

International

The BEPS Project: Planning in Anticipation

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Issue: International Transfer Pricing Journal, 2014 (Volume 21), No. 3

Published online: 12 May 2014

The authors focus in more detail on some of the specific transfer pricing-related changes that could flow from the BEPS project and offer their insights into how multinationals can be positioning themselves in anticipation.

1. Introduction

In their previous article, the authors considered some of the potential changes that could arise from the OECD's BEPS project and proposed some practical steps that multinational enterprises concerned about the BEPS project could be taking in anticipation of the possible changes. In this article, the authors focus in more detail on some of the specific transfer pricing-related changes that could flow from the BEPS project and offer their insights into how multinationals can be positioning themselves in anticipation.

2. The OECD BEPS Project

2.1. The BEPS report and the BEPS action plan

The authors have written at length in previous editions of this journal about the OECD BEPS project. ^[1] By way of brief overview, the OECD published a report in February 2013 summarizing its findings about the phenomenon of base erosion and profit shifting (BEPS) ^[2]. The report presented nothing substantively new, and was largely a rework of previous OECD thinking on this topic. However, the report concluded that an action plan should be drawn up by the OECD and implemented on an accelerated timetable in order to inform further discussion and to put in place sufficient measures both to combat and to discourage BEPS.

The action plan duly followed in July 2013 ^[3] and has since received political backing from the G20 and by mainstream politicians in a large number of jurisdictions. The European Union is also pursuing many similar initiatives, with common threads (based principally around enhanced transparency and automatic exchange of information concerning taxpayers) now beginning to emerge across the board.

The action plan itself comprised 15 specific action points, which together touch on every aspect of the current principles of international taxation – from source and residence state theories to transfer pricing, multilateral coordinated action, information exchange and international tax avoidance (for example using cross-border arbitrage via hybrid funding instruments). Whilst most of the topics mentioned in the BEPS action plan were foreshadowed in the earlier BEPS report, the action plan articulated the topics and proposals more clearly and contained a timetable for the envisaged reform.

The 15 specific action points are shown in Table 1.

Table 1

Action point	Description	Deadline
1	Address the tax challenges of the digital economy	September 2014

* **McDermott Will & Emery, London and Houston, respectively.**

1. See C. Lowell & M. Herrington, *BEPS: Current Reality and Planning in Anticipation*, 21 Intl. Transfer Pricing J. 2 (2014), Journals IBFD; M. Herrington & C. Lowell, *A Call to Rewrite the Fundamentals of International Taxation: The OECD BEPS Action Plan*, 20 Intl. Transfer Pricing J. 6 (2013), Journals IBFD.
2. OECD, *Addressing Base Erosion and Profit Shifting – Report 2013* (OECD 2013), International Organizations' Documentation IBFD.
3. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD.

Action point	Description	Deadline
2	Neutralize the effects of hybrid mismatch arrangements	September 2014
3	Strengthen CFC rules	September 2015
4	Limit base erosion via interest deductions and other financial payments	December 2015
5	Counter harmful tax practices more effectively, taking into account transparency and substance	December 2015
6	Prevent treaty abuse	September 2014
7	Prevent the artificial avoidance of permanent establishment status	September 2015
8	Assure that transfer pricing outcomes are in line with value creation: intangibles	September 2015
9	Assure that transfer pricing outcomes are in line with value creation: risks and capital	September 2015
10	Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions	September 2015
11	Establish methodologies to collect and analyse data on BEPS and the actions to address it	September 2015
12	Require taxpayers to disclose their aggressive tax planning arrangements	September 2015
13	Re-examine transfer pricing documentation	September 2014
14	Make dispute resolution mechanisms more effective	September 2015
15	Develop a multilateral instrument	December 2015

2.2. OECD progress on the BEPS action plan

The OECD laid down a highly ambitious timetable in the BEPS action plan, but so far it has stuck to that timetable and the promised deliverables have each appeared on time.

