

**Bloomberg
BNA**

TRANSFER PRICING

INTERNATIONAL JOURNAL

International Information for International Business



VOLUME 15, NUMBER 11 >>> **November 2014**

www.bnai.com

Managing Transfer Pricing Risk in the Current Environment

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Increased scrutiny of transfer pricing activity has exerted significant pressure on businesses. That said, there are areas which have seen improvements. The following article considers these changes for the better.

There has been a significant change in the transfer pricing environment both in terms of an overhaul of regulatory guidance and in terms of the media pressure placed on tax inspectors to place transfer pricing transactions under more scrutiny than in previous years.

However, despite the understandable negative reaction to these changes (most notably the country-by-country reporting templates and the increased burden on business) there have been some positive changes buried in the guidance updates that taxpayers can employ to reduce overall risk.

I. OECD Recommendations

The OECD's draft recommendations on documentation¹ and on revisions to the Transfer Pricing Guidelines² include several balanced and encouraging statements of benefit to business:

A. Low Value-Adding Services

On November 3, 2014, the OECD released a discussion draft recommending a safe harbor rate of 2-5% (markup on relevant costs) for certain "low value-adding" services to include (in this current draft):

- accounting and audit;
- processing and management of accounts receivable and payable;

- human resources;
- monitoring of health and safety standards;
- information technology services (where not part of the principal activity of the group);
- internal and external communications;
- legal services;
- activities relating to tax obligations (information gathering, preparation of returns and payments);
- general services of an administrative or clerical nature.

Whilst, typical margins for entities providing some of the above services are a lot higher than 2-5% (particularly legal services where margins can exceed 15% in practice); the above list will be useful for groups that are balancing limited resource and compliance burdens across a multitude of jurisdictions.

The OECD discussion draft embraces the EU Joint Transfer Pricing Forum paper³ (February 2010) relating to intra-group pricing for low value added services and will provide businesses with an element of penalty mitigation when pricing such services between the recommended markup on costs. A business would need to satisfy the authorities that the tested transactions are indeed "low value" and the paper includes a useful checklist to this end. This move towards a non-statutory safe harbor demonstrates a commitment to helping businesses manage transfer pricing compliance without placing significant cost burdens on them.

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One other point of note is the list of activities not considered as qualifying for a simplified approach (the implication being that these are routine enough in nature to list here if not low value-adding and a margin in excess of five per cent for pricing these services will be required):

- services constituting the core business of the group;
- research and development services;
- manufacturing and production services;
- sales, marketing and distribution activities;
- financial transactions;
- extraction, exploration, or processing of natural resources;
- insurance and reinsurance;
- services of corporate senior management.

B. Lack of Comparable Data

The lack of comparable data is one of the most common criticisms in relation to transfer pricing support and subjectivity. The OECD has confirmed in revised guidance that:

Taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation. Therefore, tax administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer of creating it. Where a taxpayer reasonably demonstrates, having regard to the principles of these Guidelines, that either no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue, the taxpayer should not be required to incur costs in searching for such data

Therefore, it is recommended that preliminary risk assessments include the consideration of successful outcomes versus potential compliance costs before embarking on a transfer pricing review.

C. Frequency of Updates

Within Europe, it has become customary to update documentation for contemporaneity every one to two years. The OECD has confirmed that:

In order to simplify compliance burdens on taxpayers, tax administrations may determine, as long as the operating conditions remain unchanged, that the searches in databases for comparables supporting part of the local file be updated every 3 years rather than annually. Financial data for the comparables should nonetheless be updated every year in order to apply the arm's length principle reliably.

These are positive developments that should reduce compliance burdens generally and be of particular benefit to businesses with a restrained degree of business change and limited resources that to commit to compliance.

II. Dispute Resolution and the Availability of Certainty Rulings

The increased scrutiny placed on transfer pricing has certainly led to an increase in transfer pricing audits and an increase in the number of tax inspectors with experience/expertise in this field.

When already under transfer pricing, an Advance Pricing Agreement ("APA") can be an effective method of elevating transfer pricing discussions to key specialists and ensuring that the pain of the transfer pricing audit has some long lasting benefit for the business. Transfer pricing issues agreed with the relevant tax administrations can be applied for several years in the future to ensure that there are no further disputes. Many jurisdictions are introducing/expanding APA regimes as a direct result of the strained audit environment, in a significant effort to provide business with certainty at an uncertain time. A decade ago, most multilateral APAs were concluded between the U.S., the U.K. and Japan; however, there are now efficient regimes in most other European territories plus South America and Asia-Pacific tax administrations. The process is not perfect and there are resource constraints in some locations (including the U.S.); many businesses are still reticent to enter into APAs due to the timescale involved. However, when already under a transfer pricing audit, there is often a desire for an expeditious resolution from both parties.

