Base Erosion and Profit Shifting (BEPS) Considerations in Transfer Pricing

By **CPA Eric Sambu** CS, LLB, MBA, MAGL, MARLA, PhD Candidate

6 August 2021

What is Transfer Pricing?

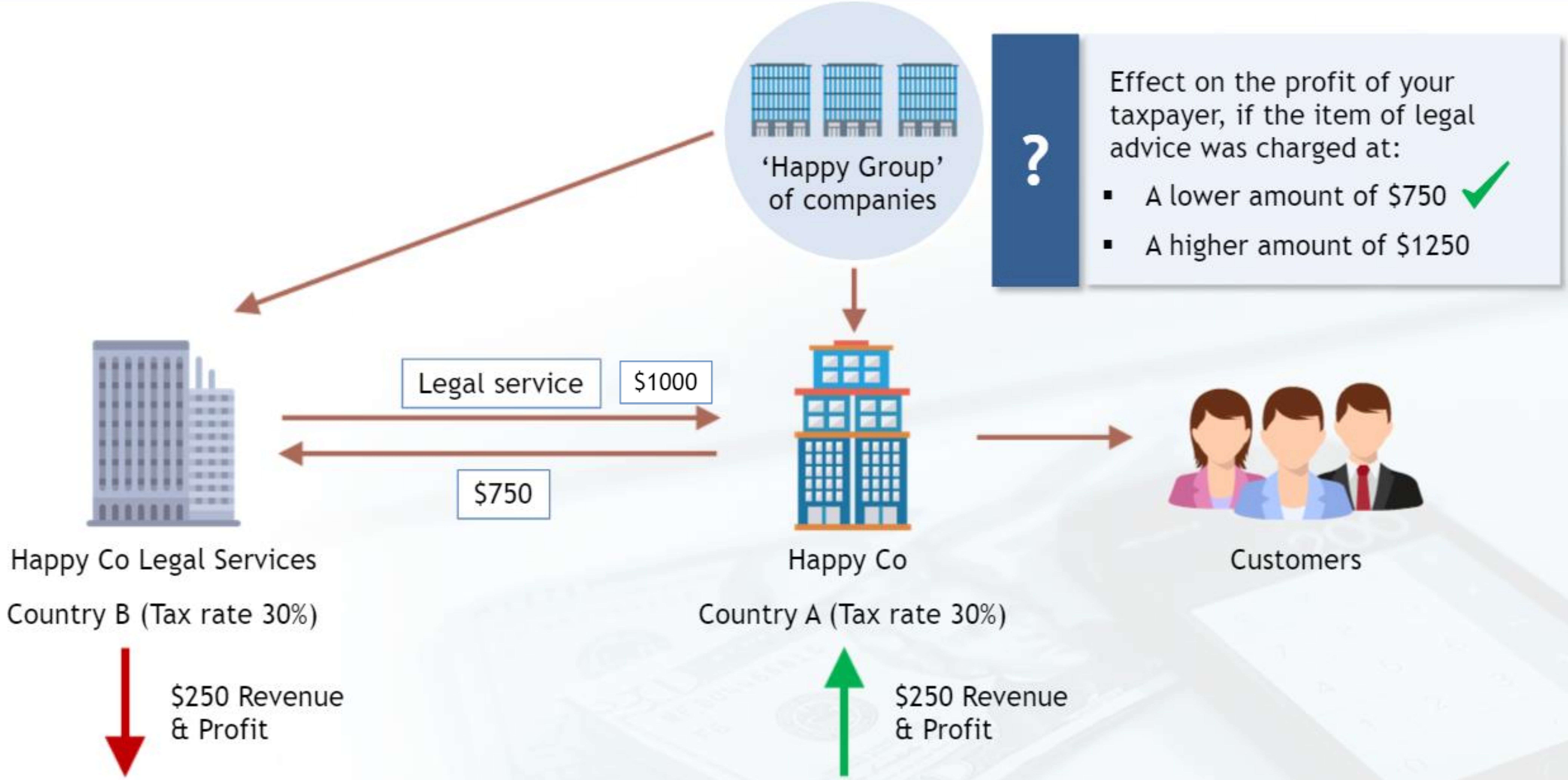
A transfer price is the price charged by a company for goods, services or intangible property to a subsidiary or other related company. Since these prices are not negotiated in a free, open market they may deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances.

If the goods, services or intangibles are overpriced in a transaction between related parties, the seller's profitability is increased and the buyer's decreased and vice versa.

