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MANAGING BEPS RISKS

BOB KEE, EXECUTIVE DIRECTOR, TRANSFER PRICING, KPMG MALAYSIA SPOKE ON MANAGING BEPS RISKS AT MIA'S BASE EROSION AND PROFIT SHIFTING (BEPS) SYMPOSIUM 2017, WITH A SPECIAL FOCUS ON TRANSFER PRICING. FOLLOWING ARE SOME HIGHLIGHTS FROM HIS PRESENTATION.



The integration of national economies and markets has increased significantly in recent years and this has strained the international tax framework, which was designed more than a century ago. The current rules have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting (BEPS), thus requiring a bold move by policymakers to restore confidence in the system. In line with this, the Organisation for Economic Co-operation and Development (OECD) released its BEPS Package with 15 Action Plans in July 2013 and this was eventually finalised in October 2015.

FOCUS FOR ACTIONS 8, 9, 10 AND 13

Actions 8, 9, 10 and 13 relate to Transfer Pricing (TP) and its risks for BEPS. Existing TP rules can be misapplied, resulting in

the allocation of profit which is not aligned with the economic activity that produces the profit. Actions 8, 9 and 10 target this issue to ensure that TP outcomes are aligned with value creation. Key areas under Actions 8, 9 and 10 are transactions involving intangibles, contractual allocation of risks and other high-risk areas. Action 13 deals with the TP disclosure.

ACTION 8 – INTANGIBLES

Transactions involving intangibles commonly result in BEPS, because intangibles are perceived to be easily transferred and transacted within a group, especially for multinational companies. In most cases, the framework to support the transactions involving intangibles such as agreements is usually in place. However, the evidence

to justify such transactions is often lacking. More often, the paying companies are not able to demonstrate the benefits derived from such intangibles.

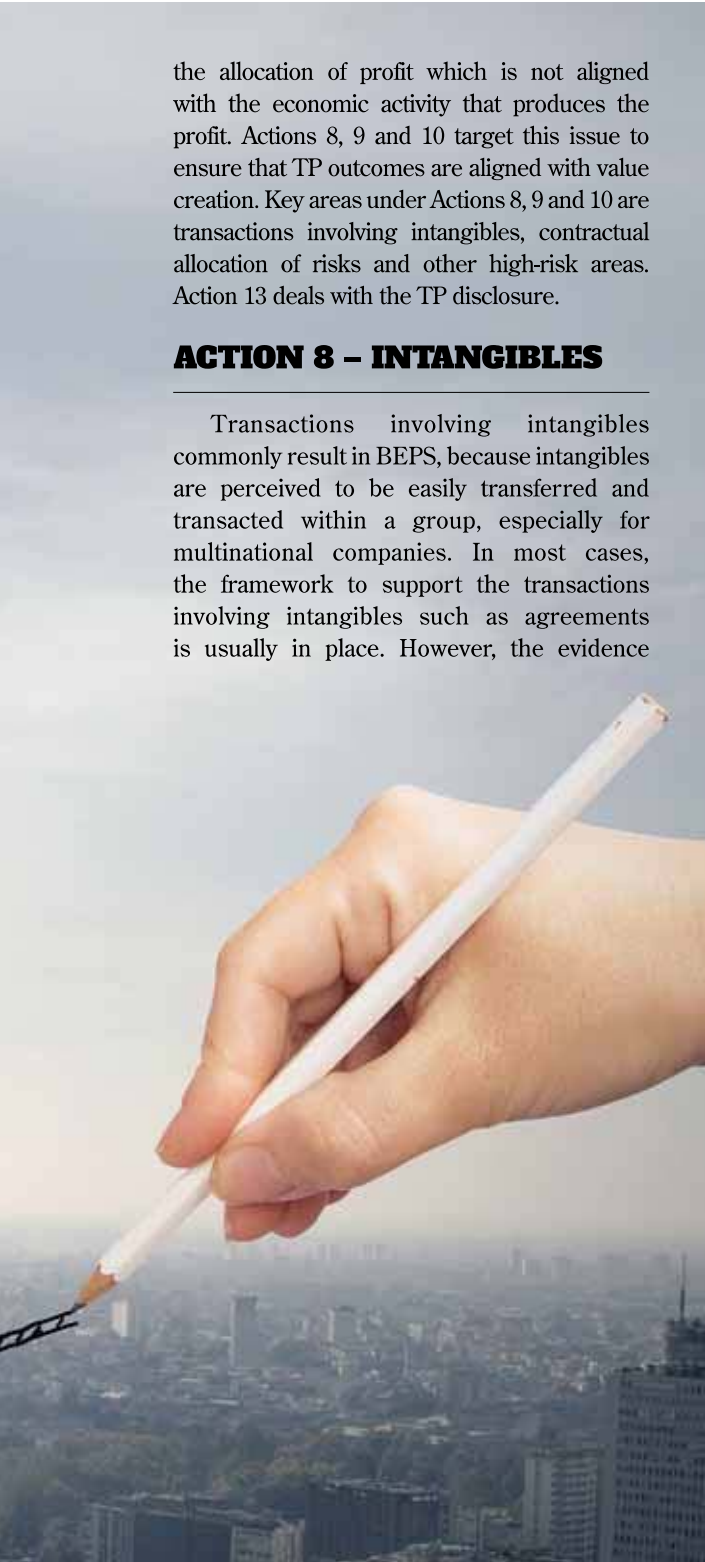
In order to address this issue, the OECD has established measures to evaluate intangibles from the TP perspective. The first step is to establish that the intangibles exist. The OECD defines intangibles as non-physical and non-financial assets that are capable of being owned and controlled for commercial use. Further, the use or transfer of the intangibles would be compensated had this occurred in transactions between independent parties.

