2016 Transfer Pricing Survey Series

How anti-BEPS policies are changing transfer pricing

EY

Building a better working world

This report is the second in a series about the global 2016 Transfer Pricing Survey conducted by EY. To receive other reports in the series, please visit **ey.com/tpsurvey** or connect with your local EY Tax contact.

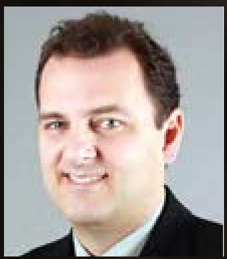
Contents

The first report in our series about our survey of 623 transfer pricing executives, *In the spotlight: a new era of transparency and risk*, used string art as an analogy to explore how an era of heightened transparency is putting new pressure on transfer pricing policies. The report concluded that companies need to become comfortable with sharing more data and prepare for more conflict in unexpected areas of both the world and their operations.

This second report analyzes in more detail what respondents in 36 jurisdictions and across 17 industries said about how they are adapting to changes catalyzed by the Organisation for Economic Co-operation and Development (OECD) in its 15 Action Plans for curtailing base erosion and profit shifting (BEPS). These changes are putting pressure on already taut transfer pricing operations.

The survey results make clear that companies need to be certain their tax strategies and transfer pricing policies are well-documented, globally consistent and ready for levels of unprecedented scrutiny by tax authorities in almost every country of both significant and insignificant operation. To continue the string art analogy, they need to make sure no threads are fraying and all are securely fastened to connecting pins.

Peter Griffin
EY Global and Americas
Transfer Pricing Leader



"There was a lot of anxiety about what a post-BEPS world would look like a couple of years ago. Now that anxiety has been replaced by uncertainty about what to do next. The survey shows that transfer pricing professionals are scrambling to meet new standards and bracing for more conflict, particularly in areas like permanent establishments and the transfer pricing around intangibles."

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BEPS: replacing a creaking infrastructure

The BEPS project was undertaken at the request of G20 countries concerned that century-old tax frameworks didn't match current ways of doing business across borders. In an era of vast global trade flows and influenced by rapidly changing technology, these frameworks may have led to situations resulting in stateless income.

The BEPS project itself culminated in 15 distinct but complementary "actions" that can be summarized into five key areas: coherence, substance, transparency, the digital economy and multilateral treaties. Taken together, BEPS is a transformational wave that is only now breaking across the community of global corporate taxpayers. As such, this year's survey offers a unique and early glimpse into the reactions and relative preparedness of the global tax paying community.

Governments around the world are moving at different speeds to implement the recommendations, often with different legislative interpretations. They are also striking different enforcement postures, which is contributing to a riskier environment for tax in general and transfer pricing in particular.

"There was a lot of anxiety about what a post-BEPS world would look like a couple of years ago," says Peter Griffin, EY Global Transfer Pricing Leader. "Now that anxiety has been replaced by uncertainty about what to do next. The survey shows that transfer pricing professionals are scrambling to meet new standards and bracing for more conflict, particularly in areas like permanent establishments and the transfer pricing around intangibles."

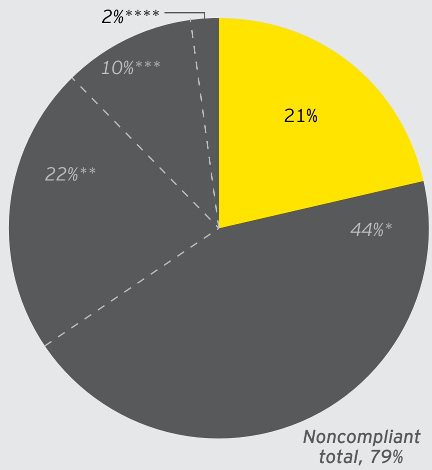
In this report, we highlight our key BEPS-related insights based on the survey and recommend actions for companies to take.

Action — Companies must catch up in creating BEPS-mandated documentation

BEPS Action 13 requires that companies stand ready to provide host governments with contemporaneous documentation of their transfer pricing policies in a format that is quite different and in greater depth in certain areas relative to prior OECD and local country guidance. This includes details of their global operations and taxation.