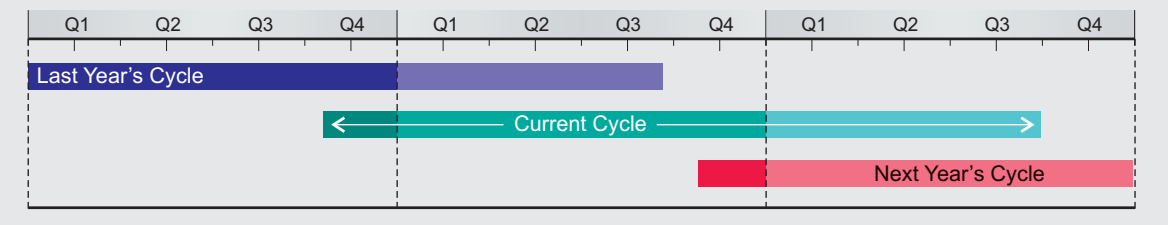
III. Pre-Emptive/Real Time Transfer Pricing Discussions

In 2012, the OECD released a discussion draft, and requested business comments, in relation to certain timing issues related to transfer pricing.⁴ In spite of the comments received, the discussion draft has drowned in the BEPS initiative. This is unfortunate as there are some important considerations here that can assist with risk management⁵. Most businesses wait until the end of the financial year before commencing their transfer pricing review; however, this is set to change as individual countries introduce new legislative requirements. In France, for example, recent changes now require the filing of significant intra-group transfer pricing information within six months of submission of the main tax return⁶ thereby increasing and bringing forward the risk of a transfer pricing challenge.

Rather than waiting for the sword of Damocles to fall, it is possible to undertake real time reviews of transfer pricing and undertake periodic true-ups during the financial year – in particular by applying a consideration of alternative methodology comparisons. Whilst timely comparable information may not be available until after peer businesses have closed and filed accounts, the overall transfer pricing policy can and should be reviewed in advance and adjustments made to manage risk. We now operate in an environment in which detection risk is high; however, adjustment risk is under the control of taxpayers and the approach adopted for economic transfer pricing. This real time approach will also assist with demonstrating much-needed consistency of transfer pricing methodologies year on year.

Many tax jurisdictions provide for pre-filing discussions on transfer pricing aimed at providing certainty in advance of transactions being entered into. Pre-transactional certainty of transfer pricing treatment can be critical for businesses and the pre-filing process (early stage discussions of key issues) can take

Diagram



1-2 months to conclude. This is a viable option for companies before transfer pricing audits occur.

IV. Overall Compliance Approach

Whilst the country-by-country reporting template involves significant work to populate and will increase audit enquiries, many businesses are looking to use it as a risk assessment tool.

An encouraging feature to surface from the debate on documentation has been the recognition that the introduction of further compliance requirements needs to be balanced, where possible and appropriate, by alleviations to the frequency and volume of the compliance burden for business. These are areas where taxpayer and practitioner alike need to be aware of what potentially they can benefit from.

V. Conclusion

In the fast-moving and politically-charged BEPS environment, taxpayers and advisers should be encouraged by the fact that the proposed fundamental changes to so many facets of the transfer pricing environment have not been all one way. Concerted efforts have been made to inject a sense of reasonable balance into the proposed changes by introducing measures that focus on an assessment of transfer pricing risk, and reasonable easing of the compliance burden, where appropriate.

But the introduction of these measures seems to have depended disproportionately on the representations put forward by taxpayers, advisers, business rep-

resentatives, the EU-JTPF, and a limited number of those tax authorities present at the OECD.

Business now needs to be vigilant in making sure that it takes full advantage of the benefits of the measures indicated above to mitigate their transfer pricing compliance risk and burden. Business also needs to ensure that it continues to press for further measures to mitigate that risk and burden still further. After all, there can be no doubt that the overall level of compliance risk and burden has increased and will continue to do so. It would be unfortunate if this trend continued exponentially without the inclusion of yet further redeeming factors.

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NOTES

¹ http://www.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-documentation-and-country-by-country-reporting_9789264219236-en

² <http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-low-value-adding-intra-group-services.pdf>

³ http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2010/jtpf_020_rev3_2009.pdf

⁴ <http://www.oecd.org/ctp/transfer-pricing/5051930.pdf>

⁵ http://www.oecd.org/ctp/transfer-pricing/Timing_Issues_Comments.pdf

⁶ Australia, Canada and Mexico already require submissions of intra-group transfer pricing information with tax returns

This article first appeared in vol. 15 iss. 11 of *Transfer Pricing International Journal*, published by Bloomberg BNA.