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Current transfer pricing landscape – an update

The 2013 OECD's Base Erosion and Profit Shifting (BEPS) initiative was aimed at combatting tax abusive and aggressive tax structures. The goal was to equip governments with domestic and international instruments, to ensure that profits will be taxed where economic activities generating these profits are performed and where value is created.

Below is an overview of the status of the transfer pricing related measures discussing which measures have been implemented to date and in particular how multinational entities (MNEs) may be impacted.

The transfer pricing related measures can be grouped into the following key areas:

- Updated OECD Transfer Pricing Guidelines;
- Transfer pricing documentation requirements; and
- Country by Country Reporting.

The main conclusion is that MNEs' burden of proof has increased, as MNEs will have to demonstrate – through a more detailed functional and risk analysis – that their implemented transfer pricing approaches are still at arm's length. MNEs can expect having to demonstrate this not only for the future years but also for any open tax years during tax audits.

Below we have provided recommendations what companies should do in practice in relation to each key area.

1) Updated OECD Transfer Pricing Guidelines

In July 2017, the OECD Transfer Pricing Guidelines were updated in line with the final BEPS reports. A strong emphasis is placed on the accurate classification of the actual inter-company transaction. This is achieved through the performance of a more thorough functional and risk analysis, following detailed steps prescribed by the OECD.

In many countries, the OECD Transfer Pricing Guidelines are leading and directly applicable when interpreting transfer pricing related tax positions. The update of the OECD Transfer Pricing Guidelines is considered a further clarification of the existing principles rather than a revision of the guidelines. This means that changes have immediate as well as retroactive effect. Therefore, in many countries tax authorities in tax audits for past years may refer to the updated guidelines, expecting taxpayers to defend their transfer pricing model on that basis. Tax audit handbooks and risk assessment checklists have in the meantime been updated to incorporate the above-mentioned, more-detailed principles.

What should companies do in practice?

- MNEs will need to review their existing transfer pricing models and test them against the new requirements, also when – based on their pre-BEPS transfer pricing risks analysis – it was determined that no substantial transfer pricing risk exposure exists (for example: transfer pricing models where the attribution of results to one jurisdiction, based on the concentration of business risks and/or intangibles, will be under scrutiny). The findings resulting from a transfer pricing risk analysis are key in determining whether MNEs need to make changes to their existing transfer pricing design and/or to adjust their intra-group legal documentation.

- MNEs need to identify specific activities for each DEMPE function and ascertain their relative importance in their respective industry in order to be able to undertake the detailed analysis, as required.

2) Transfer pricing documentation

The OECD aimed at streamlining the transfer pricing documentation requirements by introducing a standardized, three tiered documentation approach, consisting of (i) a Master file, (ii) a Local file and (iii) a CbCR (Country-by-Country Report).

It was expected that all countries participating in the BEPS project would adopt the OECD documentation approach. However, not all countries have implemented the Master file - Local file approach in 2016, some have defined materiality thresholds for filing the Master file – Local file. These thresholds may vary per country (based on local turnover, consolidated group turnover, turnover of entities in the direct ownership chain, etc.).

In addition, tax authorities require MNEs more often to prepare their transfer pricing documentation contemporaneously. This generally means that transfer pricing documentation needs to be prepared at the latest by the date of the filing of the income tax return for the relevant year. Non-compliance with preparation and filing deadlines may result in penalties or reversal of the burden of proof upon tax audit. Again, in practice the filing requirements and related penalties vary from country to country.

What should companies do in practice?

- MNEs should consider how to update the content of their transfer pricing documentation. Based on a high-level transfer pricing risk analysis, MNEs may determine that more detailed information on how risks are managed and controlled or in relation to the value chain (for example in relation to intangibles) needs to be included.

- The Master file is a strategic document for all MNE group entities that only needs to be filed in a limited number of jurisdictions. It provides MNEs the opportunity to explain and defend existing transfer pricing models and policies by putting them in the context of their value chain. Practically, it is therefore the head office of the MNE that needs to prepare the Master file to ensure the required consistency.

