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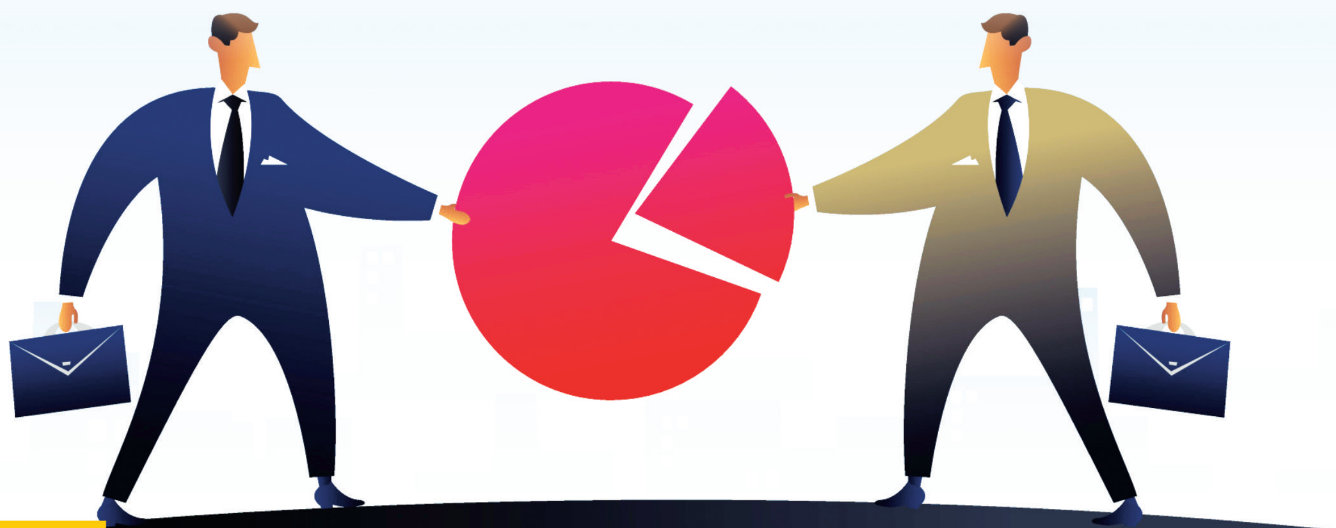

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OECD Guidance on Transfer Pricing Documentation – A Move towards Greater Transparency and Global Reporting

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WHAT IS BEPS?

Base Erosion and Profit Shifting ('BEPS') is referred to as shifting of profits across jurisdictions to take advantages of differential tax rates. The popular mechanisms for doing this are hybrid mismatches, special purpose entities (SPE), and Transfer Pricing (TP). With more than 60% of world trade taking place within multinational enterprises (MNEs), TP (the setting of prices for goods, services, intangibles etc. sold between controlled (or related) legal entities within an enterprise) is one of the most commonly used tool by MNEs for purposes of tax planning. Tax rules across the world are generally efficient in ensuring that companies are not subject to double taxation, but few MNEs takes advantage of gaps in the rules to avoid paying taxes in the jurisdiction where profit generating economic activities are carried out. BEPS strategies adopted by MNEs have resulted in loss of revenue to the Governments and further provided an undue competitive advantage to the MNEs *vis-à-vis* the small and medium enterprises (SMEs).

OECD and G20[1] countries have been working together on a 15-point Action Plan to combat use of BEPS by MNEs. The Plan recognizes that greater transparency and improved data sharing among Governments are needed to evaluate and stop the growing disconnect between jurisdictions where the profit generating economic activities are carried out and those jurisdictions where MNEs report profits for tax purposes.

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- The views and opinions expressed herein are those of the authors and are personal.

OECD/G20 BEPS PROJECT

During July 2013, the OECD launched the action plan on BEPS identifying 15 specific actions (which are scheduled to be finalized in three phases: September 2014, September 2015 and December 2015). The BEPS initiative aims at achieving greater corporate transparency by providing the tax authorities with a high level of visibility into international corporate structures of MNEs and the location of corporate profits. The primary objective of the BEPS project is income and profits should be allocated and taxed in the jurisdictions where there is value creation and not merely where capital and risks are located. The project plans to develop a new set of standards to prevent double non-taxation.