Whilst in some senses the action plan has simply provided a necessary impetus for already overdue processes to be finalized at the OECD level (such as the long-running rewrite of the intangibles chapter of the 2010 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), which is finally scheduled to be complete by September 2014), it is in other senses remarkable that the OECD has managed to stick to the timetable set down, with a large number of consultation documents being published in short order and hardly a week going by without some form of BEPS-related communication coming out of the OECD.

On 23 January 2014, the OECD held a public webcast that gave an overview of developments to date. The webcast took the form of a panel discussion, involving Pascal Saint-Amans (Director of the Centre for Tax Policy and Administration), Raffaele Russo (Head of the BEPS Project), Achim Pross (Head of the International Cooperation and Tax Administration Division) and Marlies de Ruyter (Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division).

The OECD confirmed in the webcast that the BEPS project is on track per the timetable originally envisaged in the action plan and that the OECD has received repeated support and encouragement from governments around the world for its work on this matter. The webcast also provided some valuable insight into the organization of the OECD's BEPS work. In summary:

- the work is being carried out by the Committee on Fiscal Affairs, via its relevant subsidiary bodies;
- both OECD and non-OECD G20 countries are participating on an equal footing as “Associates in the BEPS Project” (and it was noted that Columbia and Latvia have also joined on an equal footing as accession countries); and
- developing countries are being actively involved in the process. Their input is being obtained through several mechanisms such as the OECD's Task Force on Tax and Development, the OECD Global Relations Programme, via global forums on tax treaties, transfer pricing and VAT, and also through the UN.

Since that webcast, the OECD also released (on 20 February 2014) an updated timetable for stakeholder input into the BEPS process, replacing the one it issued in December 2013. The timetable contains the dates for the various discussion drafts/public consultations regarding the September 2014 BEPS project deliverables and shows that the BEPS project has lost none of its initial momentum as regards each workstream (the only exceptions being the public consultations on hybrid mismatch arrangements and on country-by-country reporting and transfer pricing, which have both been pushed back to May 2014).

The OECD's efforts in the transfer pricing sphere still stand out as the most notable aspects of the BEPS action plan work, however. Since the action plan was published, the OECD has published several important transfer pricing documents, a number of which relate to previously ongoing initiatives that have been wrapped into the BEPS project. These include the white paper on transfer pricing documentation and a revised discussion draft on the transfer pricing aspects of intangibles. The OECD also hosted a public consultation in November 2013 on transfer pricing matters (at which these documents were discussed and debated with stakeholders), and on 30 January 2014 published for public comment a discussion draft on transfer pricing documentation and country-by-country reporting.

The timetable for transfer pricing-related matters continues at great speed throughout 2014, with several areas due to be consulted upon in time for the September 2014 delivery of the various work products mandated by the BEPS action plan.

3. Planning in Anticipation

What can taxpayers expect the post-BEPS transfer pricing landscape to look like? From a helicopter view, it will most probably be very similar to the pre-BEPS landscape. However, the authors expect there to be numerous changes to process and practice as a result of the BEPS project, and these are matters that multinationals can begin thinking about now.

3.1. Monitoring BEPS developments

It almost goes without saying that a crucial aspect of anticipating BEPS developments is keeping up to speed with developments in the BEPS realm. Multinational enterprises will need to closely monitor the regular communications from the OECD concerning the BEPS project and ensure that they are fully involved (where appropriate and possible) in the consultation process in order that they may shape the development of the BEPS work products. It is only through being aware of the developments that are taking shape that multinationals will be able to decide on the most appropriate course of action for their respective effective tax rate planning.

In order to do this, multinationals need to understand the timetable and where things currently stand in the process. In 2013, there were a number of crucial transfer pricing-related developments at OECD level, which are summarized in the timeline in Table 2.

