Insights: Transfer Pricing

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Global tax reform emerging from BEPS Action Plan

On October 9, 2015, during the G-20/OECD BEPS Press Conference, US Treasury Secretary Jacob J. Lew announced, "the United States formally accepts the deliverables from the G-20/OECD base erosion and profit shifting, or BEPS, project that addresses international rules governing the taxation of company profits."[1] According to the US Treasury Department (Treasury), the Country-by-Country (CbC) Report template is expected to be very similar to what was released in the BEPS final package on October 5, 2015. The Treasury proposes, through the 2015–2016 Priority Guidance Plan, to include CbC reporting under Internal Revenue Code (IRC) Section (§) 6011 and §6038. Furthermore, the Treasury and Internal Revenue Services (IRS) has released temporary regulations to incorporate BEPS' guidelines to measure arm's-length results in IRC § 482. It is anticipated that temporary regulations will be released to implement CbC Reports in the US for tax years beginning January 1, 2016.

The Treasury announcement follows the pattern of international tax reforms (and proposals for reform) that have emerged around the world. There appears to be a consensus across governments to implement the guidance on transfer pricing documentation as contained in the final Action Plan 13 of the BEPS project. To date, some foreign governments have implemented the three-tiered approach to documentation requirements, while other governments have proposed or implemented reforms that vary in the documentation that multinational enterprises (MNEs) will be required to submit. As we move closer to the beginning of fiscal year 2016, we are witnessing a rise in governments who favor implementing BEPS.

Michael McDonald, Financial Economist at the Treasury and US delegate to the OECD for transfer pricing issues, stated that the Treasury is preparing temporary regulations that will be released by the end of the year to implement CbC Reports in the US for tax years beginning January 1, 2016. [2] Across the world, governments are making a similar pledge to examine global transfer pricing policies to prevent base erosion and profit shifting of a collective tax base. According to McDonald, a

[1] US Department of the Treasury, "Statement by Treasury Secretary Jacob J. Lew at the G-20/OCED BEPS Press Conference," news release, October 9, 2015, https://www.treasury.gov/press-center/press-releases/Pages/jl0204.aspx.

[2] "The Total Impact of BEPS on Transfer Pricing," BEPS webcast series, PricewaterhouseCoopers LLP, October 15, 2015 (webcast).

timely implementation of the BEPS Action Plan shows positive political commitment from member governments to make BEPS work.[3]

Response to BEPS by country

The table below summarizes the adoption status of BEPS by certain countries.

Country	Plans to adopt BEPS or has draft amendment	Adopted BEPS in local legislation
Australia	X	
Brazil	X	
Canada	X	
China	X	
Denmark		X
France		X
Germany	X	
Hungary		X
Ireland		X
Luxembourg	X	
Mexico		X
Netherlands	X	
New Zealand	X	
Nigeria		X
Norway		X
Poland		X
South Korea		X
Spain		X
Switzerland	X	
United Kingdom		X

Addressing issues

The guidelines set forth in Action Plan 13 have been received by some with a degree of uncertainty, primarily around the new information being requested and with the BEPS mission to increase transparency across governments. Questions have been raised with regard to how governments will interpret the new guidelines and how these guidelines will be translated into law. More concerning is the uncertainty of whether safety measures will be put in place to protect sensitive company information provided to foreign governments.

For compliance purposes, the new reporting recommendations mandate additional transfer pricing reports calling for additional financial data and information regarding MNE’s operational activities. Not only are taxpayers and government officials skeptical about sharing data with foreign governments, they are also concerned about tax authorities lacking resources to implement CbC requirements for the 2016 tax year.

[3] *Ibid.*

In a letter to the Treasury, Sen. Orrin G. Hatch (R-UT), Chairman of the Senate Finance Committee, and Rep. Paul D. Ryan (R-WI), Chairman of the House Ways and Means Committee and newly elected Speaker of the House, stated, "we are concerned about the CbC reporting standards that will contain sensitive information related to a U.S. multinational's group operations. We are also concerned that the Treasury has appeared to agree that foreign governments will be able to collect the so-called "master file" information directly from U.S. multinationals without any assurance of confidentiality or that the information collected is needed."[4]

To address these uncertainties, the Treasury has noted that the CbC Report will be collected by the United States, and that the information contained within the CbC Report will be disseminated to treaty-partner governments. McDonald stated that by coordinating the distribution of CbC information with treaty-party governments, the Treasury is working to safeguard some important confidentiality concerns raised by the US and other governments.[5] Addressing concerns regarding the information of US corporations, McDonald noted that the corporate sector is highly concentrated in the United States, and that the Treasury estimates only 10% of MNEs will meet the EUR 750 million threshold. This 10%, however, is expected to cover 90% of the international transfer pricing activity, and will save 90% of MNEs from the burden of completing the CbC Report.[6]

Changes to transfer pricing guidance

The temporary regulations, to be released by the end of 2015, are expected to be very similar to the guidelines released in the BEPS Final Package. Key changes to the guidance on transfer pricing encompass new methodologies to determine the allocation of risk and the concept of value creation that will be considered in addition to the traditional transfer pricing analyses, which consider the functions performed, assets employed, and risks assumed by a particular tax payer. Under the new guidelines, the allocation of risk should be analyzed in consideration of an enterprise's capability and functionality to manage risk.

According to Action Plan 8 through 10, "to assume risk for transfer pricing purposes, the associated enterprise needs to control the risk and have the financial capacity to assume the risk."[7] Transfer pricing transactions will now analyze risk in relation to the contribution (or value creation) of each related party in a transaction, the actual activities performed, control over strategic decisions, management or allocation of financial resources, and the assumption of all risk related to development, enhancement, maintenance, protection, and exploitation of intangible property.

The OECD's new process-based approach, rather than stand-alone independent guidance, on how to allocate risk, is achieved through the following six steps:

1. Identify economically significant risk

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[4] The US Senate Committee on Finance, "Hatch, Ryan Call on Treasury to Engage Congress on OECD International Tax Project," news release, June 9, 2015, http://www.finance.senate.gov/newsroom/chairman/release/?id=ff0b1d06-c227-44be-8d5a-5f998771188b.

[5] *See supra* note 2.

[6] *Ibid.*

[7] OECD, "Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports," OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. (2015) DOI: http://dx.doi.org/10.1787/9789264241244-en.

2. Determine how economically significant risk is contractually assumed by related parties
3. Through a functional analysis, determine how the related parties operate in relation to the assumption and management of the economically significant risk, and in particular, which party performs control functions and risk mitigation functions, which party encounters upside or downside consequence of said risk, and which party has financial capacity to assume risk
4. Interpret steps 1 through 3 to determine whether contraction assumption of risk aligns with the functions performed, risk assumed, and how related parties are compensated
5. Where a related party assumes risk, does not control the risk, nor has financial capacity to assume risk, the guidance on allocating risk must be applied
6. Transfer pricing should consider risk allocation and take into account financial and other consequences of risk assumption and risk management functions

CRA's CbC diagnostic tool

To address the new CbC reporting requirements, CRA developed a proprietary diagnostic tool that provides taxpayers with meaningful insights into a company's global transfer pricing position. Based on BEPS concepts of value creation and risk alignment, CRA's diagnostic tool (i) automates the creation of CbC Reports; (ii) provides macro view insights of company operations; and (iii) generates analyses for tax audit defense. Additionally, CRA's transfer pricing advisors help companies address the challenges posed by BEPS, diagnose potential problem areas within an organization, and create robust processes and procedures to strengthen the organization from an operational and compliance perspective, thereby reducing tax burdens and compliance expenses.

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