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Transfer Pricing: The New Frontier

Transfer Pricing Documentation in a Post-BEPS World: Evolution or Revolution?

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Agenda

- BEPS Overview
- Documentation Requirements: United States
- Documentation Requirements: Europe
- The Legal Side of Documentation: Intercompany Agreements
- US Documentation Developments
- Closing Remarks

BEPS OVERVIEW



15 Actions around 3 Main Pillars

Coherence

Hybrid Mismatch Arrangements (2)

CFC Rules (3)

Interest Deductions (4)

Harmful Tax Practices (5)

Substance

Preventing Tax Treaty Abuse (6)

Avoidance of PE Status (7)

TP Aspects of Intangibles (8)

TP/Risk and Capital (9)

TP/High Risk Transactions (10)

Transparency and Certainty

Measuring BEPS (11)

Disclosure Rules (12)

TP Documentation (13)

Dispute Resolution (14)

Digital Economy (1)

Multilateral Instrument (15)

BEPS Overview

- The BEPS reports include recommended changes to domestic laws, the OECD Transfer Pricing Guidelines, and the OECD Model Income Tax Convention
- The proposed BEPS changes are not self-executing, but depend on actions by the participating countries – multiple levels to watch out for *i.e.*, domestic legislation, EU legislation, treaty law

Documentation in a Post-BEPS Era?

- In search for increased transparency in the tax world, BEPS brought about a sharper focus on legal framework
- Transfer pricing documentation is not only a compliance challenge, but is also a tool to support the group's transfer pricing policy
- Documentation (including legal framework and transfer pricing analysis) is important for the identification/characterization of the transaction and both legs (legal framework and transfer pricing analysis) should be aligned

BEPS Action 13

- **OECD 2017 Guidelines defined three objectives of transfer pricing documentation (Chapter V, ¶15.5)**
 - To ensure that taxpayers give **appropriate consideration** to transfer pricing requirements in **establishing** prices and other conditions for transactions between associated enterprises and in **reporting** the income derived from such transactions in their tax returns;
 - To provide tax administrations with the information necessary to conduct an informed transfer pricing **risk assessment**; and
 - To provide tax administrations with useful information to employ in conducting an appropriately thorough **audit** of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses
- **In addition, OECD 2017 Guidelines:**
 - Provided guidance on implementation of transfer pricing documentation requirements
 - Provided information sharing mechanism between tax administrations

BEPS Action 13

- **A three-tiered approach to transfer pricing documentation (2017 OECD TPG, Chapter V, Section C)**
 - A “master file” addresses global business operations and transfer pricing policies at a high level
 - There is no corollary to the master file in the Section 6662 regulations
 - A “local file” for each jurisdiction where MNE operates addresses material intercompany transactions between local affiliates in the jurisdiction and related parties in other jurisdictions
 - The local file requirements are similar to those in Treas. Reg. § 1.6662-6(d)(2)(iii)(B)
 - Country-by-country reports (“CbCR”) are a new requirement in Action 13, 2017 OECD TPG, and U.S. Treas. Reg. § 1.6038-4 for all jurisdictions

• U.S. Requirements

- Contemporaneous documentation for penalty protection. Treas. Reg. § 1.6662-6(d)
- Country-by-country reports.
Treas. Reg. § 1.6038-4

• OECD TPG Requirements (BEPS Action 13)

- No contemporaneous documentation exception to penalties
- Country-by-country reports. Ch. V, Ann. III
- Master file. Ch. V, Ann. I
- Local file. Ch. V, Ann. II

The Country-by-Country Report (CbCR) as a BEPS Roadmap

- Widespread implementation
- The regulations generally adopt the guidelines set forth under BEPS Action 13 and the template report therein
- Goal is to facilitate risk assessment by the tax authorities in each jurisdiction where the MNE's has operations
- Divergences in implementation (survey in process in Asia)

CbCR a tool for tax administrations and taxpayers

Name of the MNE group: L Corporation and Affiliates

Fiscal year concerned: 2020

Currency used: USD (in thousands)

Tax Jurisdiction	Revenues			Profit (Loss) before Income Tax	Income Tax Paid (on Cash Basis)	Income Tax Accrued — Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other Than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							
United States	12,000	500	12,500	5,000	1,750	1,750	1,000	15,000	300	5,000
Ireland	15,000	0	15,000	5,800	725	725	10	30,000	15	500
Germany	0	157.5	157.5	15.75	4.72	4.72	10	35	1	10
Japan	0	113	113	11.3	3.57	3.57	10	20	1	5