Table 2

Document	Date
OECD BEPS Report	13 February 2013
Draft Handbook on Transfer Pricing Risk Assessment	30 April 2013
Revised section E on Safe Harbours in chapter IV of the Transfer Pricing Guidelines	16 May 2013
BEPS Action Plan	19 July 2013
White Paper on Transfer Pricing Documentation	30 July 2013
Revised Discussion Draft on Transfer Pricing Aspects of Intangibles	30 July 2013
Memorandum on Transfer Pricing Documentation and Country by Country Reporting	3 October 2013
OECD Public Consultation on Transfer Pricing Matters	12-13 November 2013

In 2014, a significant number of transfer pricing aspects of the BEPS project are going to be consulted on and implemented, some of which have already taken place at the time of writing. These include the deliverables listed in Table 3.

Table 3

Transfer pricing-related deliverable	Date
OECD BEPS Webcast	23 January 2014
OECD Discussion Draft on Transfer Pricing Documentation and Template for Country-by-Country Reporting	30 January 2014
OECD Global Standard for Automatic Exchange of Information ^[1]	13 February 2014
OECD Request for Input: Data/Effective Tax Rate Methodology	Expected in March 2014
OECD Discussion Draft on the Tax Challenges of the Digital Economy	24 March 2014
OECD Public Consultation on Tax Treaty Abuse	14-15 April 2014
OECD Public Consultation on the Tax Challenges of the Digital Economy	23 April 2014
OECD Public Consultation on Country-by-Country Reporting and Transfer Pricing	19 May 2014

* Not strictly a transfer pricing-related deliverable, but (in the authors' view) something that falls within the same space as the transfer pricing deliverables under the BEPS project by virtue of its emphasis on commonality of reporting standards, automatic exchange of information and enhanced transparency.

With so many aspects to the BEPS process, multinational enterprises therefore need to be proactively engaged in order to ensure that (as a minimum) they are following the developments in the BEPS realm in order that they may plan in anticipation.

3.2. The role of the transfer pricing function in a multinational group

In the authors' view, one of the critical changes that some multinationals will need to embrace concerns the role and importance of the tax function and, specifically, the transfer pricing function within a multinational group. Going forward, it will be practically impossible for a multinational group to function in the post-BEPS world without giving careful consideration to the potential impact of transfer pricing on both its day-to-day activities and its more intermittent actions (such as group restructurings). It will therefore be essential not only to employ experienced transfer pricing personnel within the group, but they will also need to be bought into business decisions at an early stage and given substantive power to offer input as stakeholders in the business.

For those multinational enterprises that do not currently involve an internal transfer pricing function in such decisions, it would be advisable to employ a *modus operandi* whereby the transfer pricing function is given a seat at the table alongside the other functions that tend to provide input into business decisions (e.g. the risk, finance, regulatory and legal teams). Employing a form of "air traffic control" whereby evolutions in the business are always passed through committees involving the transfer pricing functions will help to ensure that multinational enterprises do not inadvertently open themselves to transfer pricing disputes with tax administrations and should also ensure that, when such disputes inevitably do arise, the group has a defensible position based upon a sound consideration of the existing transfer pricing guidelines at the time and careful documentation.

In turn, there is also the need for multinational groups to view the transfer pricing function as a profit centre in the business. In the authors' experience, the transfer pricing function is often seen by multinational enterprises as a net cost centre, but this is because its contribution is to a large extent invisible, as it is a fundamentally defensive discipline; where the transfer pricing function adds value is in minimizing the cost of debates with tax administrations (in terms not only of pure cash but also internal management time).

Multinationals may therefore like to begin raising awareness in their business lines about the contribution that the transfer pricing function makes and ensuring that it has real power in the business to carry out its role.

3.3. Preparing for disputes

The authors expect a marked upturn in the number of transfer pricing-related disputes in the post-BEPS world. This will be due to a number of factors, the key one likely to be an increased awareness of transfer pricing amongst tax administrations (coupled with a lack of sufficiently experienced transfer pricing experts working for tax administrations).

