BEPS MONITORING GROUP

Response to OECD White Paper On Transfer Pricing Documentation[i]

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK and others. This response has not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse the general positions it takes.

This response has been prepared by Richard Murphy, and reviewed by other members of the group.

1. Introduction

1.1 We welcome the White Paper issued by the OECD on transfer pricing documentation. In particular we believe that the proposed two-tier structure of master and local files that is proposed is very helpful because it will simplify documentation requirements for both tax administrations and firms, and is a step towards the combined and country-by-country reporting that we believe is vital if base erosion and profit shifting by multinational corporations is to be tackled.

1.2 We recognize that this report results from work initiated prior to the BEPS project, and therefore does not directly address BEPS concerns, but its proposals will be integrated into that process. Since we are concerned essentially with BEPS, our comments will be directed to ensuring that the documentation proposals provide an adequate basis for BEPS. Our concerns will be summarised at this stage in this submission, and we look forward to opportunity in the future to expand upon many of them in more detail.

1.3 Our main concerns relate to what appear to us to be omissions from the planned transfer pricing documentation. These relate to:

> a. The lack of a statement of the purpose of transfer pricing documentation in this document, which as a result means there is no structure to the proposals made;
>
> b. The lack of a clear systematic approach to the document to be supplied which would, in our opinion, make the undertaking of a transfer pricing risk assessment harder to achieve, in turn meaning that there may be an inappropriate selection of transfer pricing audits undertaken;
>
> c. No discussion of the issue of country-by-country reporting in the proposed documentation; we expect that the request from the G8 will ensure that this matter will be considered;

d. The omission of a requirement to report data on the likely key drivers of profit allocation.

1.4 There are other issues of concern to us, but we have chosen to concentrate on these at present. That is because the issues on which we comment are those that will, we think, deliver the reform to the transfer pricing system and the engagement of companies with it that is at the heart of the OECD's current objectives whilst reforming that system to ensure that it meets the needs of 21st century tax authorities. The clarity of thinking and necessary statement of purpose to achieve that goal are missing from the proposals made at present. We make these observations with the aim of addressing those deficiencies.

2. The purpose of transfer pricing documentation

2.1 Transfer pricing documentation does not exist in a vacuum. It has a purpose, but as the consultation paper notes (para 15) this is rarely stated. This results in confusion and diversity of practice (paras 45 and 46). The consultation also, we think correctly, notes some cynicism (para 43) about the demand for transfer pricing documentation, giving rise to a less than fulsome commitment to the process by some companies. In our view, the reasons for transfer pricing documentation requirements should be explicitly stated in any resulting OECD publication that requires a transfer pricing master file if the necessary commitment to that requirement is to be secured.

2.2 In our opinion the statements as to purpose in the consultation document (paras 46 and 63) are self referencing and not persuasive: they describe a state of affairs and not reasons for the requirements. We consider that the purpose of transfer pricing documentation is not to demonstrate that the arm's length pricing approach has been properly documented. In our view its purpose should be to provide the necessary data and evidence to show that the firm has made an appropriate apportionment of its taxable profits between the various jurisdictions in which it operates. We consider that the proposed master file must include such a clear statement of its purpose in order to ensure that the process is properly understood.

3. A systematised approach to transfer pricing risk

3.1 If transfer pricing documentation exists to evidence that a multinational corporation has made an appropriate apportionment of its taxable profits between the various jurisdictions in which it operates then a systematised approach to its production and presentation is necessary.

3.2 In our opinion this risk assessment needs to be based on an approach that recognises that:

a. not all the profit of a company will be taxable, but some is;

b. the part of the profit of a company that is taxable is determined on the basis of taxable revenue less tax allowable costs and not on the basis of financial accounting profits;

c. there should be no transactions that are taxable and no costs that are deductible that are not recorded in the books and records of the company i.e. assuming tax evasion is not taking place the taxable transactions of the company are a sub-set of those total transactions of the company that result in its recorded profit or loss;

d. Only some of that sub-set of transactions of concern for taxation will be of relevance for transfer pricing purposes:

i. Some will not be taxable;
ii. Others will be solely domestic and have no international implication;
iii. Some will be international but will be with third parties;
iv. Others will be intra-group and international but will be similar in nature to third party transactions undertaken by the same company making direct comparison possible for transfer pricing purposes;
v. Some will be intra-group and international and there will be no direct group comparable transactions, but due to the nature of the transactions (e.g. because they are for readily identifiable tangible items for which comparisons can be found or are for services where market equivalents are available) the determination of transfer prices should be technically feasible, and where it is not the drivers of profit (see below) can be identified;
vi. There will be another group of transactions (hopefully small in number, but not necessarily so) which are intra-group and international where the goods, or more likely, services supplied are intangible in nature, the location of the profit drivers giving rise to value within the transaction are hard to determine, comparable prices are hard to find because there is no third party equivalent market for the services in question and the contribution the payment makes to the overall profit arising is hard to assess. These are most likely to be transactions relating to finance, intangibles, derivatives and related transactions, management services and group reorganisations, although this list is not exhaustive.

