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Transfer pricing value chains and supply chains post-BEPS

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Q&A:

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THE PANELLISTS

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Dr Vladimir Starkov is an economist and a testifying expert specialising in transfer pricing and asset valuation. He has participated in engagements involving various tax controversy proceedings, negotiation and implementation support for unilateral and multilateral advance pricing agreements with tax authorities, design of intercompany pricing methodologies, valuation of intangible property transferred in intercompany transactions, including cost-sharing agreements and preparation of transfer pricing documentation. He has conducted valuation of businesses and various intangible assets.

FW: Could you outline how the Organisation for Economic Cooperation and Development's (OECD's) international taxation framework has impacted the transfer pricing (TP) arena? What is the overall objective of recent reforms?

Hervé: Transfer pricing (TP) related to intra-group goods and service transactions impacts the international profit allocation and income taxation of multinationals. To navigate between conflicting interests of governments and facilitate international trade, the Organisation for Economic Co-operation and Development (OECD) has, since 1983, established the arm's length standard as the key TP principle for pricing international intra-group transactions. With a few exceptions, adherence to the arm's length principle has been codified in national tax laws in most countries, including non-OECD ones. The arm's length principle is fundamentally an economic concept. It considers a hypothetical arm's length negotiation between profit maximising group transaction parties. Given case-specific industrial, regulatory and competitive environments, parties with higher relative bargaining power – as evidenced by ownership of and control over valuable assets, such as unique intangibles, higher value-adding functions, entrepreneurial risk taking and ability to seek outside options – should reap a higher share of expected consolidated profits. The application of TP methods developed by the OECD is supposed to reflect that desired economic outcome. That said, international tax planning practice over time managed to impose an interpretation of OECD standards that facilitated the design and implementation of tax-efficient intra-group value chains. From the perspective of some OECD member states, many of those arrangements were 'artificial', insofar as they would not have seen the light of day without substantial tax benefits, such as tax rulings, offered by certain jurisdictions that allegedly 'eroded' the tax base in the higher-tax jurisdictions.

Starkov: The OECD's 15-action point Base Erosion and Profit Shifting (BEPS) initiative that started in 2013 effectively recognised that the arm's length principle needed a kind of 'rebooting' to eliminate a perceived disconnect between the fundamental 'arm's length principle' – considered to be sound – and its practical application by taxpayers and sovereign countries which, in certain instances, led to outcomes perceived to be distortionary. The OECD has recognised that interactions among the tax regimes of sovereign countries opened opportunities for a low taxation of income from some types of international transactions and for avoiding taxation of certain income altogether. Many multinational taxpayers allegedly have exploited such opportunities over the years, which shifted the tax base away from jurisdictions where the activities generating this income were performed. The BEPS project stressed that cooperation among countries is essential to combat the alleged aggressive taxpayers' practices. The documents developed as the result of this endeavour contain guidance that codifies application of the arm's length principle to specific types of transactions and in specific circumstances. While most of the action points of the BEPS plan were finalised in 2015-2016, a few others remain a work-in-progress. One of these is building an international consensus around the principles of taxation of the digital economy. Another is the development of an international legal framework that would allow high-tax jurisdictions to obtain a right to levy taxes on the income of multinational taxpayers that is perceived to be taxed at low rates or not taxed at all by some other jurisdictions.

FW: What specific impact have the OECD reforms on Base Erosion and Profit Shifting (BEPS) had? To what extent has this added to companies' TP documentation obligations?

Starkov: Some of the more impressive achievements of the OECD's BEPS initiative were the creation of a mechanism for exchanging the key financial, operating and tax data of large multinational taxpayers among tax authorities around the world – by way of so-called country-by-country reports (CbCR) – and developing the means for amending hundreds of existing bilateral tax treaties with clauses rooted in the BEPS principles. Both these initiatives were adopted not just by OECD member countries, but by the world at large. For example, at present, 85 countries have adopted the taxpayers' data exchange into their local laws and over 125 countries participate in the multilateral convention that allows tax authorities to exchange taxpayers' information and to conduct tax examinations abroad, if requested. These facts indicate that the era of global tax transparency is upon us, and that TP documentation must reflect this changing reality. No longer can TP documentation be tailored to satisfy the requirements of just one or a few of the taxing authorities in the world. Rather, documentation must tell a consistent 'story' in each country where a multinational group has its operations. It also must convincingly state the principles of profit allocation that apply to every jurisdiction of the group's operation, such as whether a particular subsidiary is entitled to a fixed rate of profit or a share of the residual profit of the group, and why.