Transfer Pricing

SNMBU

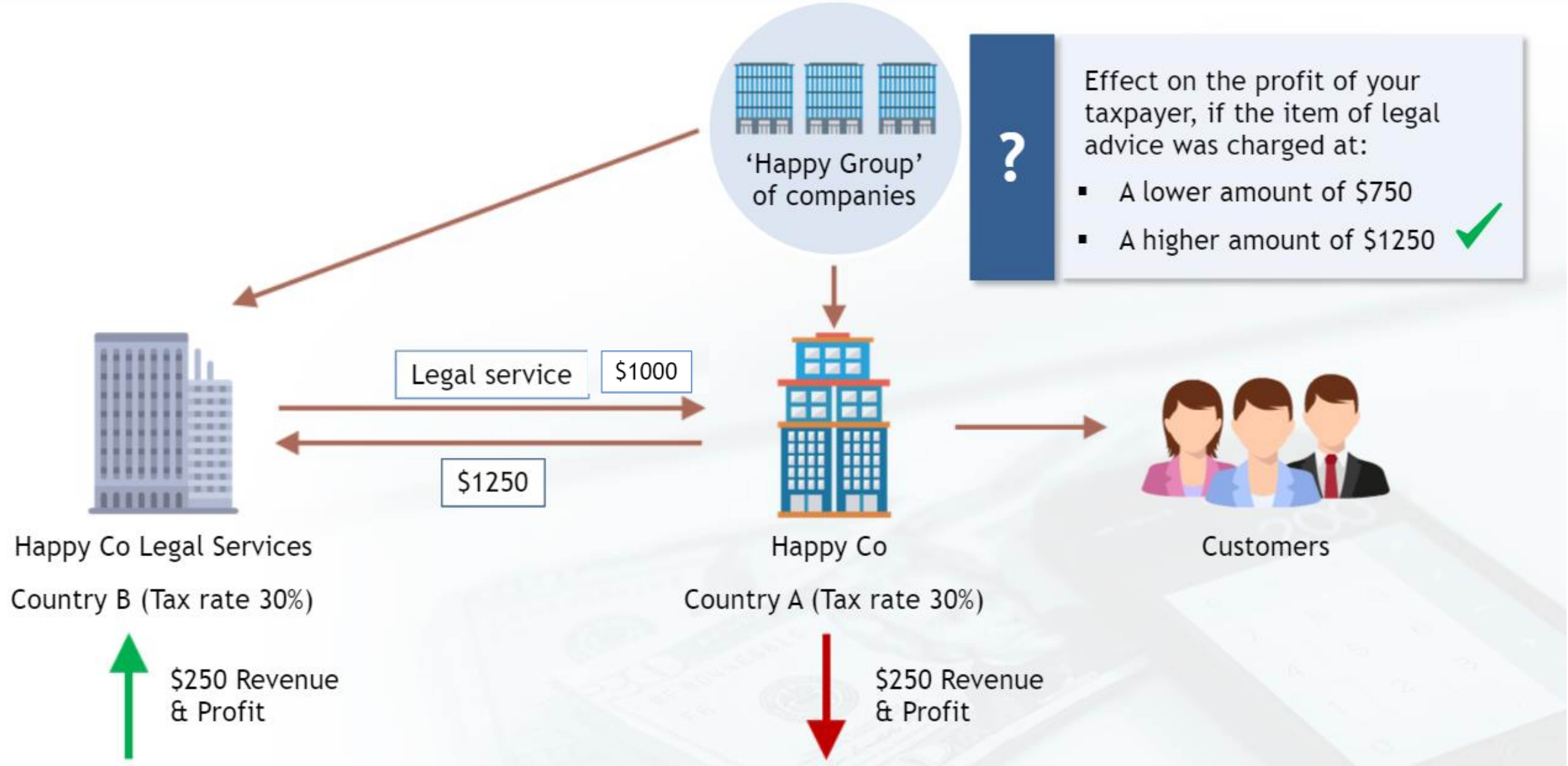
Happy Co Legal Services provides services to Happy Co



