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U.S. Docs and Master File—Transfer Pricing Apples and Oranges

Attorney Barbara Mantegani raises the alarm on how U.S. multinational enterprises should comply with the OECD's new master file requirements. In this article, Mantegani concludes that because there are significant differences between the U.S. rules and the revised OECD transfer pricing guidelines, companies should approach the master file differently than they have approached U.S. documentation in the past. They need to tell their entire global story in their master file documentation.

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Since the mid-1990s, when the U.S. revised the IRC section 482 regulations governing intercompany transactions and imposed specific transfer pricing documentation requirements on U.S. multinationals, and the Organization for Economic Cooperation and Development also issued transfer pricing guidelines that acknowledged the value of transfer pricing documentation, many countries have followed the U.S. example and established country specific documentation requirements. As a result, large multinational enterprises have grappled with how to meet the increasingly diverse expectations of an increasing number of tax authorities.

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Until the culmination of the base erosion and profit shifting (BEPS) project, the OECD guidelines did not recommend any specific documentation, but instead generally discussed the type of information that could be relevant to a transfer pricing enquiry, noting that tax administrations should limit the amount of information required to be submitted with the tax return. (*See* Chapter 5 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010)*.)

With the Oct. 2015 final report on BEPS Action Item 13, the OECD finally set forth prescriptive rules that identify three specific types of documents that the organization states will ''help meet the objective of providing tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.''

In July 2017, the OECD updated its transfer pricing guidelines to incorporate the specific recommendations of the BEPS project, including the Action Item 13 recommendations. (*See* Paras. 5.C 1-3, of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*.)

Comparing the U.S. rules with the revised OECD guidelines, particularly the master file, one can see that their differences are not just in form, but in the apparent purpose underlying the rules themselves, and therefore multinationals are well advised to approach the

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master file differently than they have approached U.S. documentation in the past.

U.S. Rules

The U.S. documentation rules—effective in February 1996—were imposed in conjunction with a complete overhaul of the substantive regulations issued under section 482 to govern the pricing of intercompany transactions.

After identifying ''the arm's-length standard'' as the proper measure of the clear reflection of income under section 482, the regulations for the first time included specific methods that taxpayers were to use to measure the arm's-length nature of their transactions.

To ''encourage'' compliance with such methods, the IRS created—also for the first time—a specific requirement that taxpayers document the results of their intercompany transactions that fall within the scope of section 482 and show how the taxpayer applied the specified method, or a properly documented unspecified method, to the transaction to demonstrate an arm's-length result. (Treas. Reg. 1.6662-6(d)(2)(iii).) While the documentation was not required to be submitted with the tax return, to avoid the onerous ''gross valuation misstatement'' penalty of section 6662 the documentation was required to be ''in existence'' on the date that the taxpayer filed its tax return.

OECD Guidelines

The OECD guidelines that were released in 1995, in contrast to the compliance, rules-based approach of the U.S., presented a principles-based approach designed to provide guidance to countries seeking to resolve double tax cases in treaty-based mutual agreement proceedings between OECD member countries. The preface to the 1995 rules encourages OECD member countries to follow the principles set forth in the guidelines in their domestic transfer pricing practices.

However, the guidelines were not prescriptive, and in fact encouraged tax examiners to be ''flexible'' when examining a multinational's transfer pricing, and take the taxpayer's commercial judgment into account when analyzing its transfer pricing results (OECD guidelines, Chapter IV, Para. 4.9 (1995)).

Post-BEPS World

In a post-BEPS environment, however, the level of transparency the OECD recommends that taxpayers provide regarding their transfer pricing policies is vastly expanded.

U.S. rules require a taxpayer to provide information about its overall industry and to provide an organization chart, but the documentation need test *only* transactions that implicate section 482, and the organization chart need show *only* those related parties that are ''relevant under section 482.''

This approach makes sense in the context of the compliance goals the IRS had at the time it created the regulatory framework, but it is in stark contrast with the OECD post-BEPS expectations that taxpayers provide three different reports—master file, local file and country by country report (CbCR).