As part of its Action plans, OECD had released draft guidance for public consultation on TP documentation and Country-by-Country (CbC) reporting under BEPS Action Plan (Action No. 13) on January 30, 2014. The discussion paper proposes to replace Chapter V (Documentation) of the existing OECD TP Guidelines and suggested a two tier approach for TP documentation containing a 'Master file' and a 'Local file'. The information/ disclosure to be given under the proposed guidance includes details like MNE group's organizational structure, business description, intangibles, inter-company financial activities, financial and tax position as well as CbC reporting of details such as place of management of each entity, revenue, earnings, tax paid, number of employees, etc.

Continuing the momentum on the above, on 16 September 2014, the OECD issued final guidance on TP Documentation and CbC Reporting (as part of its first set of recommendations on 7 action points for combating international tax avoidance by the MNEs).

The intended objective of the Guidance on TP documentation is:

1. To ensure that taxpayers give appropriate consideration to TP requirements in setting prices and conditions for intercompany transactions and in reporting the income derived from such transactions in their tax returns;
2. To provide tax administrations with the information necessary to conduct an informed TP risk assessment; and
3. To provide tax administrations with useful information to facilitate conducting a thorough audit.

The OECD has prescribed a 'three-tier' documentation structure consisting of a:

Master file containing standardized information relevant for all MNE group members, such as:

i. Organization structure;

ii. Description of the MNE's business;

iii. MNE's intangibles (as defined in Chapter VI of the OECD Guidelines);

iv. MNE's intercompany financial activities;

v. MNE's financial and tax positions.

OECD has clarified that the Master file is intended to provide a high-level overview of the MNE group's TP practices in their global, economic, financial and tax context. It is not intended to require exhaustive listings of *minutiae* (*e.g.* a listing of every patent owned by members of the MNE group). In producing the Master file, including lists of important agreements, intangibles and transactions, taxpayers should use prudent business judgment in determining the appropriate level of detail for the information supplied, keeping in mind that the Master file should typically provide a 'blueprint' of the MNE group. For purposes of creating the Master file, it has been stated that information is considered important if its omission would affect the reliability of the TP outcomes. Use of specific cross referencing to other existing documents to satisfy the relevant requirement in the Master file has been approved.

In terms of disclosure requirements, the following have been specifically included.

- Thresholds for reporting a description of the supply chain of products/services have been defined.
- The disclosure relating to the description of important service arrangements between members of the MNE group has been explained to include a description of the capabilities of principal locations providing important services and TP policies, for allocating services costs, and determining prices to be paid for intra-group services.
- With respect to the disclosures related to intangibles, the Report clarifies that disclosure required is for the entities which 'legally' own the intangibles.

Based on representations and public consultations, the OECD has excluded reporting of information such as location of 25 most highly compensated employees, and information relating to the MNE group's TP matters under Mutual Agreement Procedure (MAP) and Bilateral and Multilateral Advance Pricing Agreements (APAs), from the Master file (which was outlined in the earlier draft guidance).

Local file providing more detailed information relating to material transactions of the local taxpayer. The information contained in the Local file should supplement the Master file and assist in meeting the objective of assuring that the taxpayer has complied with the arm's length principle in its material TP positions affecting a specific jurisdiction. The key additional disclosure requirements include detailed description of the business and business strategy pursued by the local entity; key competitors of the local entity; intra-group payments and receipts (*i.e.* payments and receipts for products, services, royalties, interest, etc.) broken down by tax jurisdiction; material intercompany agreements and copies of existing unilateral/bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is 'not' a party and which are related to controlled transactions. The OECD has allowed use of specific cross referencing to information contained in Master file to satisfy the information requirement in the Local file.

CbC report requires aggregate tax jurisdiction wide information relating to the global allocation of the income, taxes paid and certain indicators of the location of economic activity within the MNE group. It is worthwhile to note that the CbC report (which earlier was proposed to be a part of the Master file) has been prescribed as a separate document with requirements being bifurcated under two heads, namely "By Jurisdiction" and "By Constituent Entity".

The disclosure requirements under the head "By Jurisdiction" include the following:

(*i*) Tax jurisdiction;

(*ii*) Revenues – To related party and to unrelated party;

(*iii*) Earnings before tax;

(*iv*) Income tax paid (on cash basis) and accrued;

(*v*) Stated capital and accumulated earnings;

(*vi*) Number of employees;

(*vii*) Tangible assets (other than cash and cash equivalents)

The disclosure requirements under the head "By Constituent Entity" include the following:

(*i*) Tax jurisdiction of organization or incorporation if different from tax jurisdiction of residence; and

(*ii*) Main business activity.

