The action plan

CLAIRE COOK highlights the OECD's final recommendations under the base erosion and profit shifting project in October 2015.

The base erosion and profit shifting (BEPS) project was launched in early 2013 at the request of the G20 group of countries. It followed increasing concerns from the Organisation for Economic Cooperation and Development (OECD) member tax authorities that multinational companies were exploiting disparities between international tax regimes, causing significant loss of revenue.

BEPS refers to tax planning strategies that exploit these gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. A key concern was the ability of some multinationals to make substantial profits in a market without having a physical presence there and booking the profits in a low tax jurisdiction.

The OECD produced its first formal report in February 2013 and in July 2013 produced the 15-point BEPS action plan (tinyurl.com/pl5d9f2) to provide governments with the ability to close loopholes in the international tax framework. Final reports on the 15 actions were made available by the OECD in October 2015, although work on their implementation continues.

In the transfer pricing arena, the concerns were that multinationals could erode profits in high-tax jurisdictions by making payments for the use of intangible assets that had been transferred to a low-tax jurisdiction. Also of concern were scenarios in which contracts between related parties did not reflect the risks borne. Such structures allowed high rewards to be earned that were out of proportion to the risks undertaken. Tax authorities also wanted a mechanism to obtain access to the locations in which a multinational's profit and tax arose, so that they could compare these to the amounts where the business activities were located.

The BEPS project originally identified several actions points on transfer pricing:

KEY POINTS

- International tax planning by multinationals has resulted in significant loss of tax.
- UK tax law is expected to be amended within 12 months.
- More emphasis to be placed on the behaviour of parties.
- Payments for use of intangibles to be reviewed.
- SMEs could be caught by these provisions.

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- *Action Point 8* – transactions involving intangibles;
- *Action Point 9* – the level of returns with respect to an entity's risk and capital;
- *Action Point 10* – high-risk transactions profit allocation and possible recharacterisation; and
- *Action Point 13* – documentation and country-by-country reporting.

Implications

What practical implications will these action points have on businesses operating internationally? The OECD transfer pricing guidelines (TPGs) are changing so previously compliant policies may need to be reviewed and, in some cases, changes to the pricing made.

It is worth pointing out that the reports incorporate a rewrite of parts of the guidelines to incorporate all of the final report recommendations. Although these have now been approved by OECD members, they await the additional work needed on intangibles so the final revised TPGs are not expected to be officially adopted until later this year. For the UK, a Treasury order will be required to adopt these into domestic tax law. This is expected within 12 months.

Some of the key changes to the TPG are as follows.

Contractual terms

There is a significant reduction in the importance of contracts for understanding and pricing transactions and more emphasis is to be placed on the behaviour of the parties involved.

Contractual terms are still acknowledged as a starting point, but the TPGs accept that these are unlikely to provide enough information for a full transfer pricing analysis. Companies will therefore need to be careful to ensure that actual conduct is aligned with contractual terms and the features surrounding the commercial transactions to support any transfer pricing used in practice.

Risk

Risk has always played a significant role in transfer pricing analysis, but the proposed TPGs emphasise the need for a party to exercise control *and* have the financial capacity to assume the risk. Three questions should determine whether risk is controlled:

- Where is the decision taken to accept risk and by whom?
- What evidence is there of an entity responding to any risks?
- Who performs and manages risk mitigation activities?

For multinationals, therefore, intragroup pricing will need to be reviewed to ensure that it reflects the appropriate allocation of risk between entities.

Intangibles

The proposed revisions to TPGs define the categories to capture all possible intangible assets and to ensure appropriate pricing of any transfers. They also ensure that appropriate returns are allocated for intangibles only when there is evidence of both financial capacity to fund the development or maintenance of the intangible and ownership of the control over risks associated with it. Lack of control over the risks would entitle the legal owner to a risk-free return only. Corporates, therefore, will need to review the functions carried out by intangible holding entities.

Low value-added services

The proposed revised TPGs recommend that countries adopt an elective safe harbour for such services. The approved list of services includes accounting, human resources, information technology and similar administrative services, with a recommended mark-up of 5% for groups electing in. As well as certainty on the mark-up rate, there is a reduction in documentation requirements focused on identification of the cost pool and allocation keys. These recommendations will need to be enacted into local laws to take effect, but the report indicates that most of the countries associated with the BEPS project have agreed to adopt this elective regime and aim to have it in place before 2018. Multinationals should consider their responses to such moves and how the location of, and recharging for, intragroup service activities will be affected.

Recharacterisation

Under the previous rules, tax authorities have been permitted to recharacterise a transaction in limited circumstances only. The revised TPGs will expand the range of circumstances in which re-characterisation can take place to include transactions that lack the commercial rationality of an arrangement between unrelated parties. Although the lack of a similar transaction between unrelated parties is not grounds in itself for non-recognition, companies will need to consider the risks of re-characterisation particularly when transactions are complex or unusual.

Documentation

Additional guidance has been provided on the format of documentation. The final OECD recommendation is that all multinational groups should prepare both a master file, acting as a blueprint for the group as a whole, and a local file, containing detailed information in each country, identifying intra-group transactions and the pricing methodologies adopted.

As well as this guidance, country-by-country reporting was detailed in the implementation package in June 2015 and is applicable for accounting periods beginning on or after 1 January 2016 if enacted in local law.

In the UK, legislation has already been brought in to apply the OECD proposals from this date. The parent company is required to report the necessary information to its own tax authorities for the whole group, which will then be shared with other relevant jurisdictions. Even if the parent of a company is not required to report in its local jurisdiction, the proposed rules require a report to be made by another group company. All groups with consolidated group revenue of at least €750m will need to prepare and file a report. The earliest reporting period will be to 31 December 2016, which must be filed by 31 December 2017.

The SME sector

Despite the emphasis on multinationals, the provisions could catch small and medium-sized enterprises (SMEs) and family businesses.

Multinationals should monitor the changes as they are introduced in domestic laws, but in the meantime we would advise that reviews of pricing policies should already be taking place.

Although the introduction of country-by-country reporting will affect only a small percentage of companies due to the €750m revenue threshold, the other proposed changes to the TPGs may have an impact on SMEs and family business whose activities are subject to transfer pricing requirements in the UK or abroad. This could include those with UK/UK transactions as well as those with cross-border transactions. Those businesses where a structure has been set up to hold intangibles offshore or which are considering a reorganisation of cross-border activities need to carefully consider whether the structure will be tax-efficient under the proposed revisions.

Companies that have previously taken transfer pricing advice and implemented appropriate contractual terms should be revisiting these to ensure that the actual allocation of risks, based on the current behaviour of the entities involved, is still in accordance with those contracts. For entities with a simple structure and where the only intra-group transactions are 'low value-added' services, we recommend reviewing the possible impact on location and pricing of these services in view of the likely action by jurisdictions adopting the elective safe harbour proposals.

By necessity, this is only a short overview and professional advice will be needed in individual instances because the tax treatment depends on the individual circumstances of each client and may be subject to change in future. That said, there may be opportunities to provide certainty and reduce the transfer pricing compliance burden for those affected.

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