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Commonsense Transfer Pricing Compliance in a BEPS World

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The need for comprehensive and consistent transfer pricing documentation has never been stronger. The OECD[1] base erosion and profit shifting ("BEPS") project, combined with a sharper focus on intercompany fees and allocations by some non-tax regulators, is causing multinational companies to reassess their compliance processes and resource requirements. To navigate this increasingly onerous regulatory environment, multinational companies must take a commonsense approach. This requires having in place efficient processes to analyze, benchmark, document, and defend their related-party transactions. To that end, certain "rules of the road" are described in this article.

Rule #1: Know Your Transactions

It goes without saying that a company has to know its intercompany transactions in order to adhere to the transfer pricing requirements in each of its jurisdictions. While this rule seems obvious, it is one that many tax departments struggle with—even when the taxpayer seems to engage in few and relatively straightforward intercompany transactions. Why is this and what can one do to remedy it?

Corporate tax departments are subject to the same cost pressures as other support functions, and most do not have dedicated transfer pricing staff. Transfer pricing is often an afterthought for them as they also have to deal with tax returns, value added tax issues, local and state taxes, effective tax rate

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1 Organization for Economic Cooperation and Development.

calculations, and so on. It is not uncommon, therefore, for a tax department to outsource a good chunk of day-to-day transfer pricing compliance to the finance group, for example. Or, the transactions may require financial expertise that the tax department does not have, such as intercompany financing or reinsurance, and that may become the responsibility of the treasury group.

Beyond these resource constraints and divisions in responsibility, accounting and financial reporting systems often are not designed with transfer pricing compliance and reporting requirements in mind. This causes additional pressures when trying to gather comprehensive lists or summaries of intercompany transaction activity and (segmented) results for transfer pricing testing purposes. Therefore, the burden of collecting data and reporting on intercompany activity falls on the same overstretched tax, treasury, finance, accounting, and other departments within corporations.

A division of accountability for the tracking, pricing, and reporting of intercompany transactions makes it challenging for tax departments to keep a track of all transactions, much less ensure that the transactions are being priced at arm's length. For example, the tax department may not be aware of certain intercompany financing transactions that their treasury colleagues enter into, in which case at least some of these transactions may be priced without consideration of the relevant transfer pricing rules.

An inventory of the typical transfer pricing reports that are prepared annually, or a spreadsheet listing known intercompany transactions and the pricing policies to be followed, often do not adequately track all significant transactions. Even if transfer pricing reports initially cover all the relevant transactions, it is highly unlikely that everyone in an organization involved in executing intercompany payments will read the reports, or consistently identify and report new transactions to the tax department. Similarly, a simple list of transactions provides no explanation to the finance team as to the basis for pricing policies, and how new transactions should be handled.

It's clear that in order to make sure that no significant intercompany transactions slip through the cracks, a dedicated intercompany transaction data collection and reporting process needs to be established and faithfully followed by all stakeholders in the company responsible for intercompany activity.

Rule #2: Have a Policy in Place

All parties involved should agree on a robust policy for setting, implementing, and monitoring defendable transfer prices. Through these policy guidelines the tax department can confirm that intercompany transactions are being identified and priced in compliance with the arm's length principle. The guidelines should be memorialized in a *policy document* that details the pricing framework for the common intercompany transactions entered into by the company and sets out procedures for when there are variations to these transactions (or for new or different transaction types). The policy document should also provide background on transfer pricing regulations so that the various parties involved in implementing policies have an appreciation for the need to do so carefully and in a robust manner.

A policy document is a great first step, but it must be paired with effective guidance for implementing and monitoring transfer pricing policies that is targeted to the tasks required of the various business groups responsible for executing intercompany transactions, such as treasury, finance, or accounting. For example, an effective on-going monitoring policy is essential to eliminate surprises otherwise bound to occur during the year-end compliance process. It is not uncommon for multinationals to invoice for their intercompany transactions based on budget data. A manufacturing entity might sell product to its related limited risk distributor at manufacturing costs plus a margin—in order to allow the distributor to earn a target return of, say, four percent. If the distributor's actual costs are higher than budgeted, it would earn less than four percent and maybe even less than the arm's length range of prices derived in the transfer pricing analysis. To avoid this outcome, it makes sense to monitor financial results on a quarterly basis and make adjustments as needed.[2]

Taxpayers also need to obtain the required data, check the reliability of the data inputs, document adjustments to transfer prices, and evaluate corresponding impacts on other taxes (such as customs). Because problems may not be immediately apparent, poor data quality can lead to non-arm's length results no matter how closely transfer pricing policies are being monitored on a real-time basis. Therefore, developing policy guidance that includes how frequently data should be checked, thresholds for elevating concerns, information required to be documented, roles and responsibilities, and other business considerations is essential for having an effective transfer pricing policy.

Last but not least, the policy should include an annual risk-based assessment of the company's global compliance requirements in order to determine and prioritize tasks to be performed by the organization. There has been a burst of activity in recent years, with countries introducing new or modified transfer pricing requirements, often conflicting, on the heels of the OECD's BEPS project. Keeping track of these changes and their impact on a company is no small task. A multinational may meet the threshold to prepare BEPS compliant master file and local file documentation in some countries but not others, for instance. Even among those countries where the threshold is met, some may ask for the information to be submitted in a standardized electronic form with the tax return, while others only require submission upon request. The timing of preparation and submission will also vary by jurisdiction.

