US OUTBOUND

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EU mandatory disclosure impending for certain transfer pricing arrangements

Mark Martin and Thomas Bettge of KPMG in the US explore the application of EU mandatory disclosure requirements to transfer pricing arrangements.

In May 2018, the EU adopted mandatory disclosure requirements for certain cross-border arrangements in EU Council Directive 2018/822, commonly referred to as DAC6 in reference to the 2016 directive which it modified. Along with country-by-country reporting requirements under Action 13 of the OECD's BEPS project, DAC6 represents part of a growing trend towards tax transparency. At the same time, the requirements fit into a broader context of EU scrutiny of cross-border arrangements that includes the European Commission's recent state aid challenges to unilateral advance pricing agreements (APAs) and other transfer pricing-related tax rulings. The mandatory disclosure requirements, however, are broader, covering some situations that present no BEPS risk.

While DAC6 entered into force in June 2018, the actual roll-out of mandatory disclosure is still ongoing. DAC6 gave EU member states until the end of 2019 to enact local legislation implementing mandatory disclosure, but that legislation is still pending in many jurisdictions. Mandatory disclosure becomes applicable on July 1 2020. Cross-border arrangements that fall within the scope of DAC6 and had their first step of implementation between June 2018 and July 1 2020 will generally need to be disclosed by August 2020. Arrangements that trigger reporting requirements from July 1 2020 on must be disclosed within 30 days. Reporting obligations fall primarily on EU intermediaries such as tax advisors, law firms, and banks, though taxpayers are responsible for reporting where an intermediary cannot fulfil this role (e.g., because of privilege) or where no intermediary is involved. Implementation details will vary by country, as will penalties for non-compliance.

Cross-border arrangements include arrangements among EU member states as well as those between one member state and a non-EU country, such as the US. Annex IV to DAC6 specifies the arrangements that are subject to mandatory disclosure, which include (but are not limited to) specified transfer pricing arrangements, certain arrangements involving the improper benefit of deductions or duplicative relief from double taxation, and some arrangements that may undermine the automatic exchange of financial account information. For certain cases, DAC6 requires reporting only if one of the main benefits one may reasonably expect to derive from an arrangement is obtaining a tax advantage. Arrangements subject to this "main benefit test" include some arrangements with confidentiality requirements or contingent fees for planners, arrangements that are available "off the shelf," and arrangements that fall into certain substantive categories.

DAC6 identifies three categories of transfer pricing arrangements, which are subject to mandatory disclosure without regard to the main benefit test, meaning they must be disclosed even if not tax-motivated. First, DAC6 applies to transfer pricing arrangements that involve the cross-border transfer of functions, risks, or assets that are projected to reduce the transferor's profits by more than half over the next three years. Requiring information on such restructurings may seem understandable, as they could present a significant BEPS risk. However, the requirement may also sweep in transactions such as onshoring intellectual property into the EU from tax havens, and other transactions that actually increase taxes of the MNE group.

Second, mandatory disclosure applies to any transfer of hard-to-value intangibles (HTVI). The OECD adopted guidance on HTVI in June 2018, with an aim to redressing information asymmetries between taxpayers and tax authorities with respect to potentially highly valuable intangibles for which no good comparables exist, and the HTVI concept reflects concerns similar to those underlying section 482's commensurate with income standard, which was introduced in the United States in 1986. For DAC6 purposes, HTVI are intangibles for which no reliable comparables exist, and for which projections of future income are highly uncertain. As transfer pricing controversies frequently centre on cases involving transfers of intangibles, requiring reporting of HTVI transfers may lead to an increase in disputes involving EU countries. As with the hallmark described above, however, this requirement may also cover transfers of intellectual property into the EU that increase the EU tax base.

Third, arrangements that involve the use of unilateral safe harbor rules must be reported. While the use of one country's safe harbor may suggest to the counterparty's country that the taxpayer has not actually attempted to determine an arm's length price, and that an adjustment may therefore be appropriate, applying mandatory disclosure to these arrangements will result in the reporting of a large number of low volume, low risk transactions, especially as DAC6 has no minimum threshold for disclosure. Notably, many multinational enterprises with US operations use the services cost method (SCM), a cost-only safe harbor under the US regulations that does not have an analogue under the OECD Guidelines, to price the provision of routine management and administrative services. Because opting not to use the SCM for these services would never result in less tax payable in the United States, the use of this unilateral safe harbor does not present any risk from an EU perspective, and thus information on these arrangements may pose more of a hindrance than a help. Similarly, the disclosure requirement would apply to the use of a US applicable federal rate (AFR) to price an intercompany loan. Because AFRs are generally lower than commercial interest rates, there should ordinarily be no EU transfer pricing risk when an AFR is used to price a loan to a US affiliate.

Although reporting of information required to be produced pursuant to EU mandatory disclosure rules may provide tax authorities with some helpful information on transfer pricing arrangements that present BEPS risks, it is uncertain whether tax authorities will be able to sort through the massive amount of information they will receive from taxpayers, particularly the information received in August 2020 which will date back to June 2018. Regardless, we anticipate that the additional information provided to tax authorities will increase the number of transfer pricing cases initiated by EU member states.

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