OECD publishes reports to address base erosion and profit shifting including revisions to its transfer pricing guidelines

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In brief

On September 16, the OECD published the first set of recommendations in connection with its Base Erosion and Profit Shifting (BEPS) action plan. The published papers address seven elements of the action plan including: Neutralising the effect of Hybrid mismatch arrangements; Preventing the Granting of Treaty Benefits in inappropriate circumstances; Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance; Feasibility of Multilateral instruments and Addressing the Tax challenges of the digital economy.

Two other papers relate to revisions to the OECD Transfer Pricing (TP) guidelines of 2010. They cover: TP Documentation, Special considerations for intangibles, Arm's Length Principle and TP Methods. These are likely to be the most relevant to taxpayers in Nigeria as recommendations on documentation could result in increased TP compliance and disclosure requirements.

In detail

Background

Last week, the OECD published reports on the Base Erosion and Profit Shifting (BEPS) Action Plan. The BEPS project was set up to address global concerns that multinationals were taking advantage of the interaction between different tax rules in different countries to achieve double non-taxation or shift profits away from the jurisdictions where the activities creating those profits are taking place. Some of the actions and recommendations released by the OECD, for example work on the OECD Transfer Pricing Guidelines and the Commentary to the OECD Model Tax Convention, will result in changes that can be effected quickly by the OECD. Others will need to be implemented by countries through their domestic law, bilateral treaties, or a multilateral instrument. The OECD reports deal with the following areas:

- Country-by-country reporting and transfer pricing documentation
- Transfer pricing and intangibles
- Digitisation of the economy
- Hybrid mismatches
- Treaty abuse
- Harmful tax practices
- Use of a multi-lateral instrument.

The preparation of these reports involved wide consultation with representatives of Tax Authorities of OECD member countries as well as some non-member countries. Over 80 developing countries and non-OECD member countries were involved in these consultations. The OECD also received inputs from other interest groups such as: International organisations (European Union, International

Monetary Fund, United Nations etc.); and the business community.

Further details on these reports are provided below.

Country-by-Country reporting and transfer pricing documentation

These relate to the revisions to Chapter V (Documentation) of the OECD's TP guidelines. The revised guidelines propose a three tier approach to documentation consisting of a master file, a local file and a separate Country-by-Country (CbC) template.

Master file

The Master file is to contain standardised information on the group as a whole, which would be relevant to all members of the group. This would include information such as details of organisational structure; analysis of the Multinational Enterprise's (MNE's) business including profit drivers, supply chains, business structures etc.; analysis of MNE's intangibles including its overall intangibles strategy and policies; analysis of the MNE's intercompany financing activities and details of the MNE's financial and tax position.

Local file

The local file is to provide more detailed information specific to the business and intercompany transactions of the local entity. This includes information on management and organisational structure, business strategy and key competitors, analysis of controlled transactions (including relevant transfer pricing analysis) and financial information. The local file supplements the master file and focuses on information relevant to the transfer pricing analysis related to transactions involving the local entity.

Country by country report

This will contain certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

The CbC data points that will be required for each country will be the following:

- Revenues (from both related and unrelated party transactions)
- Profit before income tax
- Income tax paid (cash basis)
- Current year income tax accrual
- Stated Capital
- Accumulated earnings
- Number of employees
- Tangible assets (excluding cash and equivalents)

Materiality

On materiality, the OECD emphasises that not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the local file. The OECD recommends that individual countries should establish materiality standards and thresholds in order to ensure that the efforts of tax administrators and taxpayers are only directed towards the most important issues. According to the OECD, this also helps to ensure that taxpayers are not so overwhelmed with compliance demands that they fail to consider and document the most important items.

Other issues

Some of the other issues discussed in the report include contemporaneous documentation, frequency of documentation updates and confidentiality.

Observations

Although some of the required information for the master and local files are commonly found in standard TP documentation reports, there are a number of specific requirements which taxpayers may now need to include in their TP documentation to comply with the guidelines.

With regards to the CbC disclosures, the clear implication is that this template is to highlight low tax jurisdictions where a significant amount of income is channelled to without a proportionate presence of employees.

What this means in practice is that, there will be pressure to assure that profit allocations and payments to a particular jurisdiction are supported by a sufficient number of appropriately qualified employees who are able to make a "substantial contribution" to the creation and development of intangibles.

