

## Analysis

# Master and local file: preparing for the transfer pricing culture of compliance

## Speed read

From BEPS Action 13, country by country reporting has attracted the headlines. However, the OECD's master and local file recommendations for transfer pricing documentation are also key enablers of the intended 'culture of compliance'. The master and local file approach will potentially trigger a significant increase in necessary documentation. Tax jurisdictions are updating their practices and passing laws to incorporate the changes; and taxpayers should plan for how they will manage these. Failing to do so will increase the risk of tax authority challenge, as well as creating a risk of internal compliance cost and inefficiency.



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Base erosion and profit shifting (BEPS) has already had a significant impact in raising awareness of international tax practices, and the recommendations published in October 2015 are now making their way into rulebooks around the globe.

Transfer pricing disclosure requirements are an important part of BEPS. Although country by country reporting (CbCR) has been the headline issue, it is just one element of BEPS Action 13. The other changes could be just as far reaching. Using a master and local file approach to enhance and standardise transfer pricing documentation, the OECD wants to foster a 'culture of compliance' amongst multinational enterprises (MNEs). This could have a significant impact upon MNE groups.

Table 1: Recently updated regimes

Country	Effective from	Requirements
Netherlands	1 January 2016	Master and local file mandatory where consolidated turnover exceeds EUR50m
Japan	1 January 2016 for master file, 1 April 2017 for local file	Master file mandatory where consolidated revenues exceed JPY100bn; local file thresholds inform 'contemporaneous' documentation regime
Denmark	1 January 2016	Master and local file mandatory for non SMEs
Mexico	1 January 2016	Master and local file mandatory where consolidated revenues exceed c. MXN644m
Spain	1 January 2016	Master file mandatory where consolidated revenues exceed EUR45m; transaction thresholds for local file disclosure

## The master and local file concept

Master and local file is not a new idea. Action 13 builds on the foundation laid by the previous work of the EU Joint Transfer Pricing Forum and has already been adopted in that form by some MNE groups.

Action 13 updates Chapter V of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. It now follows a three tier approach:

- A master file (the group 'blueprint') sets out an overview of the group's business, the nature of its global operations, its overall transfer pricing policies and its economic activity (annex I).
- A local file is the transactional record for the year and contains supporting analysis for each entity. It should set out entity specific details and more detailed financial and operational information on intercompany transactions. It should include comparability analysis and explain why the transfer pricing methodologies used are the most appropriate. It needs to be calibrated at the entity level, although files for different entities may be aggregated at a territory level (annex II).
- A country by country report (annex III).

This is supplemented by further compliance guidance, which recommends:

- The master file is to be created (or reviewed and updated) by the tax return filing due date for the ultimate parent of the MNE group.
- The local file is to be finalised no later than the due date of the tax return filing in the relevant territory.
- Both the master file and local file are to be reviewed annually.
- As a minimum, the financial data for the comparables should be updated every year but comparable data searches, where operating conditions remain unchanged, may be updated every three years.

The OECD recommends that this significantly enhanced approach (both in terms of the content and frequency of review) is passed into law or practice by local administrations. It also notes the use of supporting penalty regimes to make 'non-compliance more costly than compliance.'

## Implementation status

One of the complexities of this new 'common approach' is that it has been left to each jurisdiction to implement, so there will be differences in interpretation, application and filing requirements. At the time of writing, a number of territories have legislated for master and local file, often accompanied by revenue thresholds with a range of penalty and burden of proof consequences. A selection of recently updated regimes is set out in table 1. A number of other major jurisdictions are working on draft legislation, with others committed to do so soon. Those jurisdictions not yet committed to legislative changes may implement the recommendations through practice changes within their existing legal frameworks, although it is possible that some may choose not to implement this approach.

## What does this mean for MNEs?

In a word, complexity. This arises from more prescriptive content, differing interpretation in different jurisdictions and a steep increase in the volume of documentation to be produced and managed. Some key considerations are set out below.

**Content:** MNEs have a wide range of views on what constitutes appropriate transfer pricing documentation. This ranges from light touch summaries only through to intercompany agreements and transaction based reports, up

to existing master and local file structures.

The standardised and detailed content set out in the appendices to Chapter V will require a step change in effort for many groups. For example, the requirement to include the analysis of profit drivers and principal contributions to value creation by entities in the master file may be new for many groups. This reflects the move towards documentation that gives a view of the whole, and not just a narrow representation of activity of an entity selected as the transfer pricing tested party.