3.3 In our opinion the transfer pricing documentation master file should record how these varying transactions needing transfer pricing assessment are identified within the systems of the multinational corporation. Where they differ, local procedures will also need to be reported in the local file.

3.4 We think it a statement of fact that no transfer pricing audit can be assured of delivering the right outcome if the sample population to be tested by it cannot be guaranteed to be complete. We are concerned that the approach suggested in the consultation document does not require the presentation of documentation that, in our opinion, achieves this result and suggest that this needs to be remedied.

3.5 It is our suggestion that any risk assessment tool for transfer pricing documentation should as a minimum be able to reliably:

a. identify taxable transactions as a sub-set of all transactions;

b. identify international transactions;

c. stratify those transactions as far as possible into risk categories as noted above;

d. indicate the location of likely profit drivers showing the appropriateness of the location of recording of relatively low risk transfer priced transactions;

e. provide the clearest possible indication of the location of all transactions, especially those likely to be subject to transfer pricing review;

f. give the clearest possible indication of the location of the net benefit (taxable profit) arising from taxable transactions;

g. Indicate the potential likely revenue impact of challenging any arrangement, but most especially those in high-risk categories.

3.6 Such systems documentation is an essential part of the internal control environment of any transnational corporation and is, for example required to fulfill the obligations of the Sarbanes Oxley Act, and so should be readily available for most firms. If the transfer pricing master file achieved this goal then we believe that:

a. transfer pricing risk assessment would be better understood by companies;

b. transfer pricing decision making by companies would improve;

c. transfer pricing risk could be better appraised by authorities at both group and local levels;

d. fewer transfer pricing audits would be required;

e. there would be cost and efficiency savings for all parties.

4. Transfer pricing and country-by-country reporting

4.1 The White Paper makes only a very limited range of references to country-by-country reporting in the proposed master file documentation that the White Paper proposes. Such documentation has been requested by the G8, and it would seem that this file is the ideal place for it.

4.2 We note, and welcome the fact that the proposed master file documentation includes a request that the consolidated accounts of the multinational corporation should be made available to all tax authorities that engage with its subsidiaries. We do, however, stress that those accounts, prepared for financial reporting, are of only limited value for tax risk assessment purposes and are of even more limited use for transfer pricing risk assessment. Indeed, the International Accounting Standards Board, which publishes the most widely accepted accounting principles in the world (International Financial Reporting Standards) has itself said that the financial statements created using its standards are not suitable for tax authority use[ii].

4.3 Some of the obvious deficiencies of consolidated financial accounts for tax purposes are:

a. they do not necessarily included all the companies that make up a group for tax purposes;

b. they do not disclose all the companies that are consolidated, or where they are, or what they do;

c. they purposely exclude from consideration and view all intra-group transactions – which are precisely those that create transfer pricing risk;

d. they do not provide segment data that provides any useful indication of the location of transactions for tax purposes;

e. they do not necessarily reflect the transactions undertaken in the underlying accounts disclosed to the individual tax authorities dealing with the affairs of the individual companies that make up the group entity. That is because of the impact of what are called group consolidation journals that remove from account, without it being apparent, those intra-group profits arising, for example, from different accounting standards being used in different group companies that are precisely the type of transaction about which tax authorities require information.

4.3 It is for these and other reasons that civil society has created the concept of country-by-country reporting[iii]. Whilst it is common to represent that country-by-country reporting relates solely to the reporting of tax payments to government, that is not, and never has been, the case. **Country-by-country reporting would require disclosure of the following information by each Transnational Corporation (TNC) in its annual financial statements:**

a. the name of each country in which it operates; a country for these purposes being defined as any jurisdiction in which it has a business presence;

b. the names of all its companies trading in each country in which it operates;

c. what its financial performance is in every country in which it operates, without exception, including:

(i) its sales, both third party and with other group companies;

(ii) its hedging transactions, both third party and intra-group;

(iii) purchases, split between third parties and intra-group transactions;

(iv) labour costs and employee numbers;

(v) financing costs split between those paid to third parties and to other group members;

(vi) its pre-tax profit;

(vii) the tax charge included in its accounts for the country in question split as noted in more detail below;

(viii) details of the cost and net book value of its physical fixed assets located in each country including the cost of all investments (including those relating to exploration) made in assets related to extractive industries activity by location and the proceeds of sale from disposals of such assets by location;

(ix) details of gross and net assets in total for each country in which the entity operates.

