates for reporting and comparing disclosures against regional or industry benchmarks. In turn, local advisors can provide guidance on compliance and avoiding penalties, along with helping you to manage possible audits. However, it's important not to become overly dependent on outside resources. This includes retaining responsibility for information gathering and communication management in-house – there is too much at risk for this to be entirely outsourced. It's also important that internal and external teams adopt a consistent approach throughout – a piecemeal approach could make it harder to get everyone on the same page.

5 Have the evidence ready

To corroborate your documentation, it's important to specify the terms and conditions of related party transactions (eg currency, delivery terms and payment terms). It's also important to prepare intercompany invoices and intercompany agreements for all transactions and be ready to show that these are recorded in your books.

> "Documentation alone doesn't guarantee compliance."
>
> **Leslie Van den Branden**
> Partner
> Grant Thornton, Belgium

Taking control

Documentation risks include: the absence of necessary data or failure to comply with local regulations. Yet, documentation alone doesn't guarantee compliance. Key considerations include whether the functions, assets and risks are in line with your economic results. Tax authorities are likely to look closely at potential mismatches between documentation, tax returns and financial statements. It's also important to assess whether the data on functions, assets and risks is up to date. This can be challenging in businesses where there is significant innovation, expansion and/or M&A.

Implications

Taking control of the process and managing the risks demand regular and extensive review, justification and oversight, much of which would need to be applied locally. Benchmarks carried out centrally or testing the profitability of a transaction on a single country basis aren't always sufficient – many countries need to be brought into the analysis. Similarly, you can't meet local TP tax return requirements without referring to the master and local files.

Actions

1 Define and execute your TP strategy

Develop a TP strategy to guide your approach. The strategy would include the steps needed for full compliance, as well as outlining your risk appetite and desired relationship with tax authorities (eg what level of engagement and approval of policies do you want upfront?).

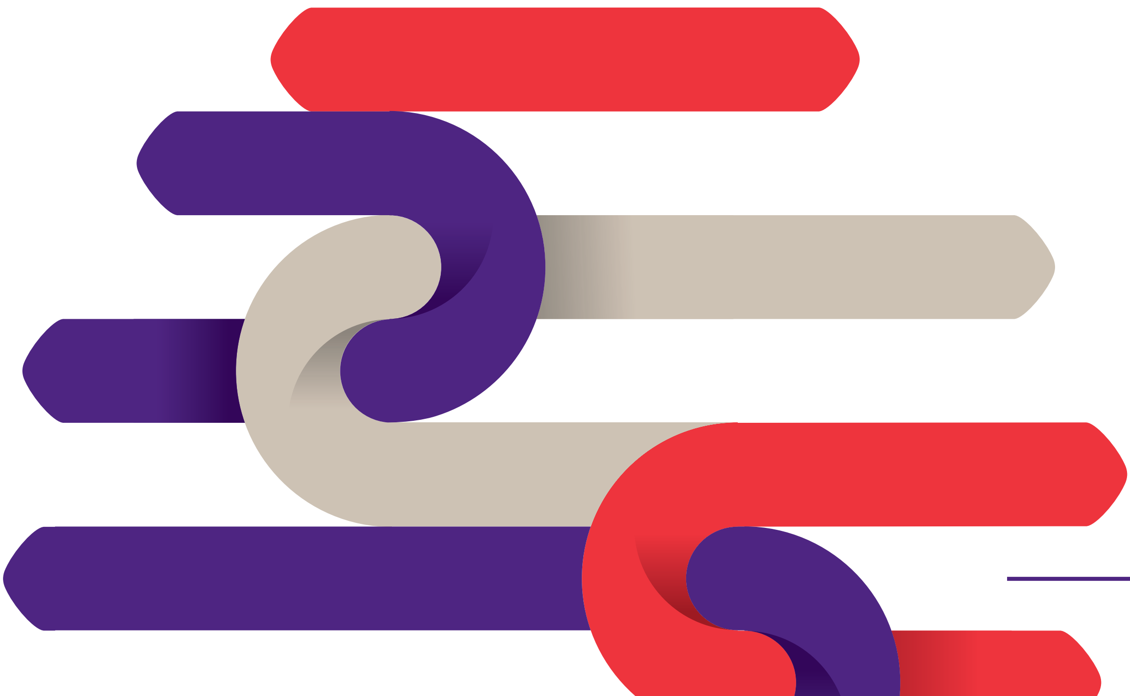
Building on these foundations, policies should be designed and applied consistently in each operating territory. Further priorities include harmonisation with other group data (eg VAT) through regular exchange of information.