It has been clarified that CbC report should not be used by tax administrations to propose TP adjustments based on a global formulary apportionment of income. In addition, the CbC report may be used by tax administrations in evaluating other BEPS related risks and where appropriate for economic and statistical analysis. Further, the CbC report should include all tax jurisdictions in which the MNE group has an entity resident for tax purposes, regardless of the size of business operations in that tax jurisdiction.

The OECD has also noted that some countries (for example Brazil, China, India, and other emerging economies) may like to add additional transactional data in the CbC report (in addition to what is available in the Master file and Local file) regarding interest, royalty, and related party service fees. In this context, OECD will review the implementation of the new reporting standards before the end of 2020 to decide whether modifications to the content of the report should be made to, for reporting of additional or different data.

COMPLIANCE ISSUES

In respect of compliance, useful guidance has been provided as under:

- *Timeframe* – it has been stated that the Master file should be reviewed and, if necessary, updated before the tax return due date for the ultimate parent of the MNE group. In respect of the Local file, the practice would be for the Local file to be finalized no later than the due date of the tax return for the respective fiscal year.
- *Materiality* – it is recommended that measures of materiality may be considered in relative terms (*e.g.* transactions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (*e.g.* transactions not exceeding a certain fixed amount). Individual countries should establish their own materiality standards for local file purposes, based on local conditions. While it is acknowledged that SMEs should not be required to produce as much documentation as larger corporations, however SMEs should be obliged to provide information about their material cross border transactions upon a specific request of the tax administration.
- *Frequency of documentation updates* – the Master file, Local file and CbC report should be reviewed and updated annually. Towards this end, it has also been recommended that as long as the operating conditions remain unchanged, while financial data for the comparables should be updated every year (in order to apply the arm's length principle), tax administrations may consider having the searches in databases for comparables supporting part of the Local file, to be updated every 3 years rather than annually.
- *Language* – it is recommended that language in which the TP documentation should be submitted should be established under local laws (a departure from the draft guidance which recommended that the Master file should be prepared in English and the Local file and relevant parts of the Master file in the local language). Countries are encouraged to permit filing of their TP documentation in commonly used languages where it will not compromise the usefulness of the documents.
- *Penalty* – The earlier recommendation in the draft guidance on imposing sizeable documentation related penalties on taxpayers that make a reasonable effort, in good faith, to demonstrate through reliable documentation that their controlled transactions satisfy the arm's length principle, has been deleted. Instead it is recommended that penalty for non-maintenance of documentation should not be imposed in case where MNE group does not have access. OECD also recommends ways to encourage taxpayers to fulfil TP documentation requirements by designing compliance incentives such as penalty protection or a shift in the burden of proof.
- *Confidentiality* - It is reiterated that tax administrations should take reasonable steps to ensure that there is no public

disclosure of confidential/commercially sensitive information. Towards this end, it is recommended the OECD Guide "Keeping It Safe" on the protection of confidentiality of information exchanged for tax purposes, which provides guidance (on the rules and practices that must be in place to ensure the confidentiality of tax information exchanged under exchange of information instruments) should be used.

- *Implementation* – It is suggested that taxpayers should deliver the Local file directly to tax administrations in their relevant local jurisdiction. There are, however, different views about the filing process for the Master file and the CbC report, and consequently about the mechanisms by which the information is to be made available to tax administrations in all relevant countries. It has been clarified that during the next several months, Working Party No. 6 of the Committee on Fiscal Affairs will undertake an analysis of potential mechanisms for filing and disseminating the Master file and the CbC report.

Impact on India

- Being a member of the G20 nations and as a member of BEPS bureau; India is actively and closely involved in the BEPS action plan and has been an active observer nation. This active involvement has also been endorsed *via* the comments made by the Joint Secretary & Competent Authority of India, Mr. Akhilesh Ranjan at the time of the release of the draft guidance, affirming that India would support the proposed two tier documentation suggested in the discussions as he believed that this would help India in making a proper risk assessment of the cases which require TP audits and will also be beneficial to taxpayers. He had affirmed that the Indian Revenue authorities (IRA) shall seek to implement the above actions in the Indian TP regulations and in administration of taxes. While ratifying India's support to the BEPS initiative, the Indian Minister of State of Finance Ms. Nirmala Sitharaman on September 22, 2014 at the G20 Finance Minister's meeting on International tax, highlighted that concerns of developing countries regarding BEPS may be different from those of developed countries and when reaching consensus, developing countries' concerns ought to be taken on board in a more consultative manner.[2]

- While there is merit in the intended objective of permitting tax administrations to have adequate information to facilitate a robust risk assessment, however in the Indian context, considering the history of aggressive TP audits faced to date coupled with the 'trust deficit' prevailing between tax payers and the IRA, taxpayers operating in India could be particularly vulnerable to this risk of information not being objectively used. The IRA may seek the Master file and the CbC report maintained by the headquarter of the MNE and may show interest in reviewing the global value chain of the MNE as revealed from these documents, to evaluate whether the TP outcome to the Indian entity is consistent with value creation in India. It is likely that the IRA shall scrutinize business structures more closely and the onus will be on MNEs to provide evidence of commercial substance.

