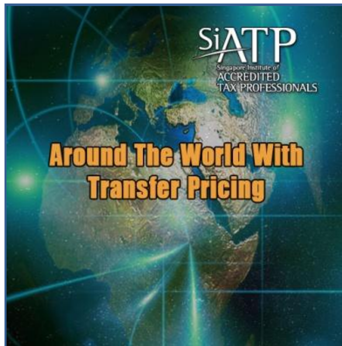

TED: Around the World with Transfer Pricing

How BEPS is Influencing TP Regimes Globally

5 May 2016, Thursday

Facilitated by:
Mr Luis Coronado

The increased complexity in Transfer Pricing (TP), and the controversy points to a heightened need for more proactive engagement with the tax authorities. The government authorities are also taking a more globalised approach in policing the tax base.

The Organisation for Economic Co-operation and Development (OECD) has and continues to provide significant direction on TP through the release of TP guidelines and more recently through the Action Plan on Base Erosion and Profit Shifting (BEPS). The OECD also issued its final reports on the 15 focus areas identified in its Action Plan. The recommendations range from new minimum standards to reinforced international standards, common approaches and leading practices.

While the BEPS Action Plan has been keenly discussed across the world, it is not law. The BEPS Action Plan is an agreed international tax framework based upon coherence, substance and transparency. Countries may reference it but the extent of adoption will vary. Taxpayers are responding by reviewing their businesses, supply chains and finance models. The convergence of these developments is escalating operating costs and above all, companies still have to ensure that they are "audit ready".

Amid this shifting backdrop of developments, the Singapore Institute of Accredited Tax Professionals organised a technical session on a much-talked about tax topic – Transfer Pricing, under its *Tax Excellence Decoded* (TED) series. Facilitated by Ernst & Young Solutions LLP's Partner and ASEAN International Tax Services Leader, Luis Coronado, the TED session provided the tax community with greater clarity on global TP developments and more importantly the implications to companies in Singapore.

Key BEPS Actions on TP

Artificial Avoidance of Permanent Establishment Status (Action 7)

As we advance into a new era of taxation, there is an increased focus on substance over form. Under Action 7 of the BEPS Action Plan, the threshold as to what would constitute a Permanent Establishment (PE) is generally lowered. For example, progressively, commissionaire arrangements and similar sales and marketing models will now likely create a PE, while the scope of PE exemptions will be narrowed to only activities that are of an exclusive preparatory or auxiliary nature.

The lowering of the threshold for PEs may result in the creation of new PEs for some companies. Should this happen, it is important for the companies to ensure that the attribution of profits to the new PEs is consistent with their TP policies.

Moreover, an anti-fragmentation provision may also be introduced to prevent enterprises from artificially splitting up their cohesive operating businesses into segmented operations and claiming that each part should not constitute a PE, on the basis that each is only performing preparatory or auxiliary activities.

To avoid being perceived to be artificially avoiding a PE, companies may wish to review and monitor the timing of treaty negotiations and updates in countries they operate in and note any multilateral instruments being put in place to ascertain the corresponding implications. It is also critical to have a robust internal communication channel in place between the tax team and business units to ascertain and mitigate PE issues and possible tax risks in order to put in place a sustainable model from a tax perspective.

Aligning TP Outcomes with Value Creation (Actions 8-10)

The BEPS Action Plan describes an intangible asset as something that is “not a physical or financial asset, which is capable of being owned or controlled for use in commercial activities, and its use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.

It should be noted that mere legal ownership of the intangible assets does not confer any right to the returns. Instead, the key in determining the appropriate allocation of the returns is in identifying the entity that is developing, enhancing, maintaining, protecting and exploiting the intangibles (DEMPE functions) and the entity controlling the associated risks.

The risks assumed can be analysed using the following six-step analytical framework:

Step 1: Identification of economically significant risks with specificity
Step 2: Identification of contractual assumption of the specific risk
Step 3: Functional analysis in relation to the risk
Step 4: Interpreting steps 1 to 3
Step 5: Allocation of the risk
Step 6: Pricing the transaction, taking into account the consequences of risk allocation

If the entity providing the funding exercises control over the financial risk assumed, it should be entitled to an expected rate of return that is commensurate with risk. Conversely, if the entity provides funding but does not control the financial risk, it should only be entitled to a risk-free return on the capital.