Taxpayers in their master file are to describe, among other things:

- The most significant value drivers;
- Top five products and/or services;
- Most important intercompany service arrangements, including R&D arrangements;
- Main geographic markets;
- Global functional analysis;
- Significant acquisitions, divestitures or restructures occurring during the year;
- Description of all intangibles ''important for transfer pricing purposes'';
- Any important intangibles transfers occurring during the year; and
- A description of the group's financing activities and intercompany financing transactions.

Clearly, the OECD—and those countries that take a similar approach—expect taxpayers to tell their entire global story in their master file documentation, and this story likely will inform how the tax authorities understand both the local file and the CbCR.

Master File

For those U.S.-based multinational enterprises that are subject to the OECD guidelines as well as the U.S. rules—presumably most large U.S.-based multinationals—these somewhat-similar-but-not-quite-the-same documentation requirements create many challenges, the most basic of which is: How do you efficiently prepare all these various documents, both from a time and expense perspective?

Looking specifically at the master file, one question that has come up is: Can I leverage the U.S. docs into a master file? The answer, in my view, is ''NO.''

The local file focuses on transactions and testing, and in format more closely aligns with the structure of the U.S. documentation report such that there likely can be some sharing of information across those documents. But the master file is completely different, both in terms of the information included, and more importantly, in what taxpayers are asked to explain about their transfer pricing practices and policies, and in this author's opinion it is not advisable to attempt to leverage data directly across the two types of documents.

Drivers of Business Profits

For example, the first piece of substantive information required by the master file is a written description of the taxpayer's business, including ''the important drivers of business profits'' (OECD Action 13 Final Report, Annex 1 to Chapter V of OECD transfer pricing guidelines).

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Compare the OECD requirement with the U.S. rules, which require ''An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services'' (Treas. Reg. 1.6662-6 (d)(2)(iii)(B)). The U.S., as noted above, is focused in the documentation exercise on ensuring that the taxpayer is *pricing* its transactions in an arm's-length manner, therefore the taxpayer needs to discuss the factors that can influence that pricing, including, presumably, the macroeconomic factors that impact the business.

On the other hand, the OECD begins by asking about drivers of business profit in general, and then asks taxpayers to provide a description of the supply chain for the group's five largest products and service offerings by turnover, plus any other products or services that amount to more than five percent of group turnover.

Focus on Pricing

The U.S. regulations do not ask for any information about global profit or revenue, but limit the documentation to ''all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the *pricing* of property or services in the United States.''

As noted above, this focus on pricing as opposed to profits reflects the goal of the regulations as stated in the preamble:

> [T]he failure to apply the arm's length standard in setting prices for controlled transactions (and the lack of contemporaneous documentation explaining that application) increases the time spent and expense incurred by both the taxpayer and the IRS in determining whether that result was consistent with the arm's length standard. Accordingly, *these regulations are designed to encourage taxpayers to make a serious effort to comply with the arm's length standard, report an arm's length result on their income tax return, document their transfer pricing analyses, and provide that documentation to the IRS upon request*, (emphasis added) (Treasury Decision 8519, 59 FR 4791-4799, February 2, 1994).

To add context, at the time that the regulations were developed the Treasury Department and Internal Revenue Service had gone through numerous highly contentious transfer pricing audits and litigation. For example, *Eli Lilly v. Comm'r*, 856 F.2d 855 (7th Cir. 1988), and *Bausch & Lomb v. Comm'r.,* 933 F. 2d 1084 (2d Cir. 1991), where the facts were hotly contested, the discovery process was arduous, and neither the government nor the taxpayer achieved the desired outcome.

Clearly this experience influenced the government's approach to its regulations, and the goals sought to be achieved through the documentation exercise, as described in the preamble noted above.

IRS Examiners

The experience of the IRS has been that the majority of taxpayers do not provide an explanation of how their intercompany pricing was established. In many cases examiners' access to a corporation's transfer pricing information is delayed or denied. Moreover, many taxpayers do not rely upon any form of comparables or other contemporaneous information either in planning or in defending intercompany transactions. The taxpayer, not having attempted to structure the transaction in accordance with the arm's-length standard, seeks to defend its position on examination by finding whatever uncontrolled transaction or transfer pricing method provides a result that most closely approximates the result initially reported. The failure by taxpayers to analyze their intercompany pricing prior to audit increases controversy between taxpayers and the IRS, as both seek to develop post hoc analyses of the arm's-length character of the transactions.