Hervé: The OECD BEPS reforms provide the basis for identifying and challenging corporate structures that show a mismatch between low economic substance of particular entities, and the high share of taxable income allocated to those entities through intragroup TP. The lack of substance mismatch can now more easily be challenged through two BEPS game-changing outcomes. First, a considerable expansion of the permanent establishment definition, whereby subsidiaries earning income from intangibles that do not have significant activities contributing to development of these intangibles now face a much higher risk of being deemed to have created a permanent establishment, and become tax liable, in other jurisdictions. Second, the replacement of legal intellectual property (IP) ownership by functional contributions to more broadly defined intangibles as the core element to justify the attribution of entrepreneurial profits across entities. In the pre-BEPS world, contractual allocation of legal ownership of IP and financial risk-taking could be sufficient for a lean, limited-substance company to operate as central entrepreneur in the value chain and earn all entrepreneurial income. Post-BEPS, these characteristics are no longer sufficient. What justifies entrepreneurial profit allocation now is the functional, substance-based contribution toward the development, enhancement, monitoring, protection and exploitation (DEMPE) of intangibles, a broader concept of 'value drivers' that goes beyond the legal definition of IP meaning intangible assets protected by law and capable of being transferred. In most multinational groups, the geographical footprint of these so-called DEMPE functions will be much broader than IP legal ownership. It follows that, in the future, the TP analysis related to the allocation of intangibles' returns will become more complex, uncertain and subject to international tax disputes, especially as the OECD provides no rigorous analytical framework for how to consider DEMPE contributions in the TP analysis. To manage the related risks, the TP documentation of multinationals will inevitably have to become more complex and analytically thorough, both in the factual description of DEMPE contributions in international value chains and in the related TP analysis.

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> VLADIMIR STARKOV
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FW: Drilling down, what specific changes impact the treatment of value and supply chains for TP purposes? What were the key factors which drove the OECD to make these changes?

Hervé: The revised OECD TP standard post-BEPS will require significant effort in the areas of TP planning and creating TP planning and documentation. For firms with global value chains, DEMPE contributions to intangibles may appear in any corner of the world. This creates a high risk that tax authorities will challenge established TP structures which allocate no more than fixed benchmarked returns to most of the operating companies of a group on the ground that they have no significant entrepreneurial contributions. Tax authorities, particularly those in emerging or net-importing countries, will have incentives to challenge any TP documentation that does not disclose the information on the amount and the allocation of the non-routine profits of the group and impose significant TP adjustments and penalties. While established TP systems should very often be sustainable, multinationals will often have an incentive to enhance the transparency over the allocation of consolidated value chain profits in their TP documentation.

Starkov: Digital transformation is now a business reality. Most multinationals have already incorporated or are incorporating digital solutions into many aspects of their operations. In addition, the number of multinational businesses that are 'born digital' grows every year. While incorporation of the digital solutions will not necessarily alter the process of value creation within a firm, in some cases digitalisation may lead to that result. Financial services, publishing, retail and marketing industries are among those that have been dramatically altered by digitalisation. However, the business model of firms that are 'born digital' are typically quite distinct from those used in 'brick-and-mortar' businesses. Digitalisation opens opportunities for businesses to, on the one hand, centralise certain functions and assets in one or a few jurisdictions, such as development, data processing and analysis functions, and servers, and, on the other hand, reach new markets at lower costs than ever before, such as via digital commerce and remotely provided services. This combination of centralisation for some operations with a broad market outreach often allows firms to benefit from an economic phenomenon, when a growing number of customers or users creates a positive impact on the existing customers or users, a phenomenon typically called the 'network effect'. Advancements in data collection, storage and analytics have allowed businesses to accumulate massive amounts of data from their customers and gain new insights from these data. Digitalisation is perceived by the international tax community to pose unique opportunities for BEPS. Digitalised businesses are said to exploit BEPS opportunities through minimising their tax liabilities in jurisdictions where their users are located, by minimising functions and assets in those jurisdictions or maximising tax deductions. Additionally, digital businesses have been accused of exploiting the design flaws of the current international tax system by directing significant profits to low-tax jurisdictions and avoiding taxation in market countries. The OECD is currently working to address the challenges posed by digitalisation by means of developing a framework that will alter existing taxing rights to allow countries to tax income generated from the cross-border activities of digital businesses, even in the absence of a significant presence of such taxpayers in the taxing jurisdictions.

