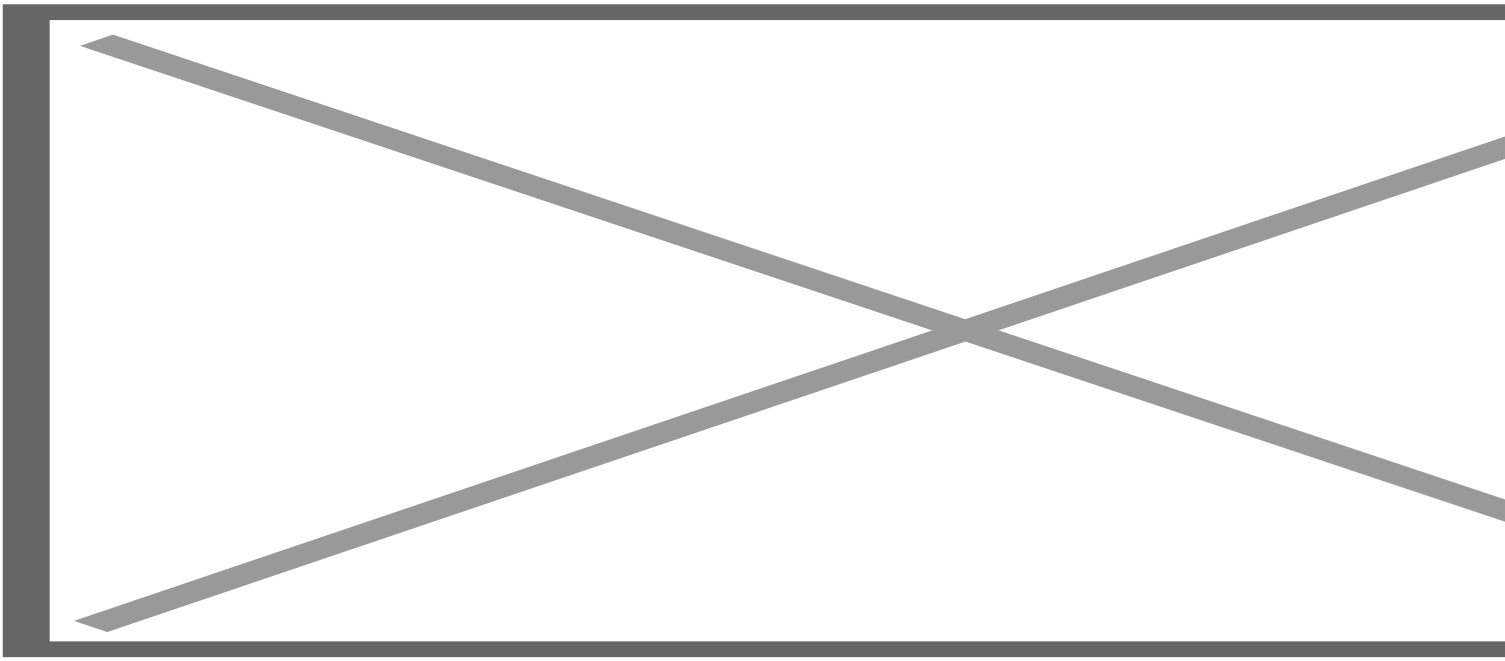
Transfer Pricing perspective

International Tax | Tax voice



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Ken Almand provides a view of the rising importance of the subject

In twenty years of working in transfer pricing I cannot remember a time when the subject commanded as high a profile as it does now. One thing is for sure – if it was not the most significant international tax issue before (an argument I frequently had with my VAT colleagues!) then it is now. This is due to a number of factors that have evolved over the past few years to ensure that transfer pricing is no longer a technical issue for the tax director of a few large multinationals in a handful of western countries. Instead it is a matter for the boardroom in locations across the world. Some of the reasons for this and what it means for business now and in future will be discussed in this article.