Transfer Pricing

SNMBU

Happy Co Legal Services provides services to Happy Co



Transfer Pricing Methods

SAMBU

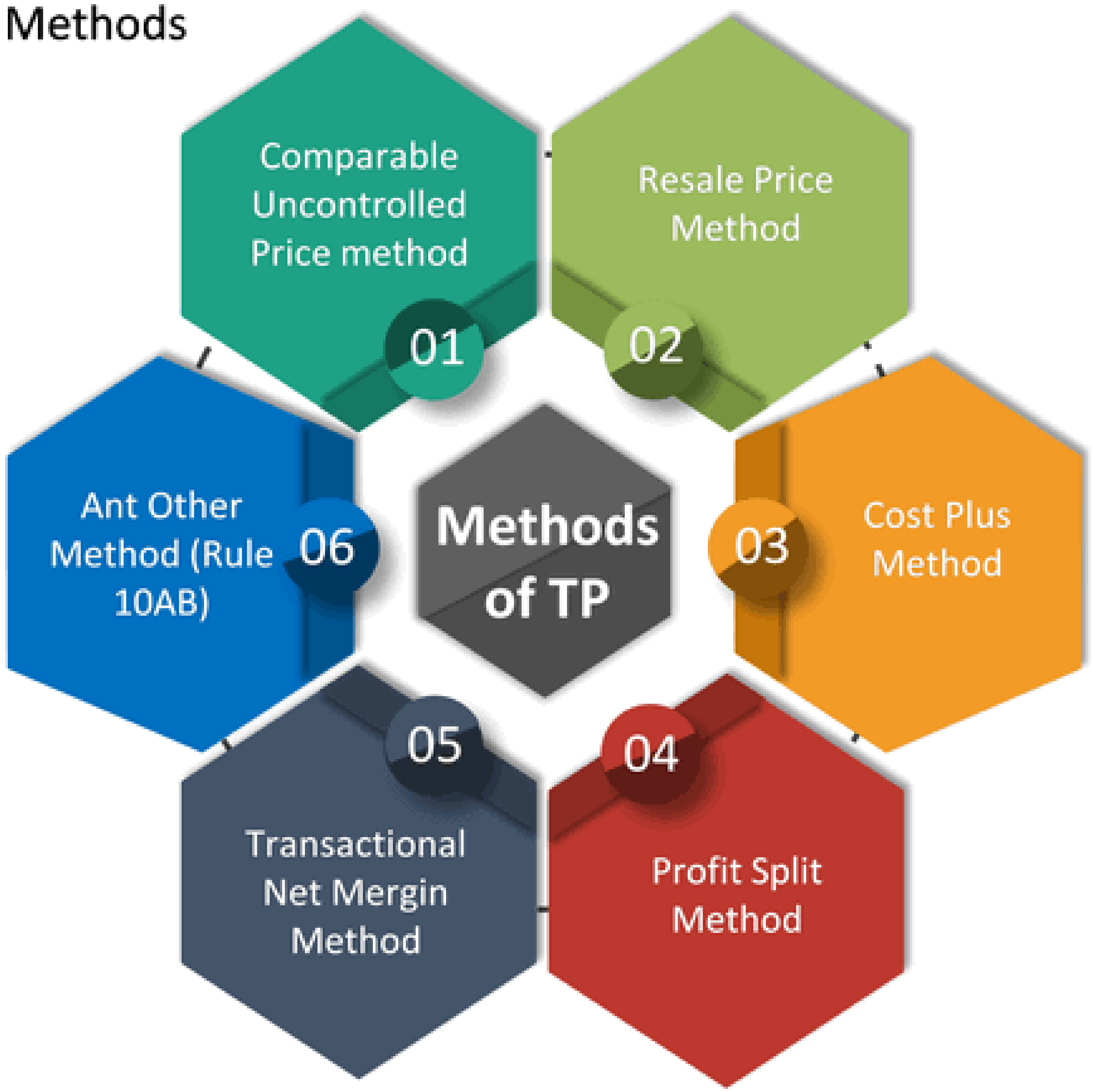
1	Comparable Uncontrolled Price Method (CUP)	Actual prices derived from uncontrolled transactions
2	Cost Plus Method (CPM)	Gross profit margin data expressed as a mark-up of production costs incurred in uncontrolled transactions
3	Resale Price Method (RPM)	Gross profit margin data derived from buy/sell transactions undertaken between uncontrolled entities
4	Transactional Net Margin Method (TNMM)	Net margin data derived from uncontrolled transactions
5	Profit Split Method (PSM)	Identifies the combined profit to be split between related persons, often based on an economic analysis.

Some countries have introduced a 'sixth method', which can apply where publicly available market pricing data (e.g. pricing of agricultural products or other commodities) is available

Transfer Pricing Rules

Several countries have established detailed regulations to ensure that the transfer pricing on cross-border transactions between related entities is acceptable.