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> YVES HERVÉ
> NERA Economic Consulting

FW: What has been the general response to the OECD reforms? How are companies reacting to the timetable for implementation, and preparing accordingly?

Starkov: There is no doubt that the BEPS reforms have significantly increased the compliance burden, particularly for large multinationals. It is probably fair to say that the need to prepare and provide annual updates for CbCR and TP master files and local files has accounted for much of this burden. In the initial stages of this compliance implementation, preparedness has varied greatly from one taxpayer to the next. Some taxpayers, for instance, started preparing 'dry runs' of their compliance documents way before the reporting deadlines, while others waited until the last minute. Many multinationals had to significantly increase the headcount of their in-house tax staff and perform upgrades to their IT systems to implement compliance processes. Yet, it may be too early for tax departments to call it a done job. Since the OECD continues to work on its BEPS initiatives, such as the minimum taxation of the income earned by multinationals in low-tax jurisdictions and taxation of the digital economy, taxpayers must be ready to face new compliance challenges in the months and years ahead.

Hervé: When it comes to tax optimisation structures such as established principals in low tax jurisdictions, many multinationals are conducting internal strengths, weaknesses, opportunities and threats (SWOT) processes that lead either to a strengthening of such structures through substance increases in terms of headcount, functions and responsibilities, adaptations of their TP model, or, sometimes, to the complete unwinding of structures no longer deemed sustainable. It seems fair to say that multinationals with less obvious exposure mostly adopt a wait-and-see approach to how tax authorities will approach intangibles and DEMPE contributions in practice. While formally they are already working hard on implementing the recommended master file and local file TP documentation concept consistently on a global scale, most of the them prefer maintaining their legacy TP models and analysis to evidence their arm's length pricing. They hope that consistency over time and regions, tax authorities' uncertainty of how to consider and value DEMPE contributions, and the conflicting interests of tax authorities, will deter them from aggressively challenging established solutions which have been mostly accepted in the past. Behind the screen of their official TP documentation, however, some multinationals are preparing back-up analyses for dispute resolution in case the revised BEPS DEMPE wave of challenging legacy solutions comes faster and stronger than expected.

FW: What best practice recommendations would you outline on how to deal with value chain analysis in terms of TP compliance?

Hervé: Foremost, companies now need to explain the company-specific comparative advantages that are the critical success factors for why they earn certain margins in their core business. To be consistent in their global tax compliance and reduce future tax disputes, it is therefore recommended that, in their master file TP documentation, multinationals disclose their value chain not only in a descriptive manner, but also conduct a quantitative value contribution analysis of how company value and profit margins are related to certain groups of intangibles, such as technology and marketing intangibles. This exercise should be consistently communicated and defended on a global scale. This facilitates TP justification and, if needed later, dispute resolution at the more granular, transactional level in the country-specific local TP documentation file. In the TP local files, the group can then assess in isolation the individual entities' DEMPE contributions to individual intangibles categories and provide convincing evidence for why many individual contributions may not justify participating in intangible returns. This transparent approach should help multinationals reduce the scope for inevitable intangible-related tax disputes.

Starkov: TP documentation that has the best chance to withstand scrutiny from local tax authorities upon audit with no, or at most minimal, adjustments, must tell a consistent 'story' about the group's operations and value drivers in every tax jurisdiction and back this 'story' up with solid evidence. The process necessary for preparing such TP documentation begins with identifying the main value drivers either for the group overall or for specific intragroup transactions. Next comes 'mapping' these key value drivers to the functions performed, risks managed and assets employed by legal entities of the group. After this, the relative bargaining position of individual entities within a given value chain is assessed considering the contributions of those entities to the overall value creation, and the relative importance of the risks managed, and the assets employed by each entity. In the final step, the results of this quantitative analysis are supplemented with economic analyses to determine whether current TP policies are consistent with value creation within the group, and, if not, more appropriate TP methods will have to be selected for various intragroup transactions. This process is sometimes called 'value chain analysis'. Even though the process of value chain analysis may require the involvement of many stakeholders within the corporate group and may be quite complex, the benefits can go well beyond creating a coherent and defensible model for tax compliance. For example, value chain analysis can be used as a strategic tool to help identify the actual, or desired, roles various group's entities are, or should be, playing and to design their incentives and rewards accordingly.

FW: With firms likely to face greater scrutiny from tax authorities in the future, how can data analytics tools help to gather, process and categorise huge amounts of data for tax reporting purposes?