Zeroing in solely on the current state of transfer pricing documentation preparation, only one in five companies – 21% – is fully compliant in all jurisdictions. The remaining organizations "may have yet to grasp the extent of what will be required going forward," says Griffin. Specifically, 44% say they are fully compliant only in those instances "where transfer pricing is viewed as high-risk." Another 22% say their approach is to "adapt" their existing master file or local reports as necessary/on demand. One out of 10 companies say they create documentation only in response to a specific audit (with 2% citing "other" but still non-compliant practices).

Which of the following best describes your compliance with transfer pricing documentation?



- Compliant
- **Noncompliant:**
  - Compliant only where transfer pricing is deemed high-risk*
  - Adapt master file only as needed**
  - Procure documentation only in the case of an audit***
  - Other****

Numbers may not sum due to rounding.

"BEPS requires taxpayers to document everything, with low or no materiality threshold or risk thresholds and in a format that is not easy to carry over from prior year reports. There will be increasing focus on data quality and for the business model documented to be aligned with activities."

– Joanne Su
EY Asia-Pacific Transfer Pricing Leader, Beijing

Such approaches are misguided, short-sighted and potentially hazardous in a post-BEPS world:

"BEPS requires taxpayers to document everything, with low or no materiality threshold or risk thresholds and in a format that is not easy to carry over from prior year reports. There will be increasing focus on data quality and for the business model documented to be aligned with activities," explains Joanne Su, EY Asia-Pacific Transfer Pricing Leader, Beijing. Su says "tax authorities may first identify and then pursue those transactions that on the face of it seem to lack economic substance." In effect, says Su, "when transactions are not well-documented, there is a high likelihood that those are scrutinized by tax authorities, turning immaterial issues to potentially material adjustments."

Companies should make every effort to meet the new transparency demands

Action **Do more to embrace BEPS principles**

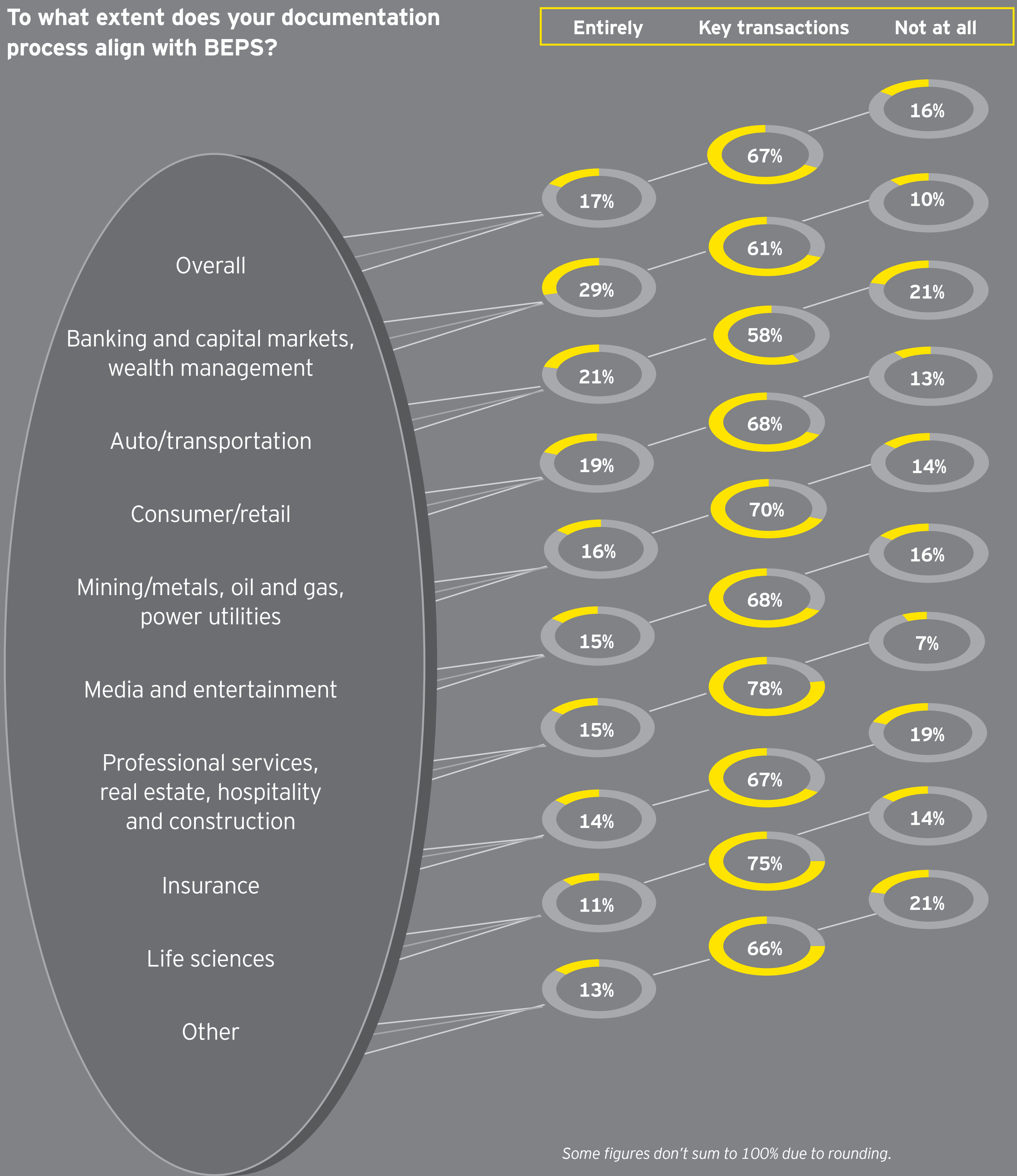
Not only are a substantial majority of companies currently guilty of failing to maintain contemporaneous documentation for all transactions, most documentation is not yet aligned with BEPS principles. Specifically, only 17% of executives say their documentation is BEPS-aligned. The rest (83%) say such record-keeping is either not at all BEPS-aligned (16%) or is BEPS-aligned only in the case of key transactions or key territories (67%).