Many of them follow the guidelines provided by the OECD. These rules require that transactions are bona fide and undertaken on an arm's length basis.



Transfer Pricing: Arm's Length Principle

SNMBU

Article 9 (1) of the OECD and UN Tax Conventions

Arm's length principle

"If conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Transfer Pricing ≠ ALP = Transfer Mispricing

Elements of Transfer Pricing Rules

- Define the scope of the rules: cross-border transactions, domestic transactions and attribution of profits to permanent establishment.
- Stipulate the compliance criteria for transactions
- Define compliance requirements of taxpayers
- Provide tax authorities with the powers necessary to enforce the rules

Components of Transfer Pricing Rules

Transfer pricing

Administrative and procedural	CORE	Practical
Reporting requirements	Scope	Comparability
Documentation	Arm's Length Principle	Transfer pricing methods
Advance pricing agreements	Adjustments	Selection of method
Statute of limitations		Arm's length range
Penalties		
Secondary legislations		

Source: World Bank Group Transfer Pricing and Developing Economies Handbook

Indicators of Transfer Pricing Risks

SAMBU

- Persistent loss making
- Lower profitability compared to industry peers
- Low-tax jurisdictions in the value chain
- Inconsistent remuneration
- Interest to non-resident related parties
- Royalties to non-resident related parties
- Services fees to non-resident related parties
- Business restructurings
- Lack of or low quality of documentation
- Non-tax related risks

What is BEPS?

- Base erosion and profit shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.
- Business operates internationally, so governments must act together to tackle BEPS and restore trust in domestic and international tax systems. BEPS practices cost countries 100-240 billion USD in lost revenue annually, which is the equivalent to 4-10% of the global corporate income tax revenue (OECD, 2021).
- Working together in the OECD/G20 Inclusive Framework on BEPS, 139 countries and jurisdictions are implementing 15 Actions to tackle tax avoidance, improve the coherence of international tax rules, ensure a more transparent tax environment and address the tax challenges arising from the digitalisation of the economy.

Are BEPS Strategies Illegal?

In most cases they are not. Largely they just take advantage of current rules that are still grounded in a bricks and mortar economic environment rather than today's environment of global players which is characterised by the increasing importance of intangibles and risk management. That said, some of the schemes used are illegal and tax administrations are fighting them.

Why is BEPS Relevant if it is all legal?

First, because it distorts competition: businesses that operate cross-border may profit from BEPS opportunities, giving them a competitive advantage over enterprises that operate at the domestic level.

Second, it may lead to inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax returns.

Finally, it is an issue of fairness: when taxpayers (including ordinary individuals) see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers

Why is OECD Focusing on BEPS Now?

The OECD has been providing solutions to tackle aggressive tax planning for years. The debate over BEPS has now reached the highest political levels in many OECD and non-OECD countries. The OECD does not see BEPS as a problem created by one or more specific companies. Apart from some cases of egregious abuses, the issue lies with the tax rules themselves. Business cannot be faulted for using the rules that governments have put in place. It is therefore governments' responsibility to revise the rules or introduce new rules.

What is the Cause of BEPS?

BEPS strategies take advantage of a combination of features of home and host countries’ tax systems. Corporation tax is levied at a domestic level. The interaction of domestic tax systems means that an item of income can be taxed by more than one jurisdiction, thus resulting in double taxation. The interaction can also leave gaps, which result in income not being taxed anywhere. Corporations have urged bilateral and multilateral co-operation among countries to address differences in tax rules that result in double taxation but at the same time have exploited them so that income goes untaxed everywhere. The report, Addressing Base Erosion and Profit Shifting, identifies a number of circumstances that, combined in different forms, give rise to opportunities for BEPS.

OECD's Role in Addressing BEPS

Many BEPS strategies take advantage of the interaction between the tax rules of different countries, making it difficult for any single country, acting alone, to fully address the issue. There is thus a need to provide an internationally coordinated approach which will facilitate and reinforce domestic actions to protect tax bases and provide comprehensive international solutions to respond to the issue. Unilateral and uncoordinated actions by governments responding in isolation could result in double – and possibly multiple – taxation for business. This would have a negative impact on investment, growth and employment globally. *The BEPS Action Plan* provides a consensus-based plan to address these issues and is part of the OECD's on-going efforts to ensure that the global tax architecture is equitable and fair.

What Does BEPS Action Plan Say?

