Introduction to the OECD TP Guidelines

Snapshot

• “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”

• Commonly referred to as the following:
  o The OECD Guidelines; or
  o The Guidelines; or
  o The Blue Book

• Issued by the Organization for Economic Cooperation and Development (“OECD”), a Paris based think tank and an international economic organization currently numbering 35 member countries
Introduction to the OECD TP Guidelines (cont’d)

Some historical perspective
Key objectives

• Commentary to Article 9 of the OECD Model Tax Convention
• To set out the principles and recommended practices to apply to international tax calculations for MNEs and tax authorities
• To set up common grounds for tax authorities and tax payers in order to reduce controversy
• To encourage harmonization and international cooperation
• To secure appropriate tax base
• To avoid double taxation
Introduction to the OECD TP Guidelines (cont’d)

Preface

The 2017 OECD Transfer Pricing (“TP”) Guidelines is divided into the following 5 main parts:

- An introduction consisting of a foreword, a preface and a glossary
- The general mechanics of determining arm’s length prices, consisting of guidance for application of the arm’s length principle (Chapter I), the 5 TP methods (Chapter II) and comparability analyses (Chapter III)
- Formal issues such as avoiding and resolving TP disputes (Chapter IV) and TP documentation (Chapter V)
- Specific transactions such as intangibles (Chapter VI), intra-group services (Chapter VII), cost contribution arrangements (Chapter VIII) and business restructurings (Chapter IX)
- Annexes to various of the foregoing chapters and an appendix recommending the use of 2017 OECD TP Guidelines to governments and taxpayers

In essence, the OECD TP Guidelines first discusses the problem of profit allocation, the goals of the arm’s length principle and the guidelines, and burdens of proof
Mechanics of determining arm’s length prices

Chapters I to III of the OECD TP Guidelines

Chapter I
The arm’s length principle

- This chapter provides the explanatory background/guidance for the application of arm’s length principle
- It defines the arm’s length principle, defends it against alternatives such as formulary apportionment and discusses fundamental concepts such as comparability, recharacterisation, loss making companies, government policies and custom valuations
- It provides a tool for understanding the financial and economic relations between the parties, how to actually delineate the actual transaction when facts vary from contractual arrangements and how to identify specific risks, who is assuming/controlling/has the financial capacity to bear such risks

Chapter II
TP methods

- There are 5 main methods to find arm’s length prices: the so-called traditional transaction methods (CUP, resale minus, cost plus) and transactional profit methods (TNMM and PSM)
- This chapter describes the aforesaid TP methods and explains how to select the most appropriate one

Chapter III
Comparability analysis

- Chapter III suggests how to perform a comparability analysis after one has delineated the actual transaction and has established the significant comparability factors. It also suggests when to do it (i.e., the price setting approach) or after (the outcome testing approach) and discusses various compliance issues
- Describes the typical 9 steps to performing a comparability analysis, bearing in mind the 5 comparability factors at each step (please refer the next slides for further details on comparability analysis)
Formal issues and specific transactions

Chapters IV to IX of the OECD TP Guidelines

**Business restructurings**
- Defines business restructurings, discusses the links between risk and profits and transfer of both, and shows how to determine arm’s length payments at the time of restructuring and thereafter
- Argues when transactions should be recharacterized and provides a number of examples of business restructurings

**Cost Contribution Arrangements**
- Provides a definition and overview of CCAs, describes how to test the arm’s length principle and how to make adjustments where needed
- Addresses issues regarding entering and leaving a CCA and structuring and documenting CCAs

**Intra-group services**
- Identification of whether services were provided and determining their arm’s length charge
- Provides reduced documentation requirements and a safe-harbour mark-up for certain low value adding intra-group services

**Administrative approaches**
- Addresses governments on compliance (TP compliance practices, safe harbours and simultaneous tax audits) and dispute prevention/resolution (APAs, MAPs, corresponding adjustments and arbitration)
- Provides insightful discussion on bi/multilateral APA process, describing eligibility conditions, the conduct and finalization of APA negotiations and monitoring an APAs implementation

**TP documentation**
- Proposes a 3 tiered approach to TP documentation, i.e., Master file, Local file and CBCR
- Discusses the timing of preparing documentation, materiality thresholds, frequency of updates, language, penalties and confidentiality
- Provides template both for reporting and implementation of the reporting package

**Intangibles**
- Identification of intangibles
- Intangible ownership and contractual terms relating to intangibles (legal ownership)
- Functions (DEMPE), assets and risks in relation to the intangibles (economic ownership)
- Guidance for determining arm’s length conditions in cases involving intangibles
Pivotal aspects of the OECD TP Guidelines 2017
Guidance for application of the arm’s length principle