In addition the prescriptions on the information to be provided by multinationals as part of TP documentation are likely to increase the rate at which local tax authorities such as the Federal Inland Revenue Service (FIRS) demand information and disclosures on related parties which are not resident in their country. The OECD has however indicated its intention to analyse and advise on the possible mechanisms by which the master file and the CbC report is to be made available to tax administrators.

Guidance on Transfer pricing aspects of intangibles

The OECD has a long running project on intangibles which now forms part of its BEPS agenda. This report provides both final and interim revisions to Chapters I, II and VI of the OECD TP guidelines.

Revisions to Chapters I and II

These include additional guidance on the application of the arm's length principle in the context of location savings, other local market features, assembled workforce, and MNE group synergies.

Location savings and local market features

Location savings are cost savings which accrue to a business as a result of operating in a particular market. Other local market features include purchasing power, local market preferences, state of the market etc. The OECD recommends that these features should be considered when undertaking transfer pricing analysis. This should be done by either looking at comparables within that market or making comparability adjustments to comparables from other markets. The revisions also recognise the need to identify and properly remunerate (where necessary) items such as contractual rights, government licenses, market know-how etc. which may be valuable intangibles held by companies in the local market.

Assembled workforce

The OECD distinguishes between instances where a transfer of an assembled workforce may require additional compensation and those instances where no additional compensation will be required. It also identified instances where the transfer or secondment of employees could result in the transfer of valuable know-how and intangibles which would attract additional compensation.

Group synergies

The OECD clarifies that a member of an MNE group should not be required to make any payments when it obtains incidental benefits arising solely by virtue of group affiliation. Where group members make deliberate concerted efforts which lead to synergies however, the group companies who have been involved should be entitled to share in the benefits of the synergies or compensated as the case may be.

Revisions to Chapter VI

Legal ownership

The revisions emphasise the fact that the legal owner of an intangible will be entitled to all returns attributable to the intangible only if, in substance, it performs and controls the important functions related to the development, enhancement maintenance and protection of the intangible; bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible. The OECD clarifies that legal ownership by itself does not confer any right to ultimately retain all the returns due from exploiting an intangible.

Outsourcing of functions

The OECD takes the view that the legal owner is free to outsource certain intangible asset-related functions. In those cases, however, the legal owner will need to control the functions outsourced and compensate those on an arm's length basis.

Funding of development

The revisions are clear on the point that mere funding of intangible related costs without the assumption of any further risks, any control over the use of the funds provided or the actual performance of funded activities will only entitle the funder to a return on the capital invested. No entitlement to the premium profit generated through the intangible should be granted in such cases.

Re-characterisation of transactions

The OECD also discusses the notion that in exceptional circumstances, it may be necessary to re-characterise transactions related to intangible assets in order to reflect arm's length conditions. This would be the case if the economic substance of the transaction differs from its form or where the arrangements impede the determination of an arm's length transfer price.

Examples

The OECD has included a large number of examples to illustrate the application of the principles outlined in the revised chapter.

Subsequent work

Due to on-going work by the OECD on ownership of intangibles, hard to value intangibles, and risk and re-characterisation, it has made a decision not to finalise some sections of the report until the completion of ongoing work. The OECD has advised that these sections should be viewed as interim drafts of guidance which have not yet been fully agreed by delegates.

Observations

The question of substance and functional value creation is at the forefront of the revisions. It will no longer be sufficient for transfer pricing analysis for intangibles to focus on pricing of transactions alone. Within the context of the revisions, a thorough value chain analysis will form the starting point of a transfer pricing exercise. There is likely to be increased pressure on one-sided TP analyses which focus on the domestic taxpayer. Tax authorities will increasingly look to examine and compare (side by side) the contribution of each of the parties (resident and non-resident) to the transaction.

Although the need to recognise the impact of local market conditions when undertaking transfer pricing analysis has been clearly communicated, the practical challenges with quantifying these will remain for Nigerian (and indeed African) members of multinational groups. The lack of public data on local comparables, the lack of a consensus on how to make appropriate comparability adjustments, and the absence of any clear plans to address these issues means that they will continue to be a problem for some time to come.

Other reports

A brief overview of the other reports recently published by the OECD is provided below.