Hervé: At a macro level, multinationals have already been preparing CbCR that may provide indicative evidence as to how TP impacts on a multinational group's profit breakdown across group entities and helps verify whether the profits arising in certain jurisdictions are plausibly justified in view of their substance, such as total headcount and assets. At a micro level, digital transformation of tax compliance processes will inevitably facilitate a tax department's overview on actual TP setting and outcome and ability to finetune TP monitoring. This will allow it to fix implementation problems which lead to deviations of TP guidelines and contractual solutions from actual applied solutions. Group tax departments can reduce tax exposure from flawed TP practices. Multinationals should consider this an absolute necessity since, in parallel with their efforts, tax authorities around the globe are also establishing digital solutions to facilitate electronic audits of huge company data sets.

Starkov: Tax authorities these days are gaining access to an unprecedented amount of new information about taxpayers. First and foremost, this information comes to them by way of CbCR that stemmed from one of the BEPS initiatives. In addition, tax authorities in some countries have started to monitor and analyse the data on cross-border financial transactions among related parties. Some tax authorities now monitor taxpayers' profitability in 'real-time', or as soon as the tax returns are filed. These new information and monitoring tools enable tax authorities to focus on certain transactions and taxpayers they deem to be 'high risk' for tax non-compliance. How can taxpayers avoid being categorised as 'high risk'? The answer is for taxpayers to develop software solutions that monitor their transfer prices throughout the year and to proactively adjust transfer prices to achieve the profitability results established in TP policies. To be effective, such solutions should be integrated with the enterprise resource planning (ERP) systems of the group, and they should allow tax departments to monitor and adjust the prices of all intra-group transactions in real-time.

FW: With reforms ongoing, what developments lie ahead for TP? Do firms need to revaluate their value and supply chains now, to take stock of a shifting international taxation environment?

Starkov: At present, the OECD is working to reach a consensus on initiatives to tax the profits of multinationals subject to low rates of taxation and, separately, on the framework to tax digitalised businesses in the countries where their users are located. The outline of the consensus on these two initiatives is expected to have been made public in October 2019. Since there is a high likelihood that these consensus proposals will be adopted by many countries, it behoves taxpayers to re-examine their global value chains to decide whether the new tax regime will make existing supply chains obsolete or risky from a tax standpoint.

Hervé: The OECD member states have, through their current draft proposals on digital taxation, created an additional layer of uncertainty for multinationals. The discussion drafts currently on the table constitute a significant detachment from the arm's length principle as reinterpreted in the course of the BEPS initiative. For example, it is discussed whether marketing intangibles' returns should always be fully taxed in the sales recipient's country, irrespective of any DEMPE contributions to marketing intangibles in other territories. While the objective is clear – namely, to disincentivise establishment of any intermediate value chain companies in low-tax jurisdictions – the outcome of the upcoming OECD discussions between countries with very conflicting interests is completely uncertain. It would be very premature to consider changing established value chains at this point. Even if a consensus at the OECD level is reached this year, the uncertainty will be present in the years ahead as individual countries implement the OECD recommendations. The new standards would have to be translated into national tax law and most would likely require revision of double taxation treaties.

FW: What advice would you offer to companies on achieving coherent, substantive and transparent tax structures for their value and supply chains?

Hervé: Transparency is the key strategic element. In the current regulatory environment and highly uncertain global economic environment, multinationals should consider implementing only those international value chains and underlying TP solutions that can be robustly defended in full transparency modus. Going forward, it is to be assumed that tax authorities will be able to overcome transparency hurdles set up by companies. Existing value chains and TP solutions should be subject to a rigorous SWOT analysis. Where the current structures can no longer be defended or where the benefits from traditional tax engineering are reduced such that they no longer offset the business costs of higher supply chain complexity, these structures should be unwound and replaced by more efficient ones.

Starkov: The most sustainable way to build a coherent, substantive and transparent tax structure must be based on a value chain analysis of the overall group or particular sets of controlled transactions. The results of a value chain analysis can and should be used to develop solutions that align intragroup TP policies with the relative values contributed by the group entities to the overall value created within the group, or within a given transaction, by such means as activities of the personnel employed, assets economically owned and risks managed by those entities. Clearly, tax departments will not be able to achieve such realignment without working closely with other departments of the group. Building a sustainable and transparent tax structure calls for coordination among many of the group's departments, such as operations, finance and the treasury, and taking into account the operating realities of the group. ■

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