Note that if sales data on source and destination bases for a jurisdiction are more than 10% different both must be disclosed on both bases for both third parties and intra-group transactions.

4.4 Tax information would need to be analysed by country in more depth requiring disclosure of the following for each country in which the corporation operates:

a. the tax charge for the year split between current and deferred tax;

b. the actual tax payments made to the government of the country in the period;

c. the liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period;

d. deferred taxation liabilities for the country at the start and close of each accounting period;

e. cumulative disclosure on a year by year and country-by-country basis of:

(i) provisions made for taxes from the time that country-by-country reporting commenced;

(ii) total tax payments made from the time that country-by-country reporting commenced.

f. separate accounting, distinct from the turnover category, for all futures, derivative and forward contract sales with separate disclosure of purchases of similar financial instruments being disclosed with netting off not allowed;

4.5 There should be additional requirements for companies operating in the extractive industries.

4.6 This form of country-by-country reporting has been designed for public disclosure to ensure that global companies could be held to account locally in each jurisdiction in which they operate. This, of course, would be information that, as a result would be invaluable to each and every tax authority in which a TNC operates and as such we recommend that a requirement for this data, which reconciles with the audited group consolidated accounts, be made a requirement of transfer pricing documentation master files irrespective of whether it is made available on public record or not.

4.7 We emphasis that the information that this form of accounting would supply would be as follows:

a. a full summary of the group's composition;

b. a full summary of all intra-group trading by the group split between:

(i) sales on both a source and origin basis;

(ii) hedging and derivatives;

(iii) cost of sales;

(iv) financing

c. a world wide labour force break down by head count and cost

d. profits and tax paid by location, as well as tax deferral by location so that the impact of tax planning between states is made clearer;

e. the location of assets

f. payments for intangibles.

4.8 In our opinion this data is essential for the identification of transfer pricing risk noted in section 9, above and would give rise to considerable savings in the preparation of other documentation and in audit time expended as a result.

4.9 However, that being noted, and as the International Accounting Standards Board has said (and as the Federal Accounting Standards Board and others would no doubt agree) financial statements are not prepared for tax purposes; hence, if transfer pricing risk is to be properly appraised then the above country-by-country reporting information must be modified for taxation purposes.

4.10 This is not the place to discuss the detail of those modifications required to country-by-country reporting to fully equip it as an essential risk assessment tool in the form of combined reporting that we consider an essential part of transfer pricing documentation, but we do at this juncture suggest that any modification will:

a. identify non-taxable transactions by jurisdiction to facilitate reconciliation of accounting and taxable profit;

b. identify high-risk transfer pricing transactions in addition to those required for public disclosure noted above. These would include all payments for intangibles, management fees and transactions related to group reorganisations;

c. identify capital allowance claims in place of depreciation.

4.11 We stress that this list is not exhaustive at this stage. What we do, however, very strongly believe is that a template to reflect such data, and its reconciliation with country-by-country reporting prepared on the basis of the firm's financial statements, is an essential part of any transfer pricing documentation and we look forward to further opportunity to comment on the development of such an approach.

5. Identification of the key drivers affecting profit allocation

5.1 Arm's length pricing is just one method of ensuring that a multinational corporation has made an appropriate apportionment of its taxable profits between the various states in which it operates. There are, of course, others available and as members of the BMG have argued previously[iv]:

Consolidated accounts are also necessary to apply the 'profit-split' method, which is already allowed within the current OECD guidelines. Under this method, the total profits of a MNC are allocated to different jurisdictions according to so-called 'allocation keys' – clear and concrete criteria defined on a case-by-case basis by the parties concerned.

5.2 We are surprised by the lack of attention given in the proposed transfer pricing documentation files to these 'allocation keys' or 'drivers of business profit' as they appear to be called in the consultation document. Given that they are commonly referred to in transfer pricing this appears to use to be a material omission.

5.3 In practice, we think those key drivers are, inevitably, linked to the location of any enterprise's:

a. customers;

b. labour force;

c. physical facilities.

5.4 The information that we have suggested should be supplied by country-by-country reporting, as modified for taxation purposes, is specifically designed to meet this need for information on the drivers of profit within the business ad provides an additional resource, as a result, for transfer pricing purposes when this cannot be undertaken on an arm's length pricing basis.

---

[i] http://www.oecd.org/ctp/transfer-pricing/white-paper-transfer-pricing-documentation.pdf

[ii] http://www.ifrs.org/IFRS-for-SMEs/histroy/Meeting-Summaries-and-Observer-Notes/Documents/SME0806b02Aobs.pdf page 15

[iii] For the best current explanation of country-by-country reporting see http://www.taxresearch.org.uk/Documents/CBC2012.pdf

[iv] See .No more shifty business' http://www.taxresearch.org.uk/Documents/Shifty.pdf