CbCR a tool for tax administrations and taxpayers

Name of the MNE group: L Corporation and Affiliates Fiscal year concerned: 2020														
Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organization or Incorporation if Different from Tax Jurisdiction of Residence	Main Business Activity(ies)											
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management of Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Dormant
United States	L Corporation		X	X		X	X							
Ireland	L Ireland		X	X		X	X							
Germany	L Germany GmbH						X							
Japan	L Japan GK						X							

Action 13

CbC MCAA Adoption

- Many countries have agreed to the automatic exchange of CbCRs by signing the Multilateral Competent Authority Agreement on the Exchange of CbC Reports (the "CbC MCAA")
 - The MCAA is meant to ease and ensure the automatic transfer of CbCRs among signatories
- As of October 2018, 74 countries have signed the CbC MCAA
- As of September 2018, more than 1,800 exchange agreements have been activated between signatories of the CbC MCAA
- The United States has not signed the CbC MCAA but is instead negotiating bilateral agreements for the exchange of CbCRs
- In the U.S., CbC reports are “return information” under Section 6103
- As of November 2018, the United States has signed bilateral agreements with 41 countries for CbCR exchange, and has publicly disclosed that it is in negotiations with 7 others

BEPS Action 13: Master File

- **Master file is expected to assist tax administrations in evaluating the presence of significant transfer pricing risk**
- **Master file requirements (2017 OECD TPG, Chapter V, Annex I):**
 - A chart demonstrating the MNE's legal and ownership structure and location of operating entities
 - A description of the MNE's business(es), including profit drivers, supply chains for certain of the group's largest products/service offerings and their main geographic markets, important service arrangements, and important business transactions
 - A description of the MNE's intangibles, including the group's strategy for intangibles, the locations of R&D facilities and management, a list of the group's intangibles that are important for transfer pricing purposes, and a list of important agreements related to intangibles
 - A description of the MNE's intercompany financial activities, including how the group is financed, which group members provide central financing functions for the group and where they are managed, and the transfer pricing policies applicable to related-party financing arrangements
 - The MNE's financial and tax positions

BEPS Action 13: Local File

- **The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting a specific jurisdiction.**
- **Local file requirements (2017 OECD TPG, Chapter V, Annex II):**
 - A description of the local entity management structure, local org chart, and a detailed description of the local entity's business, business strategy, and key competitors
 - Detailed information regarding material controlled transactions, including a description of the transactions and the context in which they occurred, the amount of intra-group receipts and payments for controlled transactions involving the local entity (by transaction category and tax jurisdiction of foreign payor/recipient), a "detailed comparability and functional analysis of the taxpayer and associated enterprises" related to each category of controlled transactions, and identification of the most appropriate transfer pricing method for each category of transaction and why and how it was applied
 - Detailed financial information for the local entity and summaries of relevant financial data for comparables

Documentation Requirements
UNITED STATES

Documentation as a Penalty Protection

US Treasury Regulations

- Sections 6662(e) and (h) provide penalties of 20% and 40% for increases to taxable income arising from Section 482 adjustments
- Section 6662 transfer pricing penalties can be avoided by demonstrating reasonable cause and good faith
- Defending against net adjustment penalties generally requires a taxpayer to:
 - Reasonably select and apply a specified method
 - Have contemporaneous transfer pricing documentation containing certain principal documents
 - Provide that documentation to the IRS within 30 days of a request

Country-by-Country Reporting: Common Ground between Section 6038 and OECD TPG

- The information required in Form 8975 and BEPS Action 13 is identical
 - Part I “Tax Jurisdiction Information” in Form 8975 asks for the same data as Table 1 “Overview of allocation of income, taxes and business activities by tax jurisdiction” in Annex III to Chapter V
 - Part II “Constituent Entity Information” in Form 8975 has the same main business activities as Table 2 “List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction” in Annex III to Chapter V

**SCHEDULE A
(Form 8975)**

(June 2017)

Department of the Treasury
Internal Revenue Service
Name of the reporting entity

Tax Jurisdiction and Constituent Entity Information

For reporting period beginning _____, 20____, and ending _____, 20____

OMB No. 1545-2272

▶ A separate Schedule A (Form 8975) is to be completed for each tax jurisdiction of the multinational enterprise group.
▶ Information about Schedule A (Form 8975) and its separate instructions is at www.irs.gov/form8975.