Rule #3: Don't Try to Fit a Square Peg into a Round Hole—Methodologically Speaking

One of the first things most transfer pricing professionals learn is that one should make sure the answer fits the facts, and not the other way around. Still, taxpayers (and transfer pricing practitioners) often default to the Comparable Profits Methods ("CPM"),[3] assuming that an entity's functions can be reliably compensated through reimbursement of costs plus a profit markup or by a targeted operating margin.

Applying the CPM to benchmark profitability for an intercompany transaction is indeed the right thing to do in many situations and also popular for its simplicity—however, it is not always the appropriate

[2] As discussed below, monitoring is also important for identifying situations when existing transfer pricing policies should be reconsidered.

[3] Or Transactional Net Margin Method ("TNMM") under the OECD Guidelines.

method. BEPS is likely to increase scrutiny of its use as more focus is placed on profitability throughout the entire value chain. For example, a related party that provides marketing services is often characterized as “routine” in nature, with its markup on costs benchmarked against comparable companies. However, depending on the nature of the services, a tax authority might suspect that the entity’s activities are creating or enhancing the value of certain marketing intangibles (such as a trade name), in which case a simple markup on costs may not be adequate remuneration. A similar challenge might be invited by an entity performing research and development or investment research services.

Allocating profits to an entity based primarily on labels such as “service provider,” “routine distributor,” or “contract manufacturer” is increasingly under scrutiny from tax authorities worldwide. Under BEPS, there is an added focus on evaluating what functions an entity is performing, the relative value of these activities in the corporation’s value chain, and the entity’s wherewithal to take on financial or business risks. There is also an emphasis on assessing whether the contractual allocation of risks, and correspondingly profits, is consistent with the conduct on the ground. For example, although the aforementioned investment research services provider has to have its investment decisions theoretically approved by an investment committee located elsewhere, it may be making all the key decisions related to identifying and vetting investments and hence deserving of more than a cost plus profit markup.

The takeaway is that each intercompany transaction should be evaluated on its own merit and facts. Basing transfer prices on what was done previously, labels given to the entity, or always taking the simple route of benchmarking profitability using the CPM can be problematic in the age of BEPS. This is especially true when a multinational has organized its supply chain using the typical “entrepreneur/limited risk distributor” model, as it is easy to be lulled into not considering all the nuances and whether the distributors do indeed only deserve a small routine profit.

Rule #4: Don’t Assume Yesterday’s Facts Are Today’s Facts

One way in which a CPM or TNMM approach can become stale, even if it made sense when initially put in place, is due to evolution of the business. Taking up the example of research and development services again, what may have begun as routine contract services can grow into more of an intangible-generating activity, say as the entity’s employees take on some responsibility for managing the development of products, along with the corresponding risks. Similarly, as discussed above, investment research may not incorporate any decision-making authority at the beginning, but can develop at least a modicum of that authority if investment recommendations start to look like they are rubber-stamped by a portfolio manager or investment committee (and certainly if research analysts start running their own funds).

The monitoring process discussed above should incorporate periodic re-evaluations of existing business operations and transfer pricing policies in order to identify such inflection points. This can include surveying any new intercompany agreements and other documentation, as well as targeted refreshing of functional interviews in key departments in order to identify significant changes in responsibilities or the nature of internal interactions. In addition, changes in profitability patterns among primary operating entities—e.g., when established profit ranges are regularly breached in either direction—may indicate changes in the quantum or allocation of value created within the organization. This can also be a trigger for re-examination of established assumptions, the implementation of transfer pricing policies, and the nature of intercompany flows.

There will be situations in which a cost-plus approach will need to change to, say, a profit or fee split as an entity's business operations become more complex and/or integrated. Decisions on these changes should be made jointly by key stakeholders, including tax, finance, controllership, operations, etc., preferably in consultation with outside advisors. The latter will, for example, provide valuable feedback on rules and common practices observed in the jurisdictions where the multinational operates.

Rule #5: Transfer Pricing Isn't Just About Tax

The quantum and nature of fees and cost allocations among related parties is not just a tax concern. Increasingly, non-tax regulatory authorities are getting into the act when it comes to scrutinizing intercompany payments for services, fee or profit splits, or more generally compensation for activities performed and services provided. Beyond the regulators, the impact of public opinion and reputational risk must be considered.

Non-tax regulatory scrutiny of transfer pricing policies is perhaps most visible in the financial services industry. For example, *Regulation W* implements Sections 23A and 23B of the Federal Reserve Act, the aim of which is to prevent a regulated banking institution from being disadvantaged by its affiliates. One way in which a bank could potentially be disadvantaged is through intercompany payments to or from those affiliates. Consequently, Section 23B requires that transactions with affiliates be conducted at "market terms or better." This requirement is typically interpreted as being consistent with the arm's length standard under the transfer pricing guidelines, with perhaps a slight tipping of the scales in favor of the banking entity.

In the world of investment funds, the U.S. Securities and Exchange Commission has for the past several years paid careful attention to the allocation of fees and costs among related fund entities for various services provided. The aim is to protect the rights of limited partners (investors) and make sure that their investment returns are not being diluted. Of course, when the relevant entities are in different tax jurisdictions, assessments of these allocations dovetail with tax-motivated transfer pricing analyses and documentation. The European Union ("EU") and various country authorities have also taken note of these issues outside the United States.

More generally, the increased transparency that is at the heart of the BEPS project, abetted by possible public disclosure of certain tax information (as per an EU proposal), raises the specter of reputational risk to multinationals engaged in aggressive tax planning strategies. Defense of these strategies based on the letter of the law being followed will not address potential public resentment that may ensue when a profitable company pays minimal taxes worldwide.

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