Just plug in the numbers

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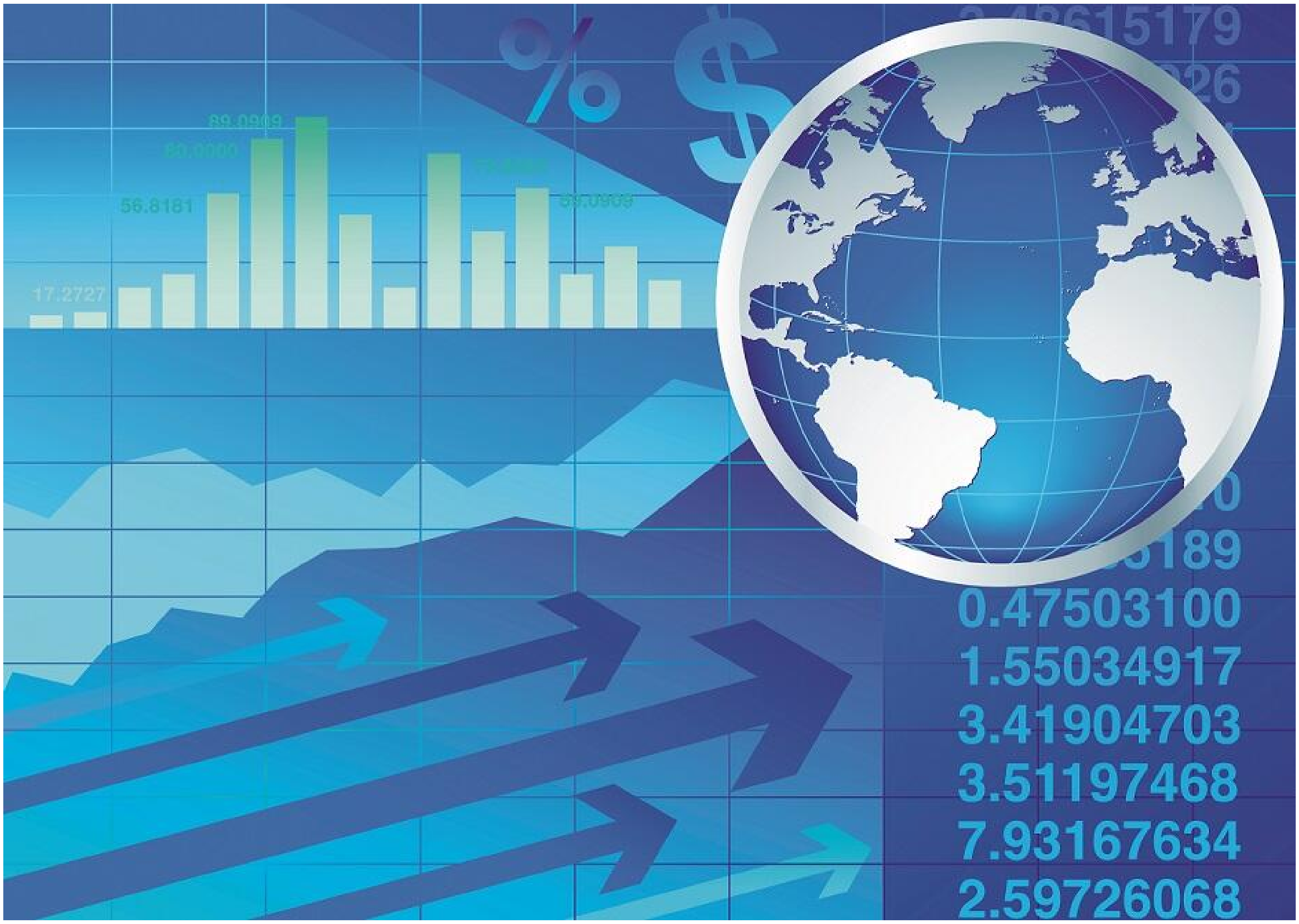

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Anton Hume and Duncan Nott explain why multinational enterprises will need to raise their game on transfer pricing documentation

Key Points

What is the issue?

Country-by-country reporting will impose new transfer pricing documentation requirements on multinational enterprises (MNEs) to give the tax authorities in each country where they operate a much clearer picture of their business

What does it mean for me?

MNEs will need to invest significant time and effort in meeting the new reporting requirements or face being placed on the target list for an expensive transfer pricing investigation

What can I take away?

There is time to test whether your systems can meet these requirements. Where enhancements are needed, acting now will allow you to resolve the issue as part of a wider strategic review of your transfer pricing arrangements

Country-by-country reporting was officially incorporated into the OECD's transfer pricing documentation guidance when the updated version of Chapter V to the OECD Transfer Pricing Guidelines was published in autumn 2014.

The guidance sets out a three-tier approach to what must be included in the contents of the documentation:

- A master file containing a high-level overview of the multinational enterprise's (MNE) business, its markets, key value drivers, intangibles, financing arrangements and core functional analysis.
- Local files describing the management structure, business strategy and functional analysis of the MNE's local entities together with its controlled transactions and their supporting economic analysis.
- A country-by-country report setting specified information relating to the global allocation of the MNE's income and taxes paid, together with indicators of locations of economic activity within the group.