In practice, tax administrations are increasingly becoming aware that transfer pricing can be a significant revenue-raiser. For example, published statistics in the United Kingdom ^[4] show that the UK tax authorities have netted over GBP 2 billion in the last three years from pursuing transfer pricing-related adjustments. In times of economic strain for many governments around the world, it is natural that taxation will be seen as an obvious source of additional income – and with transfer pricing being a discipline that never offers a precise answer (but allows for some elasticity as regards pricing and returns), tax administrations are likely to regard transfer pricing in particular as a potentially fruitful avenue of enquiry into a multinational's affairs.

Multinationals therefore need to prepare for disputes and do what they can now to minimize the costs later on in the event that a dispute arises. In the authors' experience, many transfer pricing disputes with tax administrations take far longer to resolve than they should because of a lack of internal data and robust systems at the taxpayer's end.

A multinational might therefore consider following a strategy that incorporates the elements listed below:

- devising a robust and defensible transfer pricing approach for their business lines that is both documented and implemented;
- ensuring that key management personnel have a clear understanding of, and robust position in respect of, the typical "pressure points" that tend to arise in transfer pricing disputes with tax administrations (e.g. entity classification for members of the group supplying goods and services);
- a stated internal transfer pricing policy (e.g. incorporated into handbooks for staff outside the tax function, with advice on when to seek help and what issues should be raised with the transfer pricing team);
- documenting clearly (for example in board minutes) the basis for the adoption of pricing strategies. This could involve, for example, clearly noting that a transaction that seems to be entered into at an undervalue with a related party is regarded as being on arm's length terms because of associated collateral benefits (e.g. where

4. See <http://www.hmrc.gov.uk/international/transfer-pricing-stats.pdf>.

- goods are transferred intra-group for no consideration to a distributor entity on the basis that after-sales support and maintenance will be offered by the transferor to the third-party customer);
- holding regular reviews of the group’s transfer pricing strategy (at least annually or where the business of the multinational or its functional organization is significantly altered) to ensure continuing compliance with the arm’s length standard;
- approaching tax administrations and seeking to agree transfer pricing issues in ‘real time’, for example by way of an advance pricing agreement;
- seeking to rely on safe harbours. The OECD has traditionally advised against the use of safe harbours, principally because they are not in line with the arm’s length principle and lead to taxpayers in comparable situations being treated divergently. However, in May 2016, the OECD updated its guidance on safe harbours and recommended that they be used (where appropriate) to ease compliance burdens and reduce costs. Whilst safe harbours are likely to be available only for relatively low-risk and less complex situations, a group that thinks it may be entitled to rely on a safe harbour could find them a sensible choice. They should result in a reduction in the transfer pricing burden in an immediate sense and also avoid disputes in the future by guaranteeing that a taxpayer’s pricing will be accepted by the relevant tax administration as being on arm’s length terms;
- involving third-party advisors to regularly review and stress test the group’s chosen transfer pricing approaches; and
- maintaining duplicate transfer pricing documentation locally within the group (as well as master records centrally at the parent company level), to overcome the practical difficulties of obtaining documentation from overseas related parties when disputes with tax administrations arise. This approach could be particularly relevant for subsidiaries that enter into related transactions with entities above them in the group corporate structure, as in practice it can be difficult for such entities to demand that their corporate parent provide them with information about its tax affairs (especially where the various parts of a multinational group in practice function as separate and independent business lines), etc.

3.4. Considering recharacterization risk

The OECD Guidelines (2010) generally caution against the use by tax administrations of recharacterization as a transfer pricing assessment tool. This is generally because recharacterization is arbitrary and not in line with reality. Moreover, it can multiply disputes in a cross-border context, where each tax administration recharacterizing a given transaction may do so with different outcomes.

The authors expect that this could be an area that tax administrations with aggressive transfer pricing practices may revisit. Presently, tax administrations will generally recharacterize a transaction where the transaction does not accord with reality (e.g. debt finance recharacterized as equity where the debt exceeds an arm’s length level) or where no third party would have entered into the transaction on the terms agreed between the related parties.