**Volume:** Groups that previously chose not to adopt a master and local file structure may have diligently created and refreshed transfer pricing documentation in the form of a 'vertical' transaction file centred around transaction types, with economic analysis to support transactions. This may then be further localised, depending on need and the group's policy.

The adoption of a master and local file will effectively move groups to a 'horizontal' view, i.e. the entities will be the organising factor of analysis. Therefore, the way content is created and arranged will need to be approached differently, with any transaction analysis documented from an entity perspective. This will significantly multiply the number of documents required for some groups, which will have to think differently about how to produce the content and keep files updated, moving away from linear narrative to modular content, as explored below.

**Planning:** More content, complexity and volume means that planning transfer pricing documentation will become vital. Many MNEs will not be starting from a blank page; there will be existing documentation or source material that could be converted relatively easily. Understanding the starting point before undertaking or commissioning analysis will cut down on the resource costs and the potential for inconsistent presentation.

Annex I and annex II set out the discrete pieces of information to be presented in both a master and local file. A straightforward gap analysis comparing current versus needed information can be set out as shown in table 2.

This clarifies where the current gaps are in analysis and documentation, but it also has the advantage of making the reviewer consider the modularity of the analysis: what can (or needs to) be consistent across all local files and what is necessary local data?

This brings us to another planning technique: mapping out of what is 'core' versus variable content.

Consistency is fundamental within group-wide transfer pricing analysis and documentation. One of the easiest ways for a tax administration to unpick a group's transfer pricing policy is to focus on internal inconsistency – between different locations, or from year to year. A group using inconsistent approaches for similar transactions runs the risk of the tax authority arguing for its preferred approach (usually the one that yields the most local tax). This problem will only be exacerbated with more information being exchanged and greater transparency in reporting.

Defining what is core, often centrally produced and 'locked down', versus what is local and necessarily variable, will help to reduce this risk. Much of the master file may be considered core – it is the overview of the group after all. However, the concept also extends to the local file. In reviewing an information gap analysis, it may be clear across a number of local files that there is already consistent content. Designating that as a 'core' piece of analysis to be replicated will increase the consistency of presentation; and using this analysis for each entity will reduce the work for the group as a whole.

Conversely, being specific on what the variable content is (e.g. local specific functional analysis or transaction details that require annual updating) also allows for more effective

**Table 2: Gap analysis**

OECD Chapter V requirement	Current material and location	What needs creating/ updating to meet OECD requirement?	Plan for creation/ updating
Description of management structure of local entity [...]			
Detailed description of the business and business strategy [...]			
Etc.			

planning around how and when the content is produced and who does the work.

**Managing the ongoing process:** The revised OECD approach makes it clear that transfer pricing analysis and documentation is an ongoing process. Policies must be reviewed as changes occur in the business and in the competitive landscape; and comparable data must be refreshed annually. Increasingly, jurisdictions are also creating annual tax compliance cycles for transfer pricing. Disclosure forms as part of corporation tax filings are now a feature of many compliance regimes. Inevitably, the first deadline in a year will be important in shaping the process. A well planned and articulated timetable will allow the production of core data to be streamlined and provide a clear sight of what needs to be accelerated for territories with tight timetables.

**Use of technology:** When assessing the scale of the increase in compliance that may be required, many groups may realise that they are under-resourced for the step-up. Where the nature of much of the resource requirement is process based (i.e. assembly of analysis and data population), technology based solutions may be a cost effective way to manage this. A number of technology solutions for documentation production are likely to emerge, each with their own features and approach. The choice of solution, if one is to be used, will be informed by the MNE group's individual situation. However, any technology solution will only be as successful as the resource planning informing the master and local file analysis and content creation. Otherwise, groups may find they have substituted, or added to, a compliance burden.

### Closing thoughts and action points

The master and local file reforms have been relatively low profile to date, but they are the means by which tax authorities will assess taxpayer compliance and provide an opportunity for taxpayers to put their best foot forward. Given the complexity and volume of information to manage, planning for the culture of compliance will be essential. Action points for MNEs are:

- Profile each of your entities and the stage of transfer pricing legislation in the jurisdictions in which they operate.
- Identify the data required for the master and each local file and undertake a gap analysis on what is currently available.
- Identify core and variable content to manage consistency and enable efficiency.
- Investigate technology options and develop processes to support the creation and annual updating of documentation and analysis. ■

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- ▶ BEPS: transfer pricing documentation and country by country reporting (Tom McFarlane, 20.10.15)