Compliance, specifically U.S. compliance, drives the ten principal documents required by the U.S. rules. There is no mention of overall business drivers or strategies, and no mention of the larger business context within which intercompany transactions and policies exist, for example, a discussion of the taxpayer's larger place in its industry, or even the industry itself.

Oddly, given the lack of such a requirement, many, if not most, of the transfer pricing reports that this author has written, or reviewed, include a section describing the taxpayer's industry, which is usually (mis)labeled as an ''Industry Analysis,'' and which often does not tie into any other section of the report in any meaningful way.

While the regulations do ask for information regarding the taxpayer's business, as noted above, that information is intended to inform the IRS of the factors that implicate *pricing*.

Global Business

In contrast, the new OECD guidance explains:

> The master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk. In general, the master file is intended to provide a high-level overview *in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context* (emphasis added).

In order to present that context the OECD provides a list of information, noted above, that it deems to be relevant to the inquiry, including the company's top products or services, the value chain, the intercompany agreements that exist in the group, the acquisitions or divestitures occurring in the prior year, and the company's financing arrangements, both third-party and intercompany. As described by the OECD, the master file is intended to be read in conjunction with the other pieces of documentation recommended by the guidelines—the local file and the country-by-country report—with the goal of identifying areas of transfer pricing risk for tax authorities to pursue.

Already some countries have announced an intention to ''enhance'' the master file with country-specific information (*See* Bell, ''Transfer Pricing 'Master File' Must Bow to Countries' Rules,'' TAX MANAGEMENT TRANSFER PRICING REPORT (Bloomberg BNA) (Mar. 9, 2017)), but regardless of that development, the fact remains that the basic purpose of the document is not to demonstrate compliance with specific laws, but rather to provide tax authorities with a coherent description of the global business.

Foreign Rules

There appears to be no common agreement among jurisdictions regarding who is required to prepare a master file.

Japan, for instance, only requires a master file if the company has worldwide revenue of ¥100 billion (approximately $US900 million), while Mexico's threshold is MXN 644 million, or approximately $US36 million.

The U.S. Treasury Department has announced that it does not plan to revise the 6662 regulations to require a master file, and has adopted U.S. country-by-country reporting requirements through regulations promulgated under IRC 6038 (Treas. Reg. § 1.6038-4).

Nevertheless, it is fair to say that the vast majority of U.S.-based multinational enterprises with related entities outside of the U.S. will be required by foreign rules to prepare a master file, leading to the question:

Can You Make an Apple into an Orange?

As noted above, the U.S. documentation report, which U.S.-based taxpayers have been preparing for many years, is designed for a very specific purpose, that being demonstrating the taxpayer's compliance with the arm's-length standard as described in the regulations under IRC Section 482.

The master file, which most U.S.-based taxpayers are grappling with for the first time, is intended by the OECD to be just one of several transfer pricing documents which, when read together, present the coherent, globally consistent, story of the taxpayer's transfer pricing policies and practices.

Given this, and with deference to the amount of resources involved, both internal and external, in the annual transfer pricing documentation exercise, multinational enterprises should nevertheless remain mindful of those key differences and approach the task with those differences in mind.

In short, for the next few years, or until the coherent story is fully developed and incorporated as the basis for the annual master file, companies are well advised to consider writing the master file on a blank sheet of paper, so to speak, preferably by someone who knows and understands the company.

However, if circumstances require that the master file be leveraged from across other documents, companies are well advised to have a third-party with transfer pricing expertise review all of the documents, but particularly the master file, to confirm that it has the appropriate tone, frames the issues appropriately, and is consistent with the stories told in the versions of the transfer pricing story that will go to the relevant tax authorities.

If the BEPS project made anything clear, it is that tax authorities around the globe are focusing their often limited audit resources on transfer pricing. So, to the extent that a taxpayer can present a story that shows that the transfer pricing tail is not wagging the business dog, but that it simply follows the company's reasonable business practices, the taxpayer has increased the chances that the auditor will close that file and move on to another taxpayer whose story just doesn't hold together quite as well.

This is a post-BEPS brave new world, and it is important for U.S. multinational enterprises to understand that and prepare their documentation accordingly.

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