- The documentation requirements prescribed in the Indian TP regulations under Section 92D of the Indian Income-tax Act 1961 read with Rule 10D of the Indian Income-tax Rules, 1962 are adequately robust. Therefore the additional information required to be collated, analysed and documented is likely to increase taxpayer efforts multi fold. The challenge in collating the information to prepare the Master file and CbC reports lies with the availability of information and application of business rationale defining the materiality of the information to be reported. The simple reason being reluctance of a prudent business man to share the business information across the same group due to many factors including confidentiality.

- From a confidentiality perspective, the recommended approach has greater risk of exposure of client confidential information. Therefore, taxpayer preference for a stringent confidentiality regime with regard to the filing of information in the parent company's jurisdiction and sharing this under the exchange-of-information articles in tax treaties or tax information exchange agreements is of strategic importance.
- The timing of the information could also create a huge burden for taxpayers especially where country reporting adopts different time periods. The positive recommendation to allow companies with stable operating conditions to update the searches only every 3 years with updation of financial data for comparables every year, is positive and should help in controlling the compliance costs of MNEs.
- Overall in the Indian context, the existing TP provisions related to maintenance of documentation to establish arm's length pricing and reporting of all international transactions, specified domestic transactions and deemed international transactions in the Accountant's report in Form No. 3CEB is already an arduous task. In addition to these existing provisions, bringing in the requirement of Master file and CbC report will likely be a more daunting task for MNEs operating in India considering the fact that every piece of information on the Group and the value chain is likely to be used by the IRA in its potential attempt to attribute a greater value on the goods and services delivered from India. Moreover it is to be seen that with the concepts of 'Location savings' and the 'Bright line test' on marketing intangibles, whether documentation relating to CbC shall be used as tools for the IRA to undertake adjustments to the reported international transactions of the taxpayers.
- However with the Indian Government's current approach of building an investor centric/pro business image and its continual assurances of attempts to thwart 'tax terrorism', the likelihood of the information being used aggressively against the taxpayers could be anticipated to be low. Having said that, with the belligerent approach adopted by the Indian Government on 'tax transparency' and 'black money/money laundering', there would be greater focus in having documentation reporting aligned with the global best practices.

WAY FORWARD

With the release of the final guidance on the Documentation and CbC reporting outlined in Action Plan 13, the OECD is bringing together 44 countries on an equal footing (with its member countries, OCED accession countries and G20 countries) and laying stronger emphasis on new uniform reporting obligations sought to be applied globally. While its purpose is to enhance transparency 'for tax administration' taking into account compliance costs for business, the uniform adoption of the rather complex proposed CbC reporting template will need to be seen.

Taxpayers on their part would do well to consider the following in light of the final guidance as per Action Plan 13:

- Review operations and business structures to identify areas of TP risk;

- Review existing TP documentation and prudently evaluate whether it supports substance;
- Mobilize resources and commence work to prepare for the prescribed requirements and develop infrastructure to support the same - specifically the Master file and CbC reporting;
- Anticipate greater level of scrutiny/audit by the Revenue authorities;
- Evaluate the option of seeking APA/MAP/alternate dispute resolution mechanisms to gain certainty on TP issues at the right time.

Tax administrations worldwide should objectively decide whether or not, and where, to allocate scarce uncoordinated resources to deal with BEPS, take steps to simplify compliance requirements and have regard to genuine business transactions of taxpayers. This is because documentation reporting is of interest not only for taxpayers and tax authorities alike, but also for stakeholders as it could reveal whether the tax system is working effectively and objectively towards balancing business and fiscal considerations.

1. The Group of Twenty (also known as the G-20 or G20) is a forum for the governments and central bank governors from 20 major economies. The members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.
2. Press Information Bureau release of the Text of the Intervention Made by the Minister of State of Finance in the G20 Finance Minister's Meeting on International Tax; calls for Implementation of the New Global Standards on Automatic Exchange of Information with A Common Timeline and with coverage of as Many Countries as Possible