BEPS Report and Recommendations on Transfer Pricing

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BEPS REPORT AND RECOMMENDATIONS ON TRANSFER PRICING

Taxation is at the core of countries' sovereignty, but in recent years, multinational companies have avoided taxation in home countries by pushing activities abroad to low or no tax jurisdictions. The G20 asked OECD to address this problem by creating an action plan ('Report') to address base erosion and profit shifting. Inter-alia, the project, is looking at whether, and if so why, the current rules allow for the allocation of taxable profits to locations different from those where actual business activity takes place. The project aims to provide comprehensive, balanced and effective strategies for countries concerned with base erosion and profit shifting. This inevitably brings Transfer Pricing laws and practices in focus since they directly impact inter-'State' allocation of incomes from cross-border economic activity.

This article specifically looks at the recommendations of OECD in relation to Transfer Pricing and examines proposed measures to mitigate base erosion through supporting Transfer Pricing practices. The recommendations pertaining to Transfer Pricing are discussed in Action Points 8,9,10 and 13 of the Report. Same are briefly discussed below.

OECD Action Points on Transfer Pricing

The Report notes that a major concern is the ability of corporates to misapply income allocation rules by separating income from economic activities that produce income and shift the same to low tax jurisdictions. In this regard, the Report states:

*"This most often results from **transfers of intangibles** and other mobile assets for less than full value, the **over-capitalisation** of lowly taxed group companies and from contractual **allocations of risk to low-tax environments in transactions** that would be unlikely to occur between unrelated parties."*

Thus, following are the key areas of concern:

- Intangible Transfers
- Over capitalization
- Contractual allocation of risk to low tax jurisdictions

OECD plans to tackle above issues through action points 8-10 listed in the Report. Overall, the underlying theme of Action Points 8-10 is according an overriding importance to 'substance' over form in the context of Transfer Pricing. This is not an entirely novel direction as OECD has always accorded precedence to conduct over contractual agreements to the extent there is inconsistency between the two (refer para 1.48 to 1.49 of OECD Transfer Pricing Guidelines, 2010).

Action Point 8 – 'Intangibles'

Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

OECD has reiterated the importance of arm's length allocation of intangible related returns. It is interesting to note that OECD has already issued a Discussion Draft on Intangibles (first issued on June 6, 2012 and revised on July 30, 2013) providing the platform for resolving definition and allocation issues pertaining to intangibles. In the draft, OECD advocates the 'significant people function' approach for determining intangible returns rather than following mere ownership of title and funding capacity (interestingly, as per the OECD Discussion Draft on Intangibles even the 'locus' of risk is tied to the performance of the significant people functions controlling and managing the corresponding risk).

The author is of the view that should the 'significant people function' approach be adopted in determining the 'economic owner' of intangibles, the problem of divorce between profit and economic activity may be resolved substantially. In such a system, title ownership would not by itself afford adequate protection to corporates and it must be demonstrated that the requisite return generating functions were also carried out in the low tax jurisdiction.

Action Point 9 – 'Risk' and 'Capital'

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. ***This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.*** *This work will be co-ordinated with the work on interest expense deductions and other financial payments.*

The OECD has once again expressed dissatisfaction with contractual allocation of risks determining return allocation. Moreover, in OECD's view, contribution of capital by itself cannot be the key factor in determining return. Precedence must be given to significant people functions pertaining to the economic activity in question. OECD recognizes that for practical implementation of such an approach, new rules shall be required or existing rules may have to be modified.

Action Point 10 - Other high risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

Action Point 10 is the most interesting prescription with far reaching implications should these directions be actually implemented. In several instances, multinational companies undertake transactions for which parallels may not be found in the third party world. For example, a continued financial support by parent to subsidiary in overseas territory for market penetration is one such example. It would be quite helpful if OECD were to provide additional guidance in this regard.

Further, management fees and head office expenses may not always be base eroding and fairness demands that taxpayers should be given an opportunity to demonstrate that services/ benefit from such expenses was indeed received.

Action Point 13 – Re-examine Transfer Pricing Documentation

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

OECD has emphasized on sharing of information on global income allocation and supply chain. While the idea is praiseworthy, it is not a novel prescription. Stress on information sharing with tax authorities is conspicuous even in existing international tax literature and guidance though information access constraints have always posed roadblocks for regional/ local tax administrations. While explaining the supply chain and relative position of taxpayer vis-a-vis the value creation is in the interest of the taxpayer itself and augurs for a robust Transfer Pricing defense, unfortunately, in reality (at least in Indian context) one does not see this happening to the extent required.

Affirmation of 'Separate Entity Approach'

The Report also confirms that the consensus among governments is that moving to a formulary system of apportionment of profits, sometimes referred to as 'unitary taxation' is "not a viable way forward". Unitary taxation is an apportionment based method of allocating profit earned by a corporate group amongst tax jurisdictions in which the group operates. It is an alternative to the current system whereby a branch or subsidiary within the jurisdiction pays tax as a separate entity, with prices for transactions between group members calculated on an arm's length basis using transfer pricing methodologies. **This is as expected since the separate entity approach has taken firm roots in several Transfer Pricing regimes and forms the bedrock of arm's length analysis.**

Concluding Remarks

At the risk of repetition, the author feels that should the 'significant people functions' approach be followed, it would automatically take care of base erosion concerns to a substantial extent. Emphasis on significant people functions would disallow corporates to use legal title/ contracts or even funding arrangements as convenient smokescreen to hide true allocation of functions, assets and risks. However, for this to happen in reality domestic laws of most countries may have to be amended to expressly incorporate and accord precedence to 'people functions' for determining income allocation.

The OECD recommendations (at this stage) are in the nature of broad directives calling for significant detailing before countries could refer to them as guiding posts for amending existing laws. The Report sets out timelines (one to two years from now) for introduction of detailed guidance on each action point requiring changes to 'Transfer Pricing Guidelines, 2010' as well as the Model Tax Convention. It shall be interesting to see how these recommendations take shape as they are set to to alter Transfer Pricing planning and thought process in a manner that is not only radical but meaningfully aligns transfer pricing outcomes with 'value creation'.