It sets forth 15 actions to address BEPS in a comprehensive and coordinated way. These actions will result in fundamental changes to the international tax standards and are based on three core principles: *coherence, substance, and transparency*. The Action Plan also calls for further work to address the challenges posed by the digital economy. Looking toward innovative approaches to deliver change quickly, the Action Plan calls for a multilateral instrument that countries can use to implement the measures developed in the course of the work. While the OECD steps up its efforts to address double non-taxation, it will also continue work to eliminate double taxation, including through increased efficiency of mutual agreement procedures and arbitration provisions.

BEPS Action Plan

Coherence

- Hybrid Mismatch Arrangements (2)
- Interest Deductions (4)
- CFC Rules (3)
- Harmful Tax Practices (5)

Substance

- Preventing Tax Treaty Abuse (6)
- Avoidance of PE Status (7)
- TP Aspects of Intangibles (8)
- TP/Risk and Capital (9)
- TP/High Risk Transactions (10)

Transparency

- Methodologies and Data Analysis (11)
- Disclosure Rules (12)
- TP Documentation (13)
- Dispute Resolution (14)

- Digital Economy (1)
- Multilateral Instrument (15)

BEPS Action Plan

SNMBU

Four actions to ensure coherence

Neutralise the effects of hybrid mismatch arrangements (action 2) - Mismatches in the way countries' tax laws treat entities and instruments can allow companies to claim multiple deductions for the same economic expense or cause taxable income to disappear. This action will result in treaty and domestic law provisions to neutralise these schemes.

Strengthen controlled foreign companies (CFC) rules (action 3) - One of the sources of BEPS concerns is the possibility of creating offshore entities and routing income through them to escape taxation. Strong CFC rules can address this issue by including the income of these offshore entities in the parent entity's income on a current basis.

Limit base erosion via interest deductions and other financial payments (action 4) - Some companies use excessive interest deductions to erode their taxable profits, or use debt (which generates interest expense deductions) to finance the production of tax-exempt income. This action will result in recommendations regarding best practices in the design of rules to prevent BEPS through the use of interest expense and other financial payments.

Counter harmful tax practices more effectively (action 5) - Countries have long recognised that a "race to the bottom" would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue. Agreeing to a set of common rules will help countries make their sovereign tax policy choices, and this action will result in revamping the work on harmful tax practices to that end.

BEPS Action Plan

SNMBU

Five actions to align taxation and substance

Prevent treaty abuse (action 6) - While tax treaties are designed to prevent double taxation, in some cases they are used to create double non-taxation, in particular through the use of conduit companies. This action will result in model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.

Prevent the artificial avoidance of permanent establishment (PE) status (action 7) – Under the international standard, a country may not tax the business profits of a foreign company unless the company has a PE in that country. If the company is not taxed on those profits in its jurisdiction of residence, double non-taxation results. This action will result in changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS.

Assure that transfer pricing outcomes are in line with value creation (actions 8, 9 and 10) - Transfer pricing rules serve to allocate income earned by an MNE among the countries in which the MNE does business. In some cases, MNE have been able to use and/or misapply the existing rules to separate income from the economic activities that produce that income. This most often involves transfers of intangibles or other mobile assets, over-capitalisation of group companies, and contractual allocations of risk. These actions will result in rules to prevent BEPS through transfers of intangibles, through transfers of risk or excessive allocations of capital, or through transactions which would not, or would only very rarely, occur between third parties.

BEPS Action Plan

SNMBU

Four actions to ensure transparency, while improving certainty

Establish methodologies to collect and analyse data on BEPS and the actions to address it (action 11) - Further work needs to be done to measure the scale and effects of BEPS, and to monitor the impact of the actions taken to address it. This action will identify tools to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS.

Require taxpayers to disclose their aggressive tax planning arrangements (action 12) - Improved disclosure measures can help tax administrations and tax policy makers to identify emerging risk areas, and also serve as a deterrent to engage in aggressive planning. This action will result in mandatory disclosure rules targeting these kinds of arrangements.

Re-examine transfer pricing documentation (action 13) - While taxpayers often are required to produce voluminous documents regarding their transfer pricing arrangements, in many situations the information does not help tax administrators develop a "big picture" view of a taxpayer's global arrangements. This action will result in rules regarding transfer pricing documentation that enhances transparency for tax administrations while taking into account compliance costs for business, and will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of income, economic activity, and taxes paid among countries.

Make dispute resolution mechanisms more effective (action 14) - The actions to counter BEPS must be complemented with actions to ensure the certainty and predictability needed to promote investment in today's environment. This action will ensure such certainty by developing solutions to address obstacles that prevent countries from solving treaty-related disputes.