Key highlights

- Identification of the actual transaction undertaken
- Examining contractual terms and conduct of the parties (conduct prevails over contracts if there is misalignment between the two)
- Circumstances in which the actual transaction undertaken may be disregarded for transfer pricing purposes (transactions that are not commercially rational)
- A six-step process for identifying and analysing risk
- Assumption of risk meant as “control over risk” and “financial capacity to assume risk”
- In cases where risks are funded by an entity with no ability to evidence control, then returns should be limited to a risk free rate
- Comparability factors in transfer pricing, including location savings, assembled workforce, and MNE group synergies
New risk analysis framework

Six step process for identifying and analyzing risks

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<tr>
<th>Step 1</th>
<th>Step 2</th>
<th>Step 3</th>
<th>Step 4</th>
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<td>Identify Economically Significant Risks with specificity</td>
<td>Determine how specific, economically significant risks are contractually assumed under the terms of the transaction</td>
<td>Perform detailed functional analysis of economically significant risks to determine how the associated enterprises operate. Analysis must determine which entity: 1. Performs control and risk mitigation functions 2. Encounters upside or downside consequences of risk outcomes 3. Has the financial capacity to assume the risk</td>
<td>Decide whether the contractual assumption of risk identified in Step 2 is consistent with the entities’ conduct identified in Step 3</td>
<td>Re-allocate risk to the party that assumes it based on conduct in Step 3</td>
<td>Perform TP analysis based on the delineated transactions after re-allocating risk</td>
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1. Perform Functional analysis
2. Determine Contractual Allocation of Risk
3. Identify Economically Significant Risks
4. No further analysis required
5. Economically significant risks
6. Non-significant risks

Is Conduct consistent with contract? 
Yes: Re-allocate Risk
No: Perform TP analysis based on contractual allocation of risk.
3 tiered approach to TP documentation

Master file, Local file and CbC Report

**Master File**
Key information about the group's global operations including an overview of business operations along with important information on global transfer pricing policies with respect to intangibles and financing.

**Local File**
Detailed information and support of the intercompany transactions that the local company engages in with related parties.

**CbC Report**
Key financial information on all group members on an aggregate country basis with an activity code for each member.

Country tax administrations globally are adopting the 3 tiered TP documentation approach into their local regulations at different paces and in different ways. Some countries have already enacted laws effective from 2016; some countries are expected to enact laws for subsequent tax years; and still others have not yet taken a position on this approach or no material changes are expected. Multinational businesses accordingly need a flexible yet consistent approach to their preparation of transfer pricing documentation.
3 tiered approach to TP documentation

Constituents

Master File

Country by Country Template

Local File

Evolution of existing transfer pricing documentation

- Group wide description including supply chain, value drivers, main markets, high level functional analysis, details of business changes
- Intangibles strategies and location, and R&D management and location
- High level description of group financing arrangements
- Consolidated group accounts
- Description of APAs and transfer pricing related rulings

Transaction/transactional/entity specific:

- Local management structure, detailed functional analysis and economic analysis
- Any involvement or affection by business restructurings or intangibles transfers
- Reconciliations of transfer pricing to accounts
- Copy of local APAs and transfer pricing related rulings
- Specific local country requirements

A new requirement

- Revenue
- Profit before tax
- Cash tax paid
- Current Tax Accrual
- Capital and accumulated earnings
- Tangible assets
- Number of employees
- Complete list of entities and permanent establishments for each country and its main business activity
Guidance for intangibles

Analytical framework

1. Identify the intangibles and economically significant risks associated with the DEMPE of the intangibles
2. Identify the full contractual arrangements and determine legal ownership
3. Detailed functional analysis to identify the parties performing functions, using assets, and managing risks related to DEMPE
4. Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties
5. Delineate the actual controlled transactions related to the DEMPE of intangibles
6. Where possible, determine arm’s length prices for these transactions consistent with each party’s contributions
Guidance for intangibles

Strong focus on DEMPE functions

- Requirement to directly perform or to control the performance of DEMPE functions and related risks
- Return to be retained by an entity depends on the contributions it makes through DEMPE functions to the anticipated value of intangible relative to contributions made by other group members

The new OECD guidance focuses on “substance” for conducting transfer pricing analysis of intangibles
Low value adding intra-group services

Synopsis

• Definition of low value-adding intra-group services:
  • supportive in nature
  • not part of the core business
  • do not require the use (or creation) of valuable intangibles
  • do not involve the assumption of (or give rise to) significant risks

• Typically included: accounting and auditing, human resources, IT (routine activities), internal and external communication, legal and tax services

• Explicitly not included: R&D, manufacturing, sales & marketing, corporate senior management

• Simplified charge-mechanism:
  • Mark-up of 5% considered to be appropriate profit level
  • Reasonable cost allocation methodologies

• Simplified documentation and reporting requirements:
  • Simplified benefit test: benefit to be demonstrated only by categories of services and not on a specific charge basis
  • Limited TP documentation required: description of services and benefits, intercompany agreements, calculations of charges
  • Countries may also include a threshold, where the simplified approach can be re-examined and possibly rejected
  • Withholding taxes to be levied only on amount of profit element