Intangibles however do not include group synergies, for example streamlined activities or centralised functions to derive cost savings. Nor do they include market-specific characteristics like purchasing power. These are not intangibles because they are not capable of being owned or controlled.

It is important to note that intangibles for TP purposes are not always recognised as intangible assets for accounting purposes. For example, research and development costs which are expensed off in the financial statements could be considered as intangibles under TP. Similarly, advertising costs to promote brands or products awareness could qualify as intangibles under TP even though they were not capitalised in the books. Examples of intangibles include patents, knowhow, trade secrets, trademarks, brands, customers database and even government licenses and concessions.

Once the intangibles have been established, the returns to the intangibles are to be allocated to entities based on the functions performed, the assets used and risks assumed. OECD Action 8 states that mere legal ownership of the intangibles does not determine entitlement to returns from the exploitation of the intangibles. Similarly, if an entity merely provides funding, it is only entitled to no more than risk-

TRANSACTIONS INVOLVING INTANGIBLES COMMONLY RESULT IN BEPS, BECAUSE INTANGIBLES ARE PERCEIVED TO BE EASILY TRANSFERRED AND TRANSACTED WITHIN A GROUP, ESPECIALLY FOR MULTINATIONAL COMPANIES.



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free return. In order to be entitled to all the benefits from the exploitation of the intangibles, the legal owner in substance must perform and control all the functions related to the development, enhancement, maintenance, protection, and exploitation (DEMPE) of the intangibles. The entity must also provide all the assets, including funding, necessary for the DEMPE functions and assume all the related risks.

ACTION 9: RISKS

Action 9 deals with a situation where an entity earns inappropriate returns by transferring risks among, or allocating excessive capital to, group members. The entity is inappropriately accruing returns solely because it has contractually assumed the risks or has provided capital. Action 9 ensures that transfer pricing is not based on contractual arrangements that do not reflect economic reality. Contractual allocations of risk are only applicable when they are supported by controls and actual decision-making. In summary, to assume the risks for business transfer pricing purposes, the entity needs to control the risks, which includes the decision-making and mitigation of the risks, and has the financial capacity to assume the risks. It must be noted that setting of policies does not qualify as having control over the risks. Examples of risks include strategic or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and hazard risks.

Action 9 also proposes a six-step process to test contractual allocation of risks for TP purposes. Step 1 is to identify the significant risk. The risk must be specific and not vague or undifferentiated and the materialisation of the risk will economically impact the



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returns. Step 2 is to determine how this specific, economically significant risk is contractually assumed by the associated party under the terms of the transaction. Step 3 is to perform functional analysis in relation to the risk. The functional analysis will determine how the entity operates in relation to the assumptions and management of the risk, how it performs the controls and risk mitigation functions and its financial capacity to assume the risk. These three steps can be summarised as fact finding in relation to assumptions and management of risks. Step 4 interprets the information resulting from Steps 1-3 and determines whether the contractual assumptions of risk is consistent with the conduct of the transacting parties. The next step is the allocation of risk. If the entity meets the required criteria in terms of controls, risk mitigation and financial capacity, then the risk can be allocated to the entity. The final step is the pricing of the transaction based on the contractual allocation of the risk.

Inevitably there are challenges in relation to Action 9. First and foremost, there is no clear definition of economically significant risks. Even though the OECD has provided examples of risks as outlined above, the subject matter is still very subjective. Secondly, the subject of controls over risks is also not very clear and ambiguous. In reality there is no one party that can control all the risks and therefore there are practical issues

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in determining who controls the risks. Finally, the complexity is likely to increase as the environment is moving towards risk-centric functional analysis.

ACTION 10: OTHER HIGH-RISK AREAS

Action 10 focuses on other high-risk areas, including the scope for addressing profit allocations from transactions which are not commercially rational. One area covered by Action 10 is Low Value Added Services (LVAS). The objective of Action 10 is to define low value-adding intragroup services and proposes an elective simplified approach for such services. LVAS are defined as supportive in nature and are not part of the core business. They do not create or require the use of valuable intangibles and do not assume or create significant risk.

In terms of documentation and reporting, a multinational enterprise electing for application of this simplified methodology is required to provide description of the LVAS, the beneficiaries, and the justifications for the LVAS. Written contracts governing the provision of the services must be in place reflecting the agreement of the various members of the group to be bound by the allocation rules. Such written contracts could take the form of contemporaneous documents identifying the entities involved, the nature of services and the terms and conditions. In addition, the documentation

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must also reflect the calculations and determination of the cost pool, applied mark-up and specified allocation keys. Once the multinational enterprise meets the documentation and reporting test, it is assumed that the benefit test is satisfied and a mark-up of 5% for intra-group services (without benchmarking) is applicable for the LVAS. As long as the documentation and reporting requirements are met, a single invoice describing a category of services should be sufficient. The OECD also proposes a threshold to be determined by tax authorities to qualify under the simplified method.

ACTION 13 – RE-EXAMINE THE TP DOCUMENTATION

Action 13 requires the development of rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that multinational enterprises provide all relevant information on their global allocation of income, economic activity and taxes paid among countries according to a common template.

In response to this requirement, a three-tier standardised approach to transfer pricing documentation has been developed:

- > Master File
- > Local File
- > Country-by-Country Report

Taken together, these three documents will require taxpayers to articulate a consistent TP position and will provide tax administrations with useful information to assess TP risks. ■

