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Research paper

Tax Control System of Transfer Pricing with the Beps Plan

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Abstract

The paper considers the basic principles of the tax control system concerning transfer pricing in foreign and Russian practice. The authors see the main principle of the system in the "arm's length" concept which allows determination of the validity of the applied price for an intra-company transaction in comparison with its similar conditions and the market price. The authors of the paper suggest an integral system of tax control for transactions between interdependent entities, which includes: the legislatively regulated definition of the market price, the legislatively established regulation of transfer pricing tax control, and the mechanism of penalties for violation of the tax control law for transfer pricing. The latest innovations in the tax control system concerning transfer pricing are based on measures taken by OECD countries to combat the erosion of the tax base (the BEPS plan). The authors of the paper analyze certain provisions of this plan, such as documentation provided by holdings and transnational corporations for the purpose of tax control of transactions between interdependent entities; special attention is also paid to the analysis of tax control over transactions with intangible assets between interdependent entities under the BEPS (Base Erosion and Profit Shifting) plan. Based on the analysis of innovations in accordance with the Base Erosion and Profit Shifting plan, the authors of the article proposed a tax control system for transfer pricing taking into account the latest legislative changes.

Keywords: *transfer pricing, tax control, tax base, Base Erosion and Profit Shifting plan, reporting, system.*

1. Introduction

For the tax control of transfer pricing, the Organization for Economic Cooperation and Development proposed appropriate instruments, which were adopted by the Russian Federation. Thus, the "arm's length" principle, the essence of which consists in observance of the price and economic conditions of controlled and uncontrolled transactions, is the most widespread in the international practice in the field of tax control of transfer pricing, otherwise it is recognized that manipulation of transfer prices and violation of the state tax legislation in the form of minimization of the tax base, its withdrawal to low-tax jurisdictions, etc. [1]. Also, the profitability of transactions between interdependent entities must correspond to the profitability of transactions made in market conditions between independent parties [2].

The "arm's length" principle allows determination of the validity of the applied price for an intra-company transaction in comparison with its similar conditions and the price on the market. The implementation of this principle consists in the fact that in the course of tax control, both interconnected and independent enterprises are evaluated equally, which avoids distorting the tax burden for both types of organizations, that is, it is expected that related organizations will have profits similar to the independent organizations [3]. Also, Article 1 of the OECD Model contract on Avoiding Double Taxation, which is used by States to conclude bilateral agreements, specifies a general rule on the occurrence of special tax consequences for related taxpayers. Article 9 of this document also specifies that under financial and trading conditions, when transactions are made between related entities that are different from the prevailing financial and trading conditions, the profit that should have been received as a result of the transaction in market conditions, but was not obtained under special conditions between related entities, may be attributed to the profits of one of this entity and be taxable. That is, to prevent price manipulation in order to minimize the tax base, it is necessary to adjust the financial and economic results of related entities in accordance with the market conditions for financial and economic activity, as well as the rules for such adjustment and recognition of entities connected with each other [4].

2. Methods

Based on a more detailed analysis of the tax control practice for transfer pricing in foreign countries, the tax control system also includes:

- Legally regulated definition of the market price (derived from the "reference" principle of tax control over transfer pricing;
- Legally established regulation for tax control over transfer pricing;
- Mechanism of penalties for violation of the law on tax control over transfer pricing.

On the basis of logical consolidation and interconnection of the basic elements of the tax control system for transfer pricing, the authors of the paper offered their schematic model (Figure 1) which includes both a block for taxpayers and a state unit regarding tax control over transactions between interdependent entities.