Arm’s length principle vs formulary apportionment

- The current transfer pricing rules do not always properly address the way modern businesses operate in a globalised environment, and taxpayers have thus been able to use/misuse the rules to artificially shift profits. In particular, the arm’s length principle faces challenges in addressing transfers of intangibles, risks, and capital, and other high-risk transactions. The Action plan includes three major actions to address these cases, which may include special measures either within or beyond the arm’s length principle. The Action Plan has been developed to fix the current system quickly and efficiently, without preconceptions regarding the precise nature of the changes that may be required to address these critical transfer pricing issues. However, adoption of alternative transfer pricing methods like formulary apportionment would require development of a consensus on a number of key issues (which countries do not believe to be attainable in the short or medium term) and could also raise systemic problems which could result in even more damaging problems for countries’ revenues. Accordingly, it is believed that it will be most productive to focus on addressing specific issues arising under the current arm’s length system at the present time.

How will the actions be implemented?

- The BEPS Action Plan calls for the development of tools that countries can use to shape fair, effective and efficient tax systems. Because BEPS strategies often rely on the interaction of countries' different systems, these tools will have to address the gaps and frictions that arise from the interface of these systems. Some actions, for example work on the OECD Transfer Pricing Guidelines and the Commentary to the OECD Model Tax Convention, will result in changes that are directly effective. Others will be implemented by countries through their domestic law, bilateral treaties, or a multilateral instrument.
- Addressing BEPS is critical for most countries and must be done in a timely manner so that concrete actions can be delivered quickly before the existing consensus-based framework unravels. . At the same time, governments need time to complete the necessary technical work and achieve widespread consensus. Against this background, it is expected that the Action Plan will largely be completed in 2 years.

Involving non-OECD G20 Members

- The work on BEPS, launched by the OECD, is now strongly supported by the G20 where it is a key item on the Finance Ministers' and of the Leaders' agenda. Non-OECD G20 countries were involved in the work and all (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia and South Africa) participated in the meeting of the Committee on Fiscal Affairs where the Action Plan was adopted.
- The continued participation and endorsement of all G20 countries will be critical to guarantee a level playing field and prevent inconsistent standards. To this end, and in order to facilitate greater involvement of major non-OECD economies, the "BEPS Project" has been launched, and interested G20 countries that are not OECD Members will participate in the project on an equal footing. Other non-members could be invited to participate on an ad hoc basis.

OECD Transfer Pricing Updates

- The OECD has published (August 2021) updated transfer pricing country profiles, reflecting the current transfer pricing legislation and practices of 20 jurisdictions. These updated profiles also contain new information on countries' legislation and practices regarding the transfer pricing treatment of financial transactions and the application of the Authorised OECD Approach (AOA) to attribute profits to permanent establishments.
- The transfer pricing country profiles focus on countries' domestic legislation regarding key transfer pricing aspects, including the arm's length principle, methods, comparability analysis, intangible property, intra-group services, cost contribution agreements, documentation, administrative approaches to avoiding and resolving disputes, safe harbours and other implementation measures. In addition, the newly updated country profiles include two new sections.
- The OECD has published transfer pricing country profiles since 2009, providing high-level information about the transfer pricing systems for OECD members and associate jurisdictions. In 2017, the country profiles were significantly modified to reflect the changes in the transfer pricing framework of jurisdictions as a result of the 2015 OECD/G20 Base Erosion and Profit Shifting (BEPS) Project reports on Actions 8-10 and on Action 13 which introduced revisions to the *OECD Transfer Pricing Guidelines.*

Transfer Pricing Climate

- Individual countries are continuously aligning their tax systems to address the OECD MC and BEPS Action plans. Refer to annual Finance Acts in each EAC member states, plus new regulations.
- Increased focus on MNEs – documentations, tax audits.
- Increased taxpayer awareness and compliance.
- Tax administrations has boosted their capacities to handle transfer pricing issues – exchange of information, dedicated departments (international tax experts), enhanced systems, ATAF support, Tax Inspectors Without Borders etc.
- Increased involvement of Central Banks in addressing Transfer Pricing Administration – transfers to related parties, foreign currency contracts etc.
- Revision to legislation – eg Companies Act requirements on Beneficial Owners, registration requirements, documentation and record keeping, data centers etc.
- Enhancement of tax procedures and processes – online tax platforms, electronic fiscal devices etc.

Thank you!

Q & A

Email: sambueric@gmail.com