EIN

Part I Tax Jurisdiction Information. All financial amounts must be stated in U.S. dollars. See instructions.

1. Revenues			2. Profit (loss) before income tax	3. Income tax paid (on cash basis)	4. Income tax accrued—current year	5. Stated capital	6. Accumulated earnings	7. Number of employees	8. Tangible assets other than cash and cash equivalents
(a) Unrelated party	(b) Related party	(c) Total							

Part II Constituent Entity Information

1. Constituent entities resident in the tax jurisdiction	2. TIN	3. Tax jurisdiction of organization or incorporation if different from tax jurisdiction of residence	4. Main business activities	
			(a) Activity code	(b) If you entered the code for “Other,” describe the business activity

- CBC501 Research and development
- CBC502 Holding or managing intellectual property
- CBC503 Purchasing or procurement
- CBC504 Manufacturing or production
- CBC505 Sales, marketing, or distribution
- CBC506 Administrative, management, or support services
- CBC507 Provision of services to unrelated parties
- CBC508 Internal group finance
- CBC509 Regulated financial services
- CBC510 Insurance
- CBC511 Holding shares or other equity instruments
- CBC512 Dormant
- CBC513 Other

BEPS Action 13: Master File

- Master file is expected to assist tax administrations in evaluating the presence of significant transfer pricing risk
- There is no corollary to the master file in the Section 6662 regulations and no master file requirement in the U.S.
- Why the Concern?
 - A global overview of a MNE's business can reveal sensitive information about its supply chain, business operations, intangibles and financial and tax positions
 - While CbCR is provided only to the parent country and then distributed through existing treaty networks, the master file will be directly reported to countries in which the MNE operates
- What to Do?
 - “High-level”
 - Balance to make sure reported information is not harmful if publicly disclosed

BEPS Action 13: Local File

- The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting a specific jurisdiction
- The local file requirements are similar to those in Treas. Reg. § 1.6662-6(d)(2)(iii)(B)
 - Business overview
 - Organizational structure
 - A description of (1) the method selected and the reason why it was selected; (2) the alternative methods considered and rejected; (3) the controlled transactions and internal data used to analyze them; and (4) the comparables used, how comparability was evaluated, and what adjustments were made
 - An explanation of the economic analysis and projections relied on
 - A summary of additional data acquired post-tax year but before filing return

Documentation Requirements
EUROPE

Documentation, not a new story in Europe

- **Pre-BEPS**

- EUTPD = guidelines to EU Member states (political commitment) since 2006
- A standard Master file and Country file across EU
- Objective: **to reduce transfer pricing litigation within European Union (single market)**
- National law provisions (France , Italy , Spain...) or administrative practice (U.K. ,Belgium, Germany...)
- On most case penalties apply if not compliant
- Italy: penalty waiver

Documentation, not a new story in Europe

- **Post-BEPS**

- A 3-tier approach following BEPS 13 progressively introduced as of 2016
- Beps 13 Master file does not provide value of transactions or benchmarking analyses (role of Local files)
- Some countries kept the EUTPD and introduced the CbCR.
- Objective: **to increase « transparency »** vis-à-vis tax authorities and facilitate **risk assessment** by the tax authorities

EU Tax Transparency package

- Council Directive (EU) 2015/2376 on the automatic exchange of information between Member States on their tax rulings (applicable as of January 1, 2017)
- Council Directive (EU) 2016/881 on the automatic exchange of country-by-country reports of multinational companies
- Current discussion to make CbCR public. In April 2016, the Commission adopted a (controversial) proposal for a directive which would if adopted require multinational groups to publish a yearly report on profits and tax paid in each country where they are active (country-by-country reporting)

The Legal Side of Documentation

INTERCOMPANY AGREEMENTS

Legal Framework

- Basis for identification of the commercial or financial relations (revisions to Section D of Chapter I of the TP guidelines) with verification of economic reality «to ensure that inappropriate returns do not accrue to an entity **solely** because it has contractually assumed risks or has provided capital»
- List of agreements involving IP's required in the Master file;
- Copies of intra-group agreements in the local files
- In continental Europe, agreements are generally first request from tax authorities in case of tax audit

Legal Framework

- BEPS is giving priority to economic reality in identifying the commercial or financial relations. An up to date set of intra group agreements serves as a first line of defense when:
 - The agreements duly reflect the functions, risks and assets used as described in the Master file and local files;
 - The functional analysis (including risks allocation and assets used) is periodically updated as required by the evolution of the group;
 - The agreements detail the remuneration method (identification of the cost pool if cost plus method, detail of allocation keys used for indirect allocation...);
 - A narrative is provided for group services («low value services»)

