

## ***Transfer Pricing News***

### **OECD releases discussion draft on transfer pricing documentation and country-by-country reporting**

**March 2014**



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This Transfer Pricing News provides a summary of discussion draft on transfer pricing documentation and country-by-country reporting released by Organisation for Economic Cooperation and Development (OECD) on 30 January 2014.  
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#### **In brief**

Multinational enterprises (MNEs) will face materially increased compliance burdens as a result of the hotly debated proposals to report to tax administrations, on a country-by-country basis, extensive details of their income, taxes, and business activities. Further, extensive changes to the current requirements for transfer pricing documentation reporting will also add to this burden. These are the broad consequences of the proposals made by the Organisation for Economic Cooperation and Development (OECD) in a discussion draft released on 30 January 2014.

The guidance from this discussion draft is intended to replace the transfer pricing documentation guidance contained in Chapter V of the OECD's current Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), which was adopted in 1995. Unlike the current version of Chapter V, the discussion draft requires a mandated list of documents to be included in a transfer pricing documentation package. The OECD will be giving further consideration to whether information relevant to other aspects of the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) should also be included.

The draft can be located at:  
<http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf>. Public comments on the draft can also be viewed on the OECD website.

## In detail

This initial discussion draft was created in response to the BEPS Action Plan, published on 19 July 2013. Item 13 of that Action Plan directed the OECD to “[d]evelop rules regarding transfer pricing documentation” in an effort to enhance transparency for tax administration. Pursuant to this call for transparency, the BEPS Action Plan also directed the OECD to “include a requirement that MNEs 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,” i.e., country-by-country reporting.

## Two-tiered approach to transfer pricing documentation

The discussion draft adopts a two-tiered approach to transfer pricing documentation: a “master file” containing standardised information for all MNE group members, which the OECD suggests should be completed in English, and a “local file” that provides specific information related to the transactions of a local taxpayer, which the OECD suggests should probably be provided in the prevailing local language.

The master file is intended to provide a complete picture of the MNE's global business. The information in the master file would be organized into five categories: the global organizational structure; descriptions of the MNE's business; descriptions of the MNE's intangibles, intangible development activities, and transfers of intangibles; descriptions of any intercompany financial activities; and details regarding the MNE's financial and tax positions, including allocations of income and taxes. Although some of the required information is commonly found in transfer pricing documentation, e.g., functional and industry analyses, the discussion draft also requests a number of novel items. For example, the new approach would require the title and principal office location although not the names of the 25 most highly compensated employees in each business line, charts showing the supply chain for material products and services, and lists of relevant advance pricing agreements (APAs), tax rulings, and transfer pricing matters pending under a tax treaty's Mutual Agreement Procedures.

*Observation:* The local file/ master file approach does not clearly achieve the uniformity and simplicity that was the stated goal of the OECD's work on documentation given that taxpayers will now have to assemble the master file documentation package on top of the existing and varying local country documentation requirements. Additionally, some of these requirements appear to extend the principles of tax reporting beyond transfer pricing documentation, e.g., by requiring information regarding APAs and tax rulings. Likewise, some of these requirements might not be the type of information to which tax directors normally have access, e.g., data on the 25 most highly compensated executives. The language requirements appear to be fairly strict as well, e.g. local files and translation of (parts of) the master file where needed.

As part of the master file, Annex III to Chapter V would require the completion of a “country-by-country reporting template.” The template seeks to collect income and tax details regarding each “Constituent Entity” in the MNE's global group, organized by country, during the prior year. This information would include, inter alia, each entity's revenues and profits, income and withholding taxes paid, stated capital and accumulated earnings. The template also seeks information on “certain indicators” of the location of economic activity (tangible assets, number of employees and total employee expense). Also requested is information on intercompany royalties, interest, and service fees paid or received.

*Observation:* While these disclosures are to be made to tax administrations, they currently go well beyond any of the other country-by-country reporting initiatives that have been proposed in other forums, such as under CRD IV by the European Commission. This applies both in terms of the elements covered and how the breakdown by entity would be required. Additionally, the reporting of intercompany payments of interest, royalties, and service fees seems to indicate that while these are legitimate business expenses for unrelated parties, they will be closely scrutinized when they occur between related parties because of their potential for base erosion.

To implement the master file tier of the OECD's proposed approach to documentation, it will become important that master file information is consistent from country to country. As a result, the OECD recommends that master file documentation be completed under the direction of the parent company of the MNE group and shared with each local affiliate around the world. This would allow local taxing authorities to collect the master

file from the local affiliates or, in the alternative, to request the documents from another jurisdiction under treaty exchange of information mechanisms.

*Observation:* Although the OECD stresses the need for tax administrators to handle carefully any confidential taxpayer information to avoid inadvertent disclosures, the draft's planned implementation of the master file scheme appears to generate greater risks of exposure of confidential client information. Specifically, the draft's recommendation that the master file be shared with every affiliate so that it can later be shared with the relevant tax administrators during an audit seems to unnecessarily expose taxpayers to greater disclosure risks for their confidential information. There may also be business reasons why this level of information would not be shared with all affiliated entities. The exchange of information under a relevant tax treaty might be a more appropriate and secure method for sharing confidential information.