2 Adopt a risk-based approach

A risk-based approach would build your TP strategy into a TP risk assessment process and overall tax control framework. Risk evaluations would include regular review and updating of intercompany agreements and function, asset and risk data.

3 Get on the front foot

Proactive steps to alleviate potential risks can include working with tax authorities to develop bi-lateral or multi-lateral advanced pricing agreements (APAs) – unilateral APAs may be of limited value here. The APAs would help to validate TP approaches and avoid the risk of audit and disputes. Alternatively, careful attention to mutual agreement procedures (MAPs) may offer a faster and smoother path to managing possible audits and resolving litigation.



Telling your tax story

Tax authorities are determined to make the most of the new documentation and disclosures. This includes hiring data specialists to mine and analyse the TP information more intensively. This analysis isn't just being used to review particular companies, but also set industry benchmarks.

Many tax authorities are in turn using the CbC reporting to search for possible shortfalls in the tax being paid to them. For example, a local tax authority could compare the headcount to the amount of tax a company is paying in their jurisdiction and conclude that they are missing out on their fair share of the overall tax take.

Implications

While your TP policies and how they're applied may be perfectly justified, the intense level of scrutiny requires a more proactive and robust defence. What 'story' is your data telling? How can you get on the front foot by shaping the narrative, rather than allowing this to be set by the tax authority? The need to develop your story is heightened by the growing tendency among tax authorities to focus on the easier to discern functions performed, while the more complex assets used and risks assumed are less prominent in the revenue allocation evaluations they may adopt.

Actions

1 Set your own narrative

Judge whether your policy approach can still be justified and if so how. Setting a clear narrative is especially important in relation to transactions that are likely to be challenged by tax authorities.

For example, a tax authority might ask why so much of the TP compensation is allocated to a territory with only a few active personnel, while another with plenty of staff receives less. However, there could be quite legitimate reasons why headcount may be at variance from the value generated and hence tax paid. In a case in point, a dozen designers or IT programmers in one country may generate more value than hundreds of people assembling or packing the resulting products in another location.

Similarly, ownership may be assigned on the basis of risks assumed to a territory where these risks haven't materialised – so far at least. Yet that doesn't mean that there's no risk – even though a house hasn't burned down, it still needs protection against the possibility and the owner of the asset is responsible for managing this (eg putting in safeguards or taking out insurance).

2 Align with substance

Some operations may indeed lack sufficient substance and the CbC reports would highlight this. Some restructuring or relocation could be necessary in such cases to avoid tax challenge and audit.

> "A tax planning and strategy definition exercise needs to be carried out and implemented, so that TP documentation is consistent and aligned with policy."

Wendy Nicholls
Partner
Grant Thornton, UK

Prevention is better than cure

TP documentation is one of those areas where a business might think 'I've filled in the templates, everything is in on time and therefore everything is fine'.

However, in reality, TP documentation under BEPS goes much further and opens up a host of potential pitfalls. Key documentation may be missed – the three tiers and multiple deadlines heighten such risks. The documentation and underlying policies may also be inconsistent with other returns or even between what's presented in the local file, master file and CbC reports. Consider whether APAs can be useful for some transactions too.

A tax planning and strategy definition exercise needs to be carried out and implemented, so that TP documentation is consistent and aligned with policy. This exercise should be completed quickly, as other actions such as the automatic exchange of information may bring an inaccurate perspective on your business from the different authorities.

Tax authorities are keen to maximise the additional tax generating potential and will run analytics on your data – so you should do that too, as a risk review tool. Consider how to explain, for example, why measures like revenues per employee or profits compared to assets may differ for commercial reasons, depending on the activities and markets of each group entity. This proactive risk assessment can minimise your risks. Leaving this to chance could lead to lengthy and protracted audits, tax disputes and remediation.

That's why it's vital to be clear about what's involved, how you can take better control and how you can set the narrative. Time and investment now can save a lot of needless expense and aggravation further down the line.

If you would like to discuss any of the areas raised in this article, please contact your local Grant Thornton adviser or one of the contacts listed.

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"Proactive risk assessments and possible APAs can help to minimise risk."

Paolo Besio
Partner
Grant Thornton, Italy

Global transfer pricing guide

For further information on the different transfer pricing rules and regulations in key countries see our Global transfer pricing guide at www.grantthornton.global/transferpricingguide.

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