On a related note, it is crucial to ensure the contractual risks assumed align with the actual activities carried out by each entity.

While the emphasis of the BEPS Action Plan hinges on substance, transparency and aligning TP outcomes with value creation, the level of commitment on avoiding double taxation is not consistent across the different jurisdictions. As a result of the lack of coordination among tax authorities, companies must be prepared for increased uncertainty on how TP rules will ultimately be implemented.

All in all, companies should consider undertaking a thorough review of their operating models and evaluate them based on the BEPS recommendations to identify potential risk areas. Cross-functional discussions with operations, legal, information technology and finance teams should be held regularly to assess and prepare for any changes.

Luis Coronado, Partner and ASEAN International Tax Services Leader, Ernst & Young Solutions LLP, gave participants an update on the latest developments under the BEPS Action Plan TP regulatory frameworks for key Asia-Pacific countries, including Singapore.

TP DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING (ACTION 13)

Action 13 of the BEPS Action Plan sets out a standardised approach to TP documentation and country-by-country (CbC) reporting. The TP documentation comprises a "master file" which provides tax administrations with high-level information on a multinational corporation (MNC) global business operations and TP policies, and a "local file" which provides detailed information about the local business including related party transactions.

A CbC report, on the other hand, contains broad information about the jurisdictional allocation of the MNC's profits, revenues, employees and assets. It should be noted that CbC reporting is only relevant to MNCs with a consolidated group revenue of €750 million.

Luis Coronado, Partner and ASEAN International Tax Services Leader, Ernst & Young Solutions LLP, provided participants with a holistic update on Transfer Pricing.

Generally, the CbC report should be filed in the country of tax residence of the parent entity and may be shared with other countries through automatic exchange of information. However, if CbC reporting is not implemented in the country of residence of the parent entity, it is still possible for tax authorities to obtain the CbC report from the subsidiaries resident in their countries through the secondary mechanism (which requires local subsidiaries to file a CbC report locally if CbC reporting is not implemented in the country of tax resident of the parent entity).

TP documentation and CbC reporting provide tax authorities an overview of a company's operations. Attention will be drawn towards low-substance entities with material income. To minimise potential tax controversies, companies should ensure that profits are aligned to substance. It is recommended that companies review their CbC reporting data to identify key areas of risks and to ensure consistency between the master file, local file and CbC report (particularly in the first year which would form the basis for the subsequent years).

TP in Singapore

In Singapore, the Inland Revenue Authority of Singapore (IRAS) revised its TP guidelines in early 2015 and updated its recommendation for taxpayers to prepare and maintain contemporaneous TP documentation[1] to support transactions undertaken with their related parties. The contemporaneous TP documentation must be dated and prepared within a stipulated time frame. Taxpayers have 30 days to submit the documents upon IRAS' request.

IRAS has included dollar value thresholds (administrative concession) for related party transactions, which will warrant the preparation of contemporaneous TP documentation when these thresholds are exceeded. It should be noted that in determining whether the threshold is met, aggregation should be done for each category of related party transactions.

[1] Contemporaneous TP documentation refers to documentation and information that taxpayers have relied upon to determine the transfer price prior to or at the time of undertaking the transactions.

If a company lacks contemporaneous TP documentation to support its transactions, IRAS may be less likely to accept the company's TP adjustments (if any) or to support the company's TP positions, especially in a Mutual Agreement Procedure (MAP) or an Advance Ruling Arrangement (APA) application.

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In January this year, a further revision was published with enhancements to the MAP and APA processes as well as more guidance on the application of the cost plus method.

As countries grapple with BEPS, TP regimes around the world will continue to change. Managing the varied TP systems across all jurisdictions a company operates in will be a key consideration for MNCs in this new tax era. Companies should continue to keep abreast of the latest BEPS developments and should the need arise, be ready to readjust their business and TP strategies accordingly.

This technical event commentary is written by SIATP's Head of Tax, Felix Wong. This article is based on SIATP's Tax Excellence Decoded session facilitated by Luis Coronado, Partner and ASEAN International Tax Services Leader, Ernst & Young Solutions LLP.

For more tax insights, please visit www.siatp.org.sg.

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