Box 1 illustrates the first two tiers familiar to businesses that regularly prepare transfer pricing documentation. The combination of master file and local country files prevents duplication by capturing information common to the group in one document which provides the context for supporting each group entity's transfer pricing in local files.

But country-by-country reporting is new. It will require the disclosure of high level financial indicators across a global group in a way that provides headline comparable information to each tax authority relevant to the MNE. This greatly increases transparency in line with the aims of Action 13 of the OECD and G20’s base erosion and profit shifting project. Action 13 acknowledged that tax authorities needed a better understanding of a business’s global organisation to assess tax and transfer pricing risk. The big picture of an MNE’s value chain provided by country-by-country reporting is considered key to achieving this.

Box 1 – New guidance three-tier approach

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What information is required?

Country-by-country reporting requires the completion of the OECD’s three-page template.

The first page captures headline financial information for the business.

Metrics such as the number of employees in a country is also included – see ***Table 1*** and the explanation of indicators.

Table 2 requires the listing of constituent entities in each tax jurisdiction and their jurisdiction of incorporation if this is different. Each constituent entity must then check the box for each appropriate business activity that applies or specify its activity if this is not included in the list provided.

Although ***Table 2*** is an addition to the initial template circulated by the OECD earlier in 2014, the financial information required has been reduced. Transactional reporting has been removed from the template and will instead be required in the local file. Flexibility in the financial data sources has also been permitted, for example the use of either management or statutory accounts as long as there is consistency across the group and from year to year.

Table 3 is in essence a blank page to add information as required or desired to clarify entries in the first two tables, so it should be useful to the MNE and the tax authorities.

Table 1 – Allocation of income taxes and business activities by tax jusidiction

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Table 2 – List of all constituent entities in each tax jurisdiction

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When does this go live?

Many tax authorities are keen to implement country-by-country reporting. HMRC are key proponents of implementation and enabling legislation will be included in FA 2015. The OECD implementation plan for the new rules and filing procedures were introduced in late January 2015 and address key issues such as confidentiality concerns around filing and the exchange of country-by-country reporting information between tax authorities. However, preliminary indications suggest 2016 as the most likely start date.

The effectiveness of country-by-country reporting will be monitored once it is up and running. During the consultation, some governments, particularly those from emerging markets, sought the inclusion of transactional data in the template.

A reassessment of the template has been promised no later than 2020, so evolution from its current form is possible.

Who must complete country-by-country reporting?

Currently, there is no specific exemption from country-by-country reporting for small or medium-sized enterprises and, so far, the OECD has been clear that this information should be provided if it has been requested by tax authorities. We understand that this kind of exemption has been considered and may feature in the implementation plan. In the meantime, the adoption of country-by-country reporting could affect all MNEs.

As country-by-country reporting forms part of transfer pricing documentation, local exemptions could remove filing requirements in some territories. However, MNEs headquartered in territories with an exemption should review the requirements for their subsidiaries and be prepared to provide the relevant information to meet country-by-country reporting requirements in other jurisdictions.

Unless exemptions are introduced by the OECD in its implementation plan, MNEs should expect country-by-country reporting to apply before reviewing the rules around exemptions in their relevant territories.

Prepare now for country-by-country reporting

Tax authorities will use country-by-country reporting information as part of their transfer pricing risk review.

The report will be highly influential in determining whether a business is considered to carry a higher transfer pricing risk and if a full enquiry is justified. The robustness and effectiveness of the country-by-country report will be key to managing the increased transfer pricing risks that it brings.

The risks are twofold:

- **Visibility risk** – whether the transfer pricing policy remains current and consistent with the business's functions, territories and risk profile, and that it is implemented clearly and effectively with no unexpected outcomes.
- **Delivery risk** – can the group's systems cope efficiently and is head office's understanding of the position supported by local stakeholders?

Testing the business's ability to run the numbers quickly and efficiently will be a key part of preparing for country-by-country reporting going live. This should be trialled early because systems issues may take time to overcome.

However, the ability to produce the numbers is only the start. Transfer pricing policies should be reviewed to confirm that they remain current. The outputs of the country-by-country report should also be tested to ensure they are consistent with the policy shown in the master file and local files, together with the substance and control issues which could have an impact on a tax risk assessment.

This is a good opportunity to consider the nature, location and extent of transfer pricing risk in the business.

This can then be addressed through changes to the policy or business model, communication to stakeholders and, if appropriate, the use of further explanation and disclosure in Table 3 to provide context for the report. Opportunities to strengthen the transfer pricing policy and optimise its outcomes may be identified too.

Confidentiality issues should also be considered. As well as providing additional transparency to tax authorities, country-by-country reporting could also enlighten local management. Businesses may need to think through how this information is shared and disclosed.

In summary, an effective approach to country-by-country reporting will be to:

- articulate a clear process and risk management strategy;

- roll out this approach globally;
- identify, monitor and control key risks;
- focus on the underlying systems; and
- keep stakeholders engaged and satisfied.

Final thoughts

Of all of the OECD’s recent announcements, country-by-country reporting goes to the heart of robust transfer pricing. It concentrates on the headline financial results, implicitly asking whether an arm’s length return has been achieved, with limited opportunities for explanation in the country-by-country report itself.

This raises transfer pricing risk as a whole. Early action to understand, address and manage that risk is recommended.