

***Final BEPS guidance
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Summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on transfer pricing documentation and country by country (CbC) reporting, an outcome of the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan. Developed as a replacement for the existing Chapter V (Documentation) of the Transfer Pricing Guidelines for Multinational Enterprises (MNEs) and tax administrations (OECD Guidelines), last revised in 1995, the new guidance prescribes specific documentation to be compiled by multinational enterprises to support their structuring and pricing of intercompany transactions. Specifically, among other things, the final guidance calls for taxpayers to include a list of "important agreements" pertaining to intangibles in the Master File and copies of all "material intercompany agreements" in the local transfer pricing documentation files of their worldwide affiliates.

As multinational entities focus on their intercompany agreements in light of these new disclosure requirements, careful attention should be paid to the guidance provided by the OECD with respect to contractual terms between related parties. Specifically, the OECD has stated that written contracts alone should not drive the economic outcome. If the actual characteristics of a transaction between related parties are inconsistent with the

legal written agreements, then the actual functions undertaken, risks borne, and assets employed by the parties ultimately should determine the factual substance that will affect the determination of the arm's-length conditions.

Historically, rules regarding intercompany agreements have varied widely from country to country. For example, US transfer pricing rules generally do not require intercompany agreements to be in place in order for related-party transactions to be respected by the Internal Revenue Service (IRS). On the other hand, without intercompany agreements, some countries, such as Nigeria, may disallow tax deductions for expenses resulting from intercompany charges. In a number of countries, including Argentina and South Africa, agreements are needed to facilitate the remittance of cash out of the country.

In 2013, well before the OECD issued its final BEPS guidance, Australia enacted substantive changes to its transfer pricing laws, specifically requiring that the legal form of intercompany transactions be reviewed against their substance. To the extent the two do not align, the law directs that the actual conduct of the parties overrides the legal agreement in determining an arm's-length result. Moreover, the Australian law also requires that, where the intercompany transactions are inconsistent with

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‘commercial’ independent arrangements, taxpayers must disregard the intercompany transactions and replace them with an alternate hypothesis. Given the current focus on substance among tax authorities worldwide, other jurisdictions may introduce similar requirements.

As more and more countries around the world adopt the OECD’s new documentation guidance, now is the time for MNEs to assess the level of intercompany agreement coverage for their material transactions globally and take action to remedy any identified gaps. Such an analysis is critical for many multinational companies that, historically, may not have prepared and executed intercompany agreements as a matter of course.

Moreover, as part of this intercompany agreement coverage analysis, MNEs should also reconcile the presentation of the functions performed, assets employed, and risks borne by the related parties to the intercompany agreements with the analyses presented in the transfer pricing documentation, particularly in the Master File.

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In 2013, the OECD and G20 countries adopted the 15-point BEPS Action Plan. The stated objective of the BEPS initiative was to develop a global framework to address perceived flaws in international tax rules that were seen by revenue authorities to result in the misallocation of income and expense among jurisdictions. Essentially, the OECD’s focus was on coordinating and harmonising international tax rules to eliminate mismatches and incongruities between the laws of different jurisdictions that result in double non-taxation (i.e., income, that is not taxed in any country) as well as instances where profits are perceived as geographically divorced from the activities that gave rise to that income. With respect to Action 13, the OECD’s stated goal was to increase transparency for tax administrations along with promoting certainty and predictability for taxpayers through improved transfer pricing documentation and a template for CbC reporting.

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In the final Action 13 deliverable, the new Chapter V of the OECD Guidelines, MNEs are directed to prepare transfer pricing documentation consisting of a Master File and Local Files for each jurisdiction. As well they should complete three templates intended to capture specific data points and functional and other relevant information on a CbC basis. With respect to the Local Files, under the heading “Controlled Transactions,” the final guidance specifically calls for “copies of all material intercompany

agreements concluded by the local entity” to be included in the Local File. In this context, materiality is considered from the perspective of the local country, as opposed to the consolidated group. In relation to the Master File, a list of ‘important’ related party agreements related to intangibles (including cost contribution arrangements), principal services agreements and license agreements is required. Corporate tax professionals should note that the term ‘important’ is subjective and undefined.



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Where written contracts do not exist, the OECD Guidelines indicate that the conduct of the parties and the economic principles that generally govern relationships between independent enterprises should apply.

In Chapter I, contractual terms are addressed in the context of the factors for determining comparability between a controlled transaction (or taxpayer) and uncontrolled comparables. The OECD Guidelines consider that an analysis of contractual terms should be part of the functional analysis, which looks to identify and consider the functions performed, assets employed, and risks borne by the relevant entities to the controlled transactions under review.

In addition to formal, written contracts, the OECD Guidelines highlight that contractual terms may also be found in correspondence between the parties – a reminder to taxpayers to always be conscious of the content of their internal communications including written memoranda, email, text messages, and instant messages.

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As countries around the world implement guidance from Action 13 and other BEPS actions, MNEs proactively should identify any gaps between their current transfer pricing documentation components and the new Chapter V of the OECD Guidelines, particularly with respect to intercompany agreements.

Leading practices

MNEs are best advised to memorialise the actual conduct of their related parties in line with the substance of the intercompany activities through written agreements executed in advance of the transactions commencing, considering leading practices to mitigate potential risk.