US DOCUMENTATION DEVELOPMENTS

LB&I Directives Related to Documentation

- **“Interim Instructions on Issuance of Mandatory Transfer Pricing Information Document Request (IDR) in LB&I Examinations” (LB&I-04-0118-001) (“IDR Directive”)**
 - IRM Exhibit 4.46.3-4, Transfer Pricing Compliance Process, first introduced in January 2003, required that the Mandatory Transfer Pricing IDR be issued in all examinations of taxpayers that filed Form 5471/5472 or engaged in cross-border transactions
 - The IDR Directive establishes new procedures for issuance of the Mandatory Transfer Pricing IDR
 - For examinations arising under approved LB&I campaigns, IRS Exam will follow the campaign’s specific guidance related to the Mandatory Transfer Pricing IDR, if any. If no such guidance exists, then the following rule applies
 - For examinations with initial indications of transfer pricing compliance risk (considering volume and type of transactions), Transfer Pricing Practice (“TPP”) and/or Cross Border Activities (“CBA”) Practice Area employees will issue the Mandatory Transfer Pricing IDR if assigned to the case. If no TPP or CPA employees are assigned to the case, then the Mandatory Transfer Pricing IDR will not be issued

LB&I Directives Related to Documentation

- **“Instructions for Examiners on Transfer Pricing Issue Examination Scope – Appropriate Application of IRC § 6662(e) Penalties” (LB&I-04-0118-003) (“Penalties Directive”)**
 - Under the Penalties Directive, in order to meet the reasonable cause exception under the Section 6662 regulations, taxpayers must document that they reasonably selected the best method for their analysis and reasonably applied that method
 - Indications that Section 6662(e) documentation may be inadequate:
 - Inaccurate inputs
 - Failure to adequately search for or consider material information
 - Failure to follow best method rule in selecting and applying the method
 - Results that differ significantly from the arm’s length result and that are sizable in relation to the controlled transaction
 - When a taxpayer has timely provided an analysis and conclusion selecting a specified method as best method, IRS Exam should use that method as a starting point for its analysis

LB&I Directives Related to Documentation

- **“Revised Instructions for LB&I on Transfer Pricing Issue Selection and Scope of Analysis - Best Method Selection” (LB&I-04-0118-006) (“Best Method Directive”)**
 - The Best Method Directive requires Exam to use taxpayer’s selection of a best method as a starting point
 - The decision expressly includes factual development of related party transactions
 - Review the extent to which your documentation addresses this factual development
 - If it does not, consider introducing additional material when responding to any IDRs that give opportunity
 - Identify if your documentation definitively identifies the selection of a best method in its documentation
 - The directive allows Exam teams to challenge a taxpayer’s method if the documentation fails to do this
 - Make an Upfront Investment
 - Prepare to advocate your position at the opening conference/ transfer pricing orientation. A thoughtful presentation may create an implicit presumption of an arm’s length result

U.S. Tax Reform: Aggregation

- **Section 482 Amendment**

- “[T]he Secretary shall require the valuation of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the value of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers”

- **This amendment appears to authorize the approach to aggregation that the IRS pursued in recent transfer pricing cases, such as *Amazon.com***

- **But it also raises questions:**

- Are there any limits to the Secretary’s ability to aggregate? Across separate transactions? Across jurisdictions?
- What should a taxpayer present in its master file?
- Is use of a profit split inevitable?

CLOSING REMARKS

Do's and Don'ts in the Age of Transparency and EOI

- **Don't**

- Assume information provided to one tax authority will not be provided to others
- Respond to tax authority requests without consulting with other affected affiliates
- Assume substantive (e.g., transaction characterization) and procedural (e.g., privilege) rules are similar outside the U.S.
- Take inconsistent positions in different jurisdictions
- Have a reactive-only strategy in dealing with the tax authorities

- **Do**

- **Centralize** key tax functions
- **Communicate** important issues and developments
- **Coordinate** responses among affected affiliates
- Ensure **Consistency** of documentation and positions on a contemporaneous basis
- Provide **Context** for information provided, especially CbCRs
- Take **Control** of flow of information
- Develop a **Risk Assessment** of complex tax or economic/valuation positions highlighting the technical merits and the strength of factual support from a tax litigator's perspective

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