- MNEs will need to be aware which filing requirements need to be complied with to determine how to deal pragmatically with this compliance burden. The Taxand network has prepared a detailed overview of the 2016 transfer pricing documentation and filing requirements and potential penalty exposure.

3) **Country-by-Country Reporting**

Swiss MNEs with consolidated group revenues of more than CHF 900 million are required to file a CbCR. Swiss ALBA legislation and ALBA regulations (ALBA) dealing with the CbCR filing requirement in Switzerland have been published on 28 September 2017. The ALBA was enacted in Switzerland on 1 December 2017 and applies for the 2018 financial year onwards.

Many countries have implemented CbCR legislation effective 1 January 2016, meaning that the first CbCR needs to be filed in respect of the year 2016 by 31 December 2017, to be automatically exchanged in 2018.

Switzerland has not implemented CbCR legislation effective 1 January 2016 but has opted for the so-called Parent Surrogate Filing, which allows for the ultimate parent entity of an MNE group to file the CbCR on a voluntary basis in Switzerland with the Federal Tax Authorities (FTA), despite the fact that no formal procedure to file CbCR is in place.

Many Swiss MNEs make use of this voluntary filing option. For the transmission of the CbCR to the FTA, including the voluntarily submitted CbCR with respect to tax periods prior to the entry into force of the ALBA legislation, the reporting parties have to use the XML schema of the OECD. The FTA has recently published how the voluntary reporting is to be transmitted to the FTA.

Swiss MNEs can alternatively appoint a so-called surrogate parent entity, which will file the CbCR on behalf of the MNE. This would typically apply where a subsidiary of an MNE is required by law to file a CbCR in that jurisdiction. Note that not all jurisdictions allow for surrogate parent entity filing and the CbCR filing strategy needs to take this into account.

As part of the compliance of Country-by-Country Reporting, MNEs are in many countries required to report on who is filing the CbCR for the MNE. These notifications differ significantly in manner (i.e. how they are made), content and timing from country to country and non-fulfillment of the notification requirements may have substantial penalty implications. Whilst some countries have extended the notification requirements for the first year, also these extended deadlines are fast approaching.

What should companies do in practice?

- MNEs should undertake a high-level risk-assessment of the CbCR as part of the BEPS-related risk assessment when preparing the first draft Tables 1, 2, and 3 of the CbCR.

- The information filed in the CbCR should be read in conjunction with other information available to the tax authorities, such as the Master file, Local files, transfer pricing forms and tax returns / tax return disclosures. The Taxand network has prepared a detailed overview of the 2016 CbCR reporting and filing requirements and potential penalty exposure.

4) **Other developments – BEPS Action 5 / Limitation of royalty deductions Germany (Lizenzschranke)**

In addition to the OECD approach to counter harmful tax practices as part of the BEPS Project in BEPS Action 5, most notably Germany went one step further and introduced legislation to limit the deductibility of licence fees paid to related party licensors where certain conditions are met. A deduction will be (partially) denied where the licensor a) does not undertake substantial activities related to the licensed intangible (i.e. the nexus approach is not met) and b) the income received from the intangibles is taxed at a preferential corporate tax rate of less than 25%. The German law will be applicable as of 1 January 2018.

To date, the German law does not provide clarity on key points and definitions. Importantly, the German law does not sufficiently define the meaning of preferential regimes – the scope of the new law is therefore not (yet) clear. Taxpayers are left with significant uncertainty. To date, no clarification has been issued and it is not expected that the finance ministry will publish further guidance before the end of the year.

What should companies do in practice?

- MNEs should determine which tax costs they would incur if the German Lizenzschranke would be broadly interpreted and hence as of January 2018, any royalty expenses would not be deductible.
- MNEs should assess which options are available to them under current Swiss law to mitigate the potential exposure to the Lizenzschranke.

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Zurich, December 2017

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Tax Partner AG, Taxand Schweiz

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