So where do we start? What is transfer pricing and how did we get here? The concept has been around for a long time and is simple enough. Are the terms and pricing of transactions between connected parties comparable to those between independents? As an example, if you provide tax services to a member of your family then you might provide them for free or at a reduced price compared to that which you would charge to someone with whom you have no connection. This example depends on how well you get on with your family of course! This is the arm's length principle which is the basis for transfer pricing theory and practice.

Transactions between connected parties provide the potential for those involved to control the price of a transaction and potentially to manipulate that price to their advantage. Or they may simply charge a non-arm's length price inadvertently. Either way once the transaction involves countries with different tax rates a potential tax cost saving may result. Tax administrations have been aware of this for at least a century and have taken steps to introduce legislation to prevent transfer pricing mischief.

A US president is quoted as saying:

> "Recently more and more enterprises organised abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices... in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad."

Barack Obama? George W Bush? No, John F Kennedy, in 1961. Tackling perceived transfer pricing abuses has therefore been on government policy radars for many years but it is only in comparatively recent times that concerted efforts have been made to tackle the issue. This has happened because globalisation, modern business methods and the rise in the importance of technology, the internet and intangible property has led to transfer pricing becoming a potential tax planning tool in the hands of many multinational businesses. Whether this tool has been employed for tax planning purposes or not – and it undoubtedly has by many – administrations have been forced into reviewing the existing rules by pressure from a combination of media sources, non-governmental organisations, developing countries and the general public.

The result of the pressure was that the G20 countries asked the OECD to update transfer pricing rules as part of their Base Erosion Profit Shifting (BEPS) initiative that reported back in Autumn 2015. One of the key outcomes of the OECD's momentous work was that transfer pricing should be consistent with economic substance and commercial reality. That is laudable but it is what I for one thought was supposed to be the case already. I was always taught that transfer prices were calculated by analysing functions, assets and risks. Substance prevailed over form and it was necessary to look beyond legal agreements to understand where value was really being added. The OECD has now clarified this general approach in their BEPS recommendations which is a welcome development but in many respects it is not a fundamental change in transfer pricing thinking.

Now is the time that businesses need to be reviewing their transfer pricing strategies however. There are two reasons for this. The first is that post BEPS tax planning is still an option and is always likely to be as long as countries have different tax rates. Transfer pricing planning should embrace the BEPS mantra that reward accrues to economic substance and genuine value creation and risk taking. For prudent tax planners 'twas ever thus. The tax rate differential will continue to provide tax cost management opportunities for multinationals with mobile and genuinely transferable functions, assets and risks.

The second reason businesses should review their policies is because of a greater level of transparency that should benefit tax administrations that are risk assessing multinationals. Shared master files and, for the largest groups, country by country reports, will potentially provide tax officials with insight that was previously denied to them in the vast majority of cases. Tax directors should imagine that they are tax officials and critically examine the draft master files and country by country (CbC) report for their own business, then go one step further and analyse local files, benchmarking, underlying agreements and the system that produces transfer pricing figures for returns and accounts. All ok? Good, because there are unprecedented numbers of countries that see transfer pricing as a golden opportunity to raise tax revenues. Given that the subject by its nature may require elements of subjective and objective reasoning to arrive at a supportable position it is not surprising that the scope for challenge and negotiation is seen as high by many jurisdictions. Someone once said that there are no right answers in transfer pricing but plenty of wrong ones and it is an approach which some tax authorities seem to take to heart. Beware – we are potentially on the verge of a new wave of tax authority audits that will catch the unwary or ill prepared.

Finally there is the matter of reputational risk. Now that businesses will be sharing significant amounts of potentially sensitive information the risk of confidentiality failures, cyber attacks on tax administrations or

reputational damage in consequence of being splashed across the newspapers is sure to rise. The EU has been debating the introduction of rules requiring groups to publish financial information and the clamour for greater corporate transparency enjoys growing support. Suddenly transfer pricing is no longer a matter for the tax department but also for the boardroom