



# Insights: Transfer Pricing

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## OECD releases Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting

### Introduction

The Organisation for Economic Co-operation and Development (OECD) published a **Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting** on January 30, 2014 as part of its Base Erosion and Profit Shifting (BEPS) initiative.<sup>1</sup> If adopted in its current form, the proposed guidance in the Discussion Draft will have a major impact on the transfer pricing documentation requirements for Multinational Enterprises (MNEs). Apart from increased general transfer pricing documentation obligations, it includes a new requirement to make comprehensive data available on the location of economic activity, allocation of profits, and taxes across the worldwide group.

The Discussion Draft notes that it reflects only a limited consideration of the issues and does not necessarily reflect consensus views of the Committee on Fiscal Affairs (CFA) or Working Party n°6 (WP6). The OECD has set a short time frame for consultation. Comments on the specific issues set out in the Discussion Draft are requested by February 23, 2014. There will be a consultation meeting in April or May, with the guidance to be finalized by WP6 shortly thereafter. The finalized text of the document will replace the existing text of Chapter V of the OECD Transfer Pricing Guidelines concerning transfer pricing documentation.

### Overview

The Discussion Draft notes that despite the proliferation of documentation requirements among tax jurisdictions since the original documentation guidance in Chapter V was adopted in 1995, tax administrations often find the documentation MNEs prepare to be “less than fully informative and not adequate for their tax enforcement and risk assessment needs.”

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<sup>1</sup> Action 13 of the OECD’s BEPS Action Plan released on July 19, 2013 called for a review of the existing transfer pricing documentation rules and the development of a template for country-by-country reporting of income, taxes, and economic activity. The deadline for the completion of Action 13 is September 2014.

The draft guidance seeks to establish a balance between guiding the development of new documentation rules that provide tax administrations with more focused and useful information for risk assessments and audits, while making MNE compliance more straightforward through greater consistency in tax jurisdictions' existing rules. It proposes to achieve this through the adoption of a standardized two-tier transfer pricing documentation structure. This is similar to the standardized documentation concept set out in 2006 in a European Union (EU) Code of Conduct,<sup>2</sup> which has already been adopted by some MNEs.

The structure in the Discussion Draft comprises a master file that contains standardized information relevant to all entities in an MNE, together with a file for each local entity that demonstrates compliance with the arm's length principle in relation to its material cross-border transactions with other associated enterprises. The master file could reflect the whole group or one or more lines of business.

The purpose of the master file "is to elicit a reasonably complete picture of the global business, financial reporting, debt structure, tax situation and the allocation of the MNE's income, economic activity, and tax payments." The Discussion Draft seeks to provide local tax administrations with a broader, yet also targeted, understanding of a group than they may have had under prior documentation guidance. Annex I of the Discussion Draft sets out the general MNE information that should be included in the master file. Notable inclusions are:

- A description of the important drivers of business profit for the MNE.
- A description of the overall strategy for the development, ownership, and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.
- The title and country of the principal office of each of the 25 most highly compensated employees in a business line.
- A description of how the group is financed, including identification of important financing arrangements with unrelated lenders and the identification of any members of the MNE group that provide a central financing function for the group and place of effective management of such entities.
- A description of important business restructuring transactions during the fiscal year.

In a major development, the master file section on a group's financial and tax positions also includes a requirement for country-by-country reporting of certain information, a template for which is provided in Annex III of the Discussion Draft. This would provide a tax administration with comprehensive data including on global allocation of profits and taxes paid across the group, indicators of the location of economic activity (e.g. tangible assets, number of employees, and total employee expense), and aggregate amounts of intra-group transactions, by country.

Whilst very important, the Discussion Draft notes that country-by-country data would not be a substitute for a detailed transfer pricing analysis and so would not constitute conclusive evidence

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<sup>2</sup> On June 27, 2006 the Council of the European Union (EU) adopted a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union.

that transfer prices were or were not appropriate. It also notes that a number of difficult technical questions arise in designing the template and that a wide variety of views have been expressed.

An entity's local file (the contents of which are outlined in Annex II of the Discussion Draft) would supplement the master file and focus on information and transfer pricing analysis relevant to its cross-border transactions, based on what is material within the context of the local country's tax system.

The Discussion Draft notes that implementation of a two-tiered master file/local file transfer pricing documentation requirement would need countries to modify their domestic rules to require a local entity to produce the information contained in Annexes I-III. The master file requires the provision of information on foreign rulings that may not involve the local entity and which the local entity may not have in its possession. It is likely that some countries will experience difficulties in changing their rules to allow for this. For example, France introduced several new transfer pricing regulations in December 2013, including additional transfer pricing documentation obligations. See *Insights: Transfer Pricing* for further details. These included requiring a French entity to disclose rulings obtained by related entities from foreign tax authorities. The French Constitutional Council reviewed the new law and agreed that this requirement was in line with the French Constitution, but stated that a French entity does not need to disclose such documents where it does not have them in its possession.

Other practical points raised in the Discussion Draft:

- “Best practice” requires that the master file and the local file be prepared no later than the due date for the filing of the local entity's tax return and that the country-by-country template should be completed within one year of the end of the fiscal year of the group's ultimate parent.
- In general, both the master file and local file should be reviewed and updated annually, though may not need to significantly change year to year.
- The master file should be prepared and submitted to all tax administrations in English, though translation of specific parts may be needed; a local file may need to be prepared in the relevant local language.
- In relation to comparables:
  - Database searches included in the local file should be updated every three years, though the comparables' financial data should be updated annually.
  - Local comparables should generally be used where they are “reasonably available,” rather than regional comparables.
  - Where a taxpayer reasonably demonstrates that either no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue, the taxpayer should not be required to incur costs in searching for such data.

## Conclusion

If adopted in its current form, the new guidance will increase the documentation burden for MNEs in general and for some substantially, at least in the initial years of implementation. The introduction of

the country-by-country reporting requirement is the most significant development. In the future, the ready availability of this information, particularly in relation to a group's "bigger picture", will become a significant factor in tax administrations' transfer pricing risk assessments and audits.

In considering how to implement the required country-by-country reporting, it is crucial to look at existing documentation and consider what needs to be done to develop it along the required lines. In particular, the content of existing master files should be reviewed, or a plan established to develop a master file if one does not exist. In each case, allowing for the specific elements listed in the Discussion Draft, the focus should be on what the important facts really are, what the key questions are that the documentation needs to answer, and what economic rationale and analysis are needed to sufficiently explain the group overall and the place of the local entity within it, to an inquisitive local tax authority. It is possible that a review by a fresh pair of eyes may identify efficiencies as well as help manage the additional transfer pricing risk that could result from the extra disclosure.

Comments on the Discussion Draft should be submitted in writing to [transferpricing@oecd.org](mailto:transferpricing@oecd.org) by **February 23, 2014**. Although the OECD is allowing very little time for a thorough consideration of the impact of the new requirements, input from businesses on the Discussion Draft is critical. CRA will be providing comments.

Please contact us if you'd like to discuss your thoughts or specific feedback regarding the Discussion Draft for us to include in our reaction to the OECD, or if you'd like to discuss the impact of these proposals for your organisation.

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