While the need to prepare BEPS-compliant documentation is only just approaching, the form and depth of information required means that companies need to plan now for getting things done right and on time. Relying on pre-BEPS-based arguments and content to support the transfer pricing arrangements will in many instances prove inadequate.

In terms of industry variance, financial services (banking, capital markets and wealth management) currently lead the way in terms of documentation readiness. Nonetheless, with only 29% reporting full alignment, even the leaders still have a long way to go. Still, other industries such as life sciences and insurance face an even longer trek, reporting, respectively, that only 14% and 11% of their documentation is BEPS-aligned.

Industry by industry

To what extent does your documentation process align with BEPS?

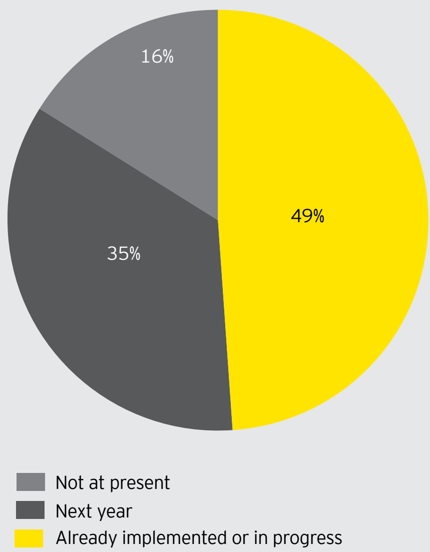


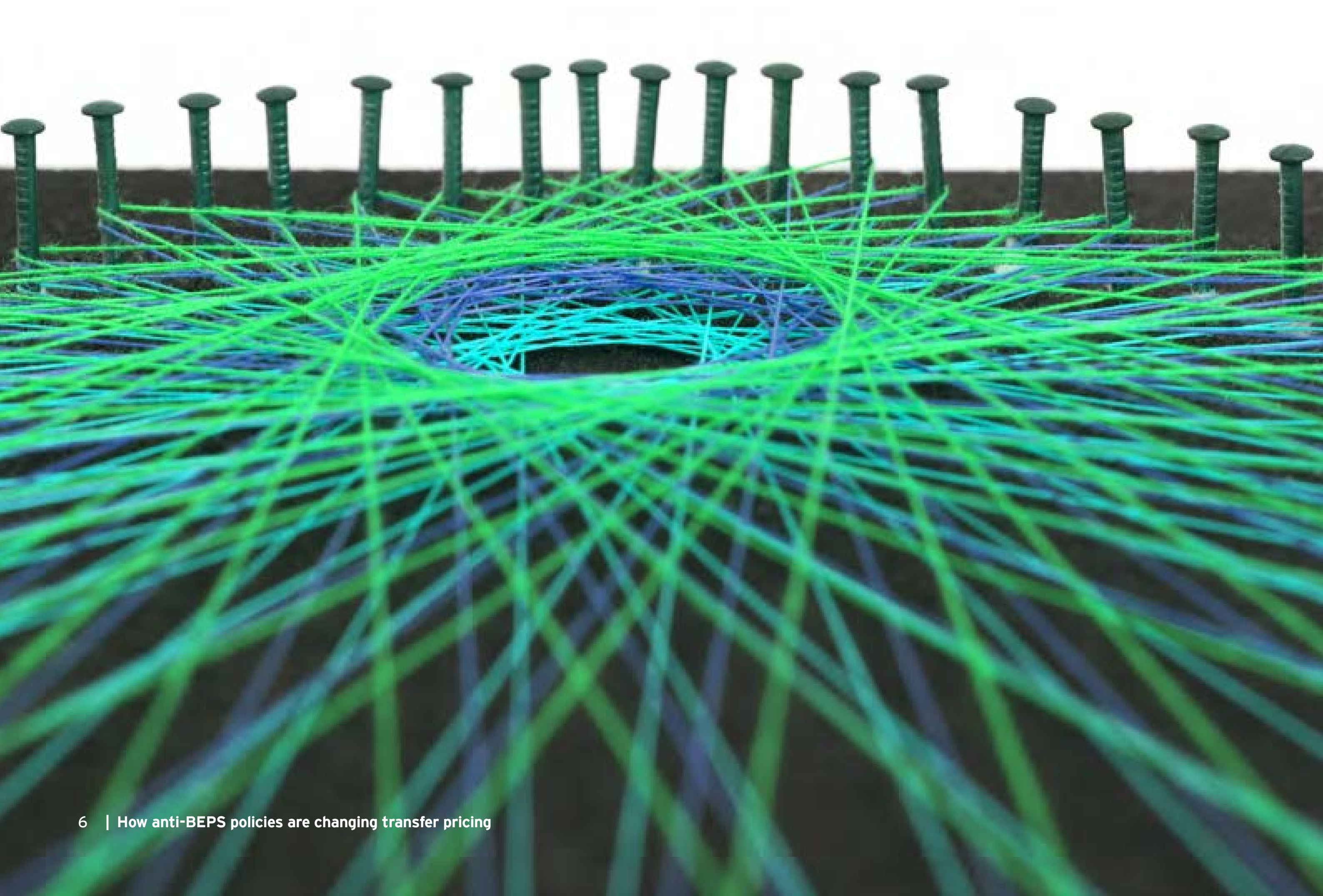
Some figures don't sum to 100% due to rounding.

On the plus side: organizations at least appear to be taking action. Nearly half, 49%, say that a BEPS-aligned global documentation process is either already implemented or in progress. Note, however, that since our earlier statistics indicate that only 21% overall are in full compliance, most within this 49% group are merely "in progress."

Another third, 35%, say they will take up the reins in this regard next year, while 16% are as yet taking no steps. But overall, says Griffin, "too many companies are not as far along as they need to be. … It's nearly 2017 — companies need to be prepared by now." In particular, says Griffin, "the need to prepare a BEPS-compliant master file and local file will apply as soon as you have a group entity in a jurisdiction where the rules apply, and is not dependent on the rules in the headquarter jurisdiction or usually reliant on transaction/size thresholds."

To what extent are you planning to implement a global documentation process aligned with the BEPS master file format?