Given the narrow scope of these two approaches, there does seem to be some room for recharacterization to become a broader enquiry. The authors note specifically here that the BEPS action plan mentions the possibility of measures “beyond the arm’s length principle” being employed in suitable cases. In a recharacterization context, the authors would not be surprised if this took the shape of:

- more tax administrations beginning to make secondary transfer pricing adjustments (e.g. where debt is recharacterized as equity and then withholding tax and possibly associated penalties are demanded for domestic withholding tax on dividend payments); and
- some limited additional recharacterization rights within the OECD Guidelines– perhaps specifically in the context of concerns around cross-border tax avoidance, which seems to run through the BEPS action plan as a common thread. For example tax administrations may be accorded greater scope to recharacterize a transaction in a punitive fashion where avoidance is found to exist and can be stuck down by domestic legislation. Similarly, the terms of the multilateral instrument proposed as part of the BEPS action plan may also provide some scope for limited recharacterization in aggressive tax planning areas involving transfer pricing.

Bearing all of these elements in mind, multinational enterprises should therefore be considering the impact of the risk of recharacterization on their existing structures – indeed, it should be a matter that merits consideration in going forward for new ventures, too.

For example, would a multinational consider that it is in safe waters as regards the entity classification and return on functions for each of its group service providers (e.g. would a limited risk distributor in its group be at risk of recharacterization as a full risk distributor)? Does the group rely heavily on debt dumping and leverage that could be open to recharacterization on the basis of equity function arguments? Would those arguments raise additional complex issues around secondary transfer pricing adjustments?

If the group considers that there are aspects of its transfer pricing policy or group effective tax rate planning that are vulnerable to recharacterization, the group could at that stage consider the cost/benefit analysis in terms of voluntarily recharacterizing as opposed to waiting for an adjustment to be made by the tax administration.

Moreover, in the course of conducting such a survey of recharacterization risk, groups may in fact find that they have opportunities to proactively recharacterize in their favour. They may find, for example, low-risk functions that are overcompensated and opportunities for modifying functions and pricing in such a way as contributes to a beneficial impact on their effective tax rate.

3.5. Reassessing portfolio methods and unbundling set-offs

3.5.1. Portfolio methods

Ideally, the arm's length principle should be applied on a transaction-by-transaction basis. However, it is often the case that there are transactions that are so closely linked that they form a composite whole. This tends to be a function of the way in which the multinational in question views the transactions from a business perspective. This is often seen in the context of intangibles, but it can, in theory, arise in any transactional context involving goods and services.

The authors' experience in such situations is that tax administrations are generally willing to accept a portfolio approach to the application of the arm's length principle. This is a pragmatic approach that recognizes the fact that businesses see a form of economic logic in bundling the transactions in question.

However, the authors would not be surprised to see tax administrations beginning to unbundle such transactions and require multinational enterprises to demonstrate the application of the arm's length principle to the composite elements. This is likely to be driven in particular by the concerns expressed in the BEPS report and the BEPS action plan around the length of many multinational enterprises' global value supply chains, and the perceived possibility they raise of the inappropriate segmentation of profits to low-tax jurisdictions.

3.5.2. Set-offs

Moreover, the authors expect to see some movement in the general willingness of tax administrations to allow intentional set-offs in transfer pricing methodologies. Presently, many tax administrations allow multinational enterprises to incorporate a set-off into a transaction whereby the totality of the arrangement is on arm's length terms, but the individual elements (viewed in isolation) may not be. Most commonly, this occurs where two parties make reciprocal supplies to one another at an undervalue (e.g. for no consideration or perhaps for cost with no markup), with perhaps a balancing payment from one party where necessary. The rationale from the group's perspective is that the overall transaction is on arm's length terms because equivalent value has moved in both directions (with a balancing payment, where necessary).

This kind of intentional set-off is not permitted for more than two taxpayer entities and also may not be used for situations where bilateral supplies take place within a group, with one supply at an undervalue and the other at an overvalue (the net position being that an arm's length price is achieved overall).