Addressing the tax challenges of the digital Economy

The report examines a number of new business models, as well as old business models that have changed in scale because of the digital revolution, including e-commerce, payment services, app stores, cloud computing, high frequency trading, participative network platforms and online advertising. The report also contains an examination of the tax structures that these business models allow. The report outlines potential options to address the broader tax challenges of the digital economy including a new threshold for taxation based on a Significant Digital Presence. Under this proposal, an enterprise engaged in 'fully dematerialised digital activities' could be deemed to have a taxable presence in a country if it maintained a 'significant digital presence'.

Neutralising the effect of Hybrid Mismatch arrangements

Hybrid mismatches are cross-border arrangements that take advantage of differences in the tax treatment of financial instruments, asset transfers and entities to achieve "double non-taxation" or long term deferral outcomes which may not have been intended by either country. The OECD's work sets out general and specific recommendations for domestic hybrid mismatch rules and model treaty provisions which will put an end to multiple deductions for a single expense and deductions in one country without corresponding taxation in another. Once translated into domestic law and tax treaties, the recommended rules will neutralise the effect of hybrid mismatch without disturbing any other tax, commercial or regulatory outcomes.

Preventing the granting of Treaty Benefits in inappropriate circumstances

The OECD's work in this regard is aimed at preventing treaty shopping. "Treaty shopping" generally refers to arrangements through which a person who is not a resident of one of the two States that concluded a tax treaty may attempt to obtain benefits that the treaty grants to residents of these States. Different anti-abuse rules have been proposed. These rules are still in draft form and will be included in the next update to the OECD Model tax convention. Further work is however needed with respect to the precise contents of the model provisions and related Commentary included in the report.

Harmful Tax practices

While the bulk of the work on BEPS is directed at the positions and actions of taxpayers, the work on countering harmful tax practices focuses on the actions of states.

The work looks to address the harmful effects of preferential tax regimes. To counter harmful tax practices more effectively, the BEPS Action Plan mandated a revamp of the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime and on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes.

Use of multilateral instrument

At the commencement of the BEPS project, the OECD recognised the need to address the speed of adoption of any measures that it develops to counter BEPS practices. To address this situation, the OECD proposes to develop a multilateral instrument so that countries may swiftly implement measures developed in the course of the work on BEPS.

The recently-released OECD paper confirms that a multilateral instrument is both desirable and, from a tax and public international law perspective, technically feasible. There is still no discussion on the practicality of such an instrument.

The takeaway

The BEPS Action plan is a consensus based plan to address the issue of base erosion and profit shifting and is part of the OECD's ongoing efforts to ensure that the global tax framework is fair and equitable.

It represents an internationally coordinated approach which will facilitate and reinforce domestic actions to protect tax bases.

With the progress that has been made so far, it is clear that the OECD is determined to push through the entire BEPS package.

The involvement of developing countries in the consultations is evidence that the tax authorities in developing countries are becoming increasingly exposed to contemporary tax issues and hence more sophisticated.

Of immediate importance to Nigerian taxpayers are the revisions to the OECD TP guidelines since the Nigerian TP regulations are to be applied in line with the provisions of these guidelines as updated from time to time.

The recommendations on the content of TP documentation will help provide further clarity on TP documentation standards. It could mean significant additional TP analyses for taxpayers who do not currently have up to standard TP documentation reports.

The recommendation on materiality is one which many Nigerian taxpayers will be happy to see the FIRS take on board. At present, the Nigerian TP regulations do not include a materiality threshold for compliance. This forces taxpayers to undertake costly and time consuming TP analysis for relatively immaterial transactions. It also has the tendency to place disproportionate compliance burdens on small businesses. By introducing materiality thresholds, the FIRS will help both its officers and taxpayers focus on the more important transactions and issues.

The proposals regarding the master file and CbC reports could encourage the FIRS to request for more disclosures on related parties that are not resident in Nigeria.

For intangible transactions, taxpayers may need to provide more robust two sided analyses to justify royalty and similar payments made to related parties. There is likely to be an increased emphasis on the substance supporting these transactions. Taxpayers will also need to consider whether the local entities are entitled to additional remuneration because they own intangible assets or have made contributions to the development of intangible assets owned by their related parties.

The practicality of making comparability adjustments to reflect local conditions will continue to be an issue which may persist for some time to come.

Taxpayers should immediately start to assess how these proposals could impact their current transfer pricing practices with the aim of making necessary adjustments that can help them avoid disputes with the FIRS and additional tax costs.

Let's talk

For a deeper discussion, please contact:

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