Action

Be prepared for full implementation of country-by-country reporting

As for Action 13's mandated country-by-country reporting (CbCR), again, most companies appear to have made far less progress than might be prudent. Here, two-thirds are either still in the initial modeling phase (45%) or, worse, have made no steps at all (22%). Only one-third of companies say they have key transition actions underway. This could have negative consequences.

"Tax jurisdictions will use CbCR data to target their audits and build their cases," says Tracee Fultz, EY Northeast Region Transfer Pricing Leader in the US. "If companies produce this data earlier on, they will have time to pinpoint any weaknesses on their own. Certainly, people still have more time in which to comply with CbCR. But if they wait too long, they could find themselves in a corner with very little opportunity to make any adjustments to operations based on what the CbCR data reveals."

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– Tracee Fultz
EY Northeast Region
Transfer Pricing Leader in the US
Ernst & Young LLP

BEPS: impacts on PEs and intangibles

Action **Prepare for more BEPS-related controversy, in particular in the areas of PEs and intangibles**

BEPS-driven consequences and pressures are also winding their way through the tax controversy landscape. Indeed, amid so much change and with so much more information in the hands of tax authorities, survey respondents are poised for an era of heightened controversy across multiple defined areas, especially in emerging markets where they haven't encountered it previously.

Our next report in this transfer pricing survey series specifically focuses on controversy-related aspects; however, given the expected increase in controversy from the specific BEPS Action Plans on permanent establishments (PEs) and intangibles, these are discussed further below.

Action **Increase awareness of PE-related impacts**

The largest increase in transfer pricing related controversy is expected relating to issues of PE, the key focus of BEPS Action 7. Essentially, Action 7 substantially lowers the threshold under which a host nation can declare a corporate presence as a PE and therefore subject to income tax. Three years prior, only 27% cited PE as a significant driver of controversy. But going forward over the next two years, the figure climbs to 44%.

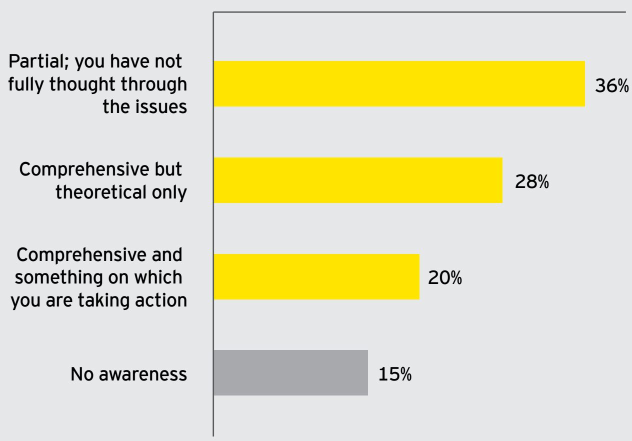
The new rules, says Su, EY Asia-Pacific Transfer Pricing Leader, "cast a wider net by which tax jurisdictions will be making claims on income." Specifically, BEPS more narrowly defines a range of elements within the plan/buy/sell service spectrum for which the presence of any of such elements in any given country could give rise to PE status. Consequently, says Su, "companies need to take a close look at their approach to make sure what was once a benign presence is, under today's rules, a taxable one – and do so in time to make adjustments where needed."

The types of PEs that respondents have had challenged are spread across the spectrum of permanent establishment instances, with a slightly greater focus on sales agents (dependent agency), services PEs, business travelers/secondees and construction. This may suggest that knowledge of how to prevent PEs being asserted may not be all that well understood, which is reinforced in the low level of awareness of the materials in relation to BEPS Action 7, with only 20% of respondents stating that they have a comprehensive and practical understanding of the new proposals.

As the responses show, over half of respondents have either partial awareness but have not thought through how the rules would apply to them, or have no awareness at all. This also most likely is why 36% of respondents are not considering taking any action at this stage in relation to PEs, while at the other end, 15% are looking at restructuring part of their activities as a result. The remainder were looking at performing some form of review at varying levels. On a going-forward basis, sales agency and services PEs were the areas anticipated as being most likely challenged, while the actual attribution of profit itself was also a key anticipated area of focus.