As with portfolio approaches, the authors would not be surprised to see tax administrations taking a more precise approach to set-offs and requiring the demonstration of the arm's length principle on a transaction-by-transaction basis. Most notably, this is likely to go hand in hand with the increasing reliance on profit-split methodologies that the authors have previously ^[5] predicted will become the main method of choice in the post-BEPS world. Where transactions cross borders and are bundled in some way, it is almost inevitable that each tax administration will seek in the post-BEPS world to unbundle them and ensure that it has achieved its appropriate tax-take from the situation.

Multinational enterprises that employ portfolio or intentional set-off methods in their transfer pricing practices could therefore consider taking the following steps:

5. Herrington & Lowell, *supra* n. 1 (*BEPS: Current Reality and Planning in Anticipation*).

- conducting active reviews of controlled transactions to identify those where an economic rationale has resulted in a portfolio approach or an intentional set-off;
- assessing the historic evidence in place for the adoption of the portfolio/set-off approach, and assessing the appropriateness of that approach;
- where necessary, bolstering that historic information with the findings of the review and ensuring that the approach is followed only where it is still thought to be appropriate; and
- pricing individual transactions on an arm's length basis where a portfolio/set-off approach is no longer thought to be appropriate (or where, perhaps, the risk of challenge from a tax administration is thought to be high).

3.6. Revisiting the tested party concept

The starting position under the OECD Guidelines is that the “tested party” (i.e. the party for which a financial indicator is tested per the chosen transfer pricing method) is the less complex party. In general, this is because it is thought to be easier to conduct a functional analysis on such a party, and in turn it is generally thought that comparables will be easier to find for less complex entities.

In addition, the tested party for a given tax administration is usually the domestic party involved in a cross-border transaction. This tends to flow from two key factors: the practical difficulties of obtaining information from foreign entities and the fact that tax administrations are less interested in foreign tax bases than in their own. In the authors' view, it is possible that these aspects of the tested party concept could change – in particular because of the increasing use of the profit-split method in the post-BEPS world. Multinational enterprises that rely therefore on using one-sided transfer pricing methods in high-tax jurisdictions would be wise to assess how they will deal with requests for information from, and the imputation of profit-split returns to, low-taxed related counterparties.

3.7. Reassessing selected transfer pricing methodologies

The authors have said before that they expect profit-split methodologies to become the key approach in the post-BEPS world (especially where there are cross-border supplies involving residence-source state situations). Accordingly, multinationals that rely on significant amounts of “one-sided” transfer pricing determinations in their group should consider reviewing their position. Such groups may consider reassessing the appropriateness of the profit-split method instead of their selected method, and also assessing the impact of an enforced profit-split methodology in the event of a dispute with a tax administration.

Such groups will need to ensure they have sufficient financial information in place covering all the parties to the transactions in question. This information will be crucial to determining not only whether the profit-split is the best method, but also in calculating the amount of profit that needs to be split and an appropriate profit-split.

4. Conclusions

The OECD's BEPS project promises to radically change many aspects of the present international tax system. Whilst the degree to which change will really follow is as yet still unclear, the project is proceeding on course per its original ambitious timetable and seems to still have wide-ranging and strong political support.

In the transfer pricing realm, there is the potential for changes in many aspects of practice; many of these go beyond the headline changes (such as country-by-country reporting) and go fundamentally to the heart of the way in which transfer pricing methods and systems work. Ultimately, the changes are likely to come in a patchwork, with different administrations adopting divergent practices (e.g. to questions such as recharacterization), meaning that taxpayers will need to ensure that they are on top of developments globally in all the markets where they operate.

In advance of the changes, multinationals can be planning in anticipation by reviewing their existing structures and implementing robust transfer pricing methodologies. Moreover, keeping abreast of developments will place multinationals in a strong position to seize the opportunities that will inevitably come out of the reform; the inevitable gaps and frictions between domestic regimes will arise as different countries go their own way in the BEPS process.