The local file would supplement the master file and ensure that the MNE has complied with the transfer pricing provisions of a specific jurisdiction. The focus of the local file would be the transfer pricing analysis of the transactions that take place between a local country affiliate and associated enterprises in different countries during the year at issue. Annex II to Chapter V would require certain specific background information about the local entity, as well as detailed factual and financial information about the transactions which are covered. For example, the local file should contain a description of the management structure of the local affiliate, a local organisation chart, and descriptions of the individuals to whom local management reports, as well as a discussion of any relevant business restructurings or intangibles transfers.

*Observation:* Some of the information requirements for local files might already exist in a robust and well-crafted functional analysis. Other detailed requirements - e.g., identification of the individuals that have direct or indirect reporting relationships - might be of only limited value to tax administrators while simultaneously increasing compliance burdens on local taxpayers.

### Timing

The OECD emphasises that transfer pricing documentation should be based upon information reasonably available at the time the transfer price was determined. The OECD also acknowledges that mismatches in the due dates of transfer pricing documentation in various jurisdictions can make it difficult for taxpayers to prioritize global documentation obligations and to provide relevant information to tax administrations on a timely basis. As a result, the discussion draft indicates that it is a best practice to prepare transfer pricing documentation contemporaneously with filing of the tax return for the fiscal year at issue.

The draft also notes that final statutory financial statements relevant to the country-by-country data requirements may not be available until after the due date for tax returns in some countries. Accordingly, the discussion draft would extend the date for completion of the country by country reporting template until one year following the last day of the fiscal year of the ultimate parent entity of the MNE group.

*Observation:* In some instances, the relevant cash tax figure may not be known within the time frame provided for completing the country-by-country reporting template, even under the proposed extended timeline.

The draft guidance acknowledges that taxpayers should not be obliged to retain documents beyond a reasonable period and that tax administrations should restrict requests for documents from prior periods.

### Materiality

The OECD recognises a balance between the tax administrations' desire for information and the compliance burdens placed on taxpayers. As a result, the discussion draft recommends that local jurisdictions adopt specific materiality thresholds that take into account, inter alia, the size of the transaction and nature of the local economy. The discussion draft does not, however, provide any guidance on what would constitute an immaterial transaction, but it does seek public comment on whether more specific guidance could be provided.

The discussion draft recommends simplification measures that would limit the transfer pricing documentation requirements for small and medium-sized enterprises (SMEs) on the basis that smaller enterprises should not

be required to produce the same amount of documentation that might be expected from larger enterprises. Nevertheless, the draft takes the position that SMEs should be required to provide information and documents about their material cross-border transactions.

*Observation:* Although it appears that SMEs might be spared from some of the compliance burdens of transfer pricing documentation, SMEs would still be required to complete the country-by-country reporting template (i.e., Annex III). As a result, despite the proposed balancing of benefits and burdens, it does not appear that SMEs will escape much of the compliance burdens placed on larger taxpayers in practice.

### Comparables consideration

Although the discussion draft recommends that transfer pricing documentation be updated annually, it does acknowledge that business descriptions, functional analyses, and comparables may not change materially from year to year. As a result, in those situations, the OECD suggests that searches for new comparables in the local file could be updated every three years. Financial data for the comparables, however, must still be updated annually to determine an arm's length amount.

*Observation:* Although the draft guidance appears to accept that business conditions may not change materially from year to year, it does not adopt any flexibility regarding comparable data.

The discussion draft also notes that local comparables generally should be used over regional comparables because of the general requirement to use the most reliable information.

### Penalties

The OECD notes that penalties, as well as penalty protection, can provide a powerful incentive to comply with transfer pricing documentation requirements. Nevertheless, the discussion draft indicates that it is “unfair” to impose large documentation-related penalties on taxpayers that make a reasonable, good faith effort to demonstrate the arm's length nature of their covered transactions through documentation. In addition, the draft notes that penalties should not be applied to taxpayers that fail to submit information to which they did not have access.

### The takeaway

The OECD's strategic objectives of making transfer pricing documentation more efficient and better targeted should be supported. The approach, as originally developed, sought to streamline and rationalise information requirements to benefit both tax administrations (i.e., with better information) and taxpayers (i.e., by delivering a more efficient process). However, based on the proposals in the current discussion draft, it is not clear that these goals have been achieved as, overall, the package seems somewhat one-sided with little clear benefit to business.

Overall, the discussion draft proposes a large number of significant changes which could result in a very short period for business to adjust to life with increased reporting obligations, including country-by-country information. The OECD will need to carefully consider whether the reporting of tangible property, number of employees and payroll expense in practice might lead to adjustments more in line with a formulary apportionment type of transfer pricing system, along with all the potential for increased disputes and double taxation that entails.

It will, in particular, be important to ensure that the consultation process is pursued to deliver as much flexibility as possible. Securing the confidentiality of information will also need to be a major priority.

Finally, the OECD statement in the draft that it will be giving further consideration to whether information relevant to other (non-transfer pricing) aspects of tax administration and the BEPS Action Plan should also be included in the common template means that the documentation requirements may be expanded well beyond transfer pricing risk assessment purposes.

The update to the Guidelines in Chapter V is planned to be finalized by May 2014.

**For more detailed information, please consult your international tax representative or contact any of the following members listed below:**

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