These trends and responses show that the area of PEs is a key source of risk. "It is evident that while the assertion of PEs by tax authorities has been somewhat inconsistent in its level of application by tax authorities, it is a clear area of focus," says EY Global and Americas Transfer Pricing Controversy Leader David Canale. Worryingly, this is not necessarily matched by the level of preparation and assessment by taxpayers to meet this increased risk. "The implications from the assertion of PEs can be far-reaching to your operating and tax model and should be understood and mitigated given the likelihood of a challenge being more of a chance than ever."

Would you describe your awareness of the materials published in connection with BEPS Action 7 as ... ?



Numbers may not sum due to rounding

Action Intangibles deserve closer focus

A key focus of BEPS Action 8 is to require greater substance behind the cross-border charges of royalties and for other intangibles. In this area, while 32% of executives said that transfer pricing of intangible property had been a source of significant concern over the past three years, the percentage surges to 49% going forward.

Though the above findings show that organizations clearly anticipate greater intangibles-focused controversy as a result of BEPS, only one in five, 21%, say they have both taken a close look at the new rules and taken action. By contrast, 79% have yet to fully respond. For example, 37% say they are partially aware of the new rules but have not fully thought out what it means for their organization. One in four, 24%, say they have taken a comprehensive look at the impacts, but in theory only. Nearly one in five, 18%, say they have no real awareness whatsoever of what the new tests will mean for their organizations. This points to a clear gap between anticipated levels of heightened intangibles scrutiny versus relative preparedness.

This lack of response or preparedness is "both surprising and somewhat disturbing," says Marlies de Ruiter, EY Global ITS Tax Policy Leader based in Rotterdam, the Netherlands. In general, "BEPS substantially raises the stakes in terms of what is required to benefit financially from charging for brands, processes and other intellectual property (IP)," de Ruiter says. "Traditional concepts such as beneficial and legal ownership are being upended. To value IP, tax authorities will instead look closely at new disclosures that contain facts such as the number of people working at a location along with their skills and strategic and high value adding roles (the so called development, enhancement, maintain, protect and enhance – DEMPE – functions within BEPS Action 8)."

Overall, says de Ruiter:

"The longer that companies take in terms of evaluating their exposure under the new rules, the less opportunity they'll have to make their operations BEPS-compliant. These tend to be particularly relevant for senior executives performing key IP enhancement and management roles. If, for example, analysis under the new rules suggests the need to either move people around or increase functionality to demonstrate substance, or alternatively modify pricing arrangements, these can take significant time. In general, companies need to get moving in this area so they have time to make any needed adjustments."

"The implications from the assertion of PEs can be far-reaching to your operating and tax model and should be understood and mitigated given the likelihood of a challenge being more of a chance than ever."

– David Canale
EY Global and Americas Transfer Pricing Controversy Leader

To what extent did/will this issue fuel controversy over the past three/next two years?

	Past three years	Next two years
Transfer pricing of goods and services	72%	75%
Intangible pricing	27%	44%
Permanent establishment	32%	49%
Intragroup financing	39%	48%

Intragroup financing – a source of controversy?

	Past three years	Next two years
All	39%	48%
Financial services *Banks, capital markets, wealth and asset managers – does not include insurers*	58%	67%
Insurance	64%	57%

New rules on intragroup payments are likely to spur controversy for all – but the impact will be especially pronounced among financial services companies such as banks, market makers, and asset and wealth managers. BEPS Action 4 targets "excessive" — significantly above market rate — interest and other financing-related transactions suspected as a means of shifting income. Over the past three years, intragroup financing arrangements have been an issue for 58% of the above spectrum of financial services companies — compared to only 39% for taxpayers overall. But going forward, 67% of this broader financial services group feels this will be a source of controversy, compared to only 48% overall.

Note that the view differs for insurers. Over the past three years, 64% of insurers have seen controversy stemming from their intragroup financing activities. But going forward, the figure actually declines to 57%. This may be because financing for insurers could be perceived as a lower priority for tax administrators compared to intragroup reinsurance or branch capital allocation, and as insurers are not typically highly leveraged due to regulatory constraints. In addition, the European Union's Solvency II directive also placed more limitations on intragroup financing from 2016. Anti-BEPS measures limiting interest deductibility may also be a factor.