Commerciality

Under the arm's-length principle, related entities are required to realise outcomes consistent with those that would be achieved between independent parties. In this context, particular attention should be paid to the precise explanation provided for each party's assumption of risk.

For example, if one party bears foreign exchange risk in a particular transaction, this risk should be documented in the agreement (e.g., by denominating the currency of an intercompany payment).

Further, any relevant terms that may affect the price of the intercompany transaction should be documented. For example, in intercompany funding arrangements, taxpayers should include all relevant terms that typically would be present in third-party funding arrangements that would influence the interest rate applied – not only should the currency, term, and amount be included, but also subordination, guarantees, covenants, and security.

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Contemporaneous

Intercompany agreements should be drafted and executed prior to a transaction being effected. Contracts made effective prior to the date of execution are unacceptable in many jurisdictions and the practice may increase risk. Ensuring coverage of material intercompany transactions in real time is also key to risk mitigation, and corporate tax personnel are well advised to collaborate with in-house counsel to develop, maintain, and monitor a catalogue of intercompany agreements, including a summary matrix setting out the parties to the contract, execution date, expiration date, and type of transaction covered. If this centralised catalogue is missing, there is a risk that the listing of intercompany agreements in the Master File could be incomplete.

Consistency

Consistency of contractual terms and standardisation of definitions across agreements can be beneficial for corporate tax and legal professionals with a large inventory of intercompany agreements to manage. Drafting a model agreement for use in memorialising intercompany transactions may aid in efficiency and cost control. Specifically, a model agreement may help ensure that defined terms are clear and consistent across the organisation, that contracts reflect the appropriate allocation of risk and warranty language, and that standard terms are included in the contract (e.g., choice of law, arbitration or mediation clauses, indemnity provisions).

Although a model agreement may help to reduce compliance costs and reduce administrative burden, every intercompany contract must still be tailored to the type of transaction and, most importantly, reflect the rules of the local jurisdiction. Local counsel should review all intercompany agreements prior to execution to ensure compliance with applicable rules.

In addition, when drafting intercompany agreements, corporate tax professionals and in-house counsel should pay close attention to the way in which the contractual terms reflect the functional profile of the parties to the agreement. Specifically, in the case

of service agreements, care should be taken to enumerate the explicit functions that will be performed by the service provider. The explicit functions described and documented in the legal agreements must then be consistent with the description of the benefits the service recipient receives in its local transfer pricing documentation. To the extent that agreements relate to tangible or intangible assets, clear and specific descriptions of the assets in question are also important.

When drafting agreements applicable in jurisdictions that respect the arm's-length standard, the foundational principle of most transfer pricing regimes, taxpayers may want to consider including language stating that the consideration paid will be arm's length rather than giving a specific percentage or figure. This phrasing can help avoid a common pitfall where an intercompany agreement specifies payment of a certain dollar amount or a fixed markup that over the course of a multiple-year agreement could yield a non-arm's-length result. This approach may also contribute to cost savings because it will not be necessary to update the agreement every time the comparables on which the remuneration is based fluctuate.



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In instances where the consideration for the transaction is based on a cost-plus mark-up or expressed as a percentage of a given amount (e.g., revenue, operating profit), corporate tax personnel should ensure that the cost or income base to which the rate will be applied is specified. Frequently, companies will focus on the percentage and leave the pool of costs or revenue to which the rate will be applied undefined. This mistake can be costly in practice as minor changes to the cost or revenue included in the base can create significant fluctuations in taxable income even when modest rates are applied.

A careful balance is required in drafting agreements to ensure there is enough explicit information for the agreements to be meaningful, consistent with substance, and easily reconciled to transfer pricing documentation prepared on the one hand, but also flexible enough to continue to apply as the business evolves over time.

Taxpayers may want to consider drafting confidentiality clauses and survival clauses to ensure that sensitive information is not misappropriated.

Confidentiality

Many taxpayers have expressed concern about maintaining confidential information in the face of seemingly extensive information sharing among tax authorities. With the OECD calling for all material intercompany agreements to be included in the Local Files MNEs prepare for the jurisdictions in which they operate, there is the potential for exposure of confidential information, particularly in the context of intercompany technology and intellectual property license agreements. Taxpayers must use discretion when including proprietary information in their intercompany agreements, balancing the need for completeness with respect to the detail contained in their contracts with the need to protect proprietary information. Taxpayers may want to consider drafting confidentiality clauses and survival clauses to ensure that sensitive information is not misappropriated.

The road ahead

Given many tax authorities currently require contemporaneously executed intercompany agreements, in order to respect local deductions and that some tax authorities already mandate the local registration of executed agreements, the requirement that the Local File contain all material intercompany agreements is another factor contributing to the advisability of documenting intercompany arrangements. Further, it is anticipated that tax authorities will continue to focus on the conformity between a MNE's internal legal agreements and the outcomes of its intercompany transactions.

In this uncertain environment, taxpayers are best advised to assess their established intercompany agreements proactively and take steps to eliminate any gaps. Further, by adopting leading practices with respect to intercompany agreement drafting, MNEs can improve their documentation practices and potentially achieve efficiencies resulting in lower compliance costs. Given the speed with which countries around the world are adopting the final BEPS guidance, the time for action by taxpayers is now.

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