BEPS: there's work to be done

BEPS has already imposed heightened transparency, updated or altered definitions and characterizations, and introduced imminent mandates and deadlines on transfer pricing professionals. In string art terms, the threads have been pulled tighter than ever. Companies must take action to shore up their designs.

Key BEPS-driven issues for tax directors to lead their companies in addressing BEPS include the enhanced level of documentation of transfer pricing arrangements, the greater ambit for PEs, broader justifications for IP management and pricing models — even intragroup financing and controversy readiness and procedures. It is clear that companies need to confirm the alignment of their pricing models and documentation to the new realities.

Amid so many demands, why are companies moving more slowly than expected? Is it a lack of resources or awareness? More than likely, says Griffin, this could be a case of uncertainty as to how the rules will be applied across various jurisdictions. "It may take several years or more before the full impact of BEPS becomes clear. This will no doubt drive profound change in practices amid not only the G20 but also developing market tax authorities — and in fact already is." Nonetheless, says Griffin, companies cannot afford to wait much longer. "For global businesses, the time to respond to BEPS — to evaluate, address, align and adjust — is now."

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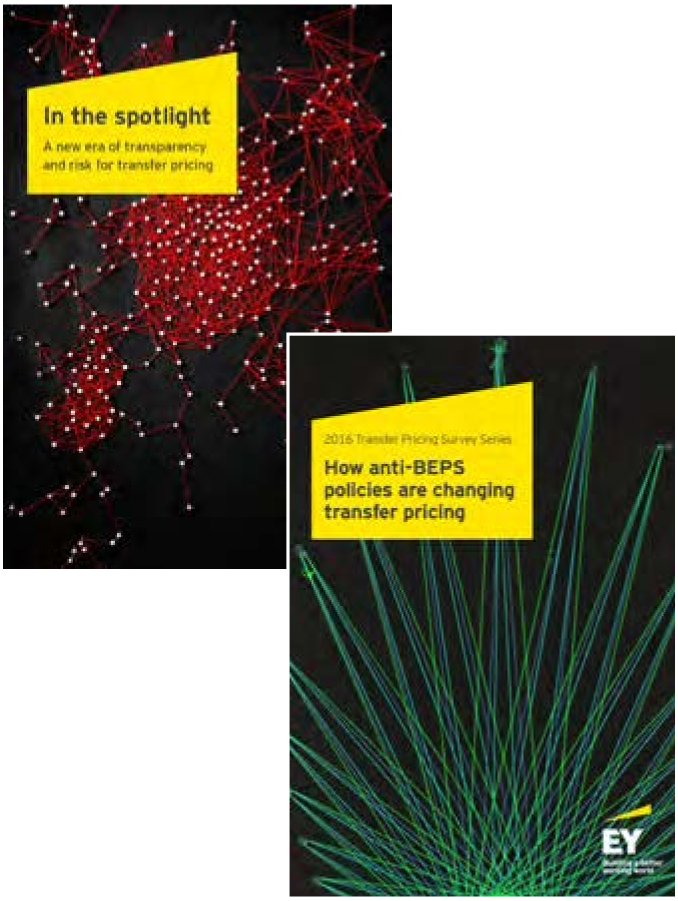

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EY Transfer Pricing contacts

Peter Griffin
EY Global and Americas Transfer Pricing Leader
+1 612 371 6932
peter.griffin@ey.com

Curt B. Kinsky
EY Asia-Pacific Area Leader – Transfer Pricing
+852 2629 3098
curt.kinsky@hk.ey.com

Oliver Wehnert
EY EMEIA Leader – Transfer Pricing
+49 211 9352 10627
oliver.wehnert@de.ey.com

Ichiro Suto
EY Japan Leader – Transfer Pricing
+813 3506 2411
ichiro.suto@jp.ey.com

David Canale
EY Global and Americas Transfer Pricing
Controversy Leader
+1 202 327 7653
david.canale@ey.com

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