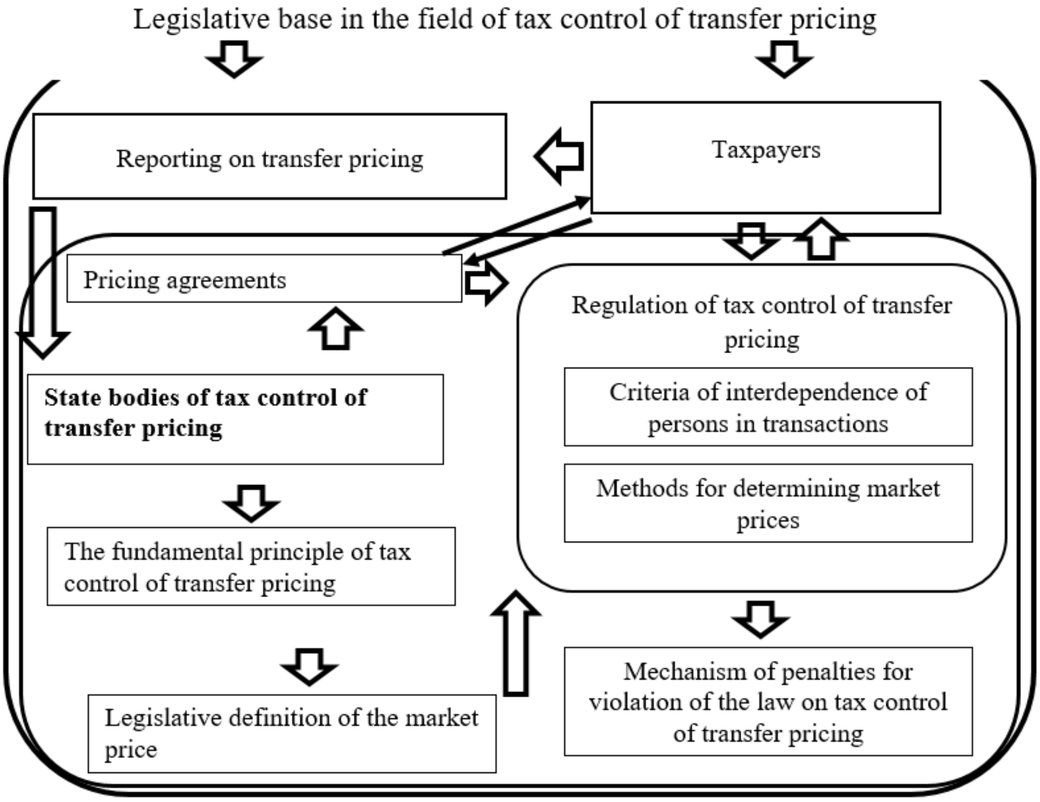

Fig. 1: Tax control system for transfer pricing

Table 1. Documentation provided by taxpayers to regulatory authorities

Documentation type	Information provided in the documentation
Local file	a) information, which is provided on the activities of a transnational company in a particular country, their organizational structure and key competitors; b) information, which is provided on transactions of a transnational company with related persons, including functional and comparative analysis, justification of selected methods of pricing in transactions; c) information, which is provided on the paid and received amounts for transactions between interdependent persons of a transnational company, indicating the tax jurisdictions of the parties to the transactions; d) financial statements, which are provided for companies of a particular tax jurisdiction
Country Report	a) the organizational structure of the transnational company should be fully described; b) all activities and geographic markets of a transnational company, including supply chains, should be described; c) data on transactions with intangible assets of a transnational company, pricing policies for them, should be indicated; d) the mechanism of financing within a transnational company, should be described; e) the consolidated financial statements of the transnational company, should be provided;
Master File	a) information on revenue (broken down between dependent and independent counterparties); a) information on profit (loss) before taxation; b) information on income tax (income) to be paid; c) information on capital; d) information on accumulated profits; e) information on the number of employees; e) information on tangible assets; g) information on the list of taxpayers in each country, indicating the type of activity.

On 10.05.2015 the Organization for Economic Cooperation and Development has developed a package to combat the erosion of the taxable base and the withdrawal of profits from taxation - the Base Erosion and Profit Shifting (Base Erosion and Profit Shifting) plan, according to which transfer pricing is controlled through the following activities [5]:

- № 8-10 - questions of a parity of financial results with creation of cost in a supply chain are disclosed;
- № 13 - the approach to the formation of reporting on transfer pricing at the international level is regulated.

As a result, , the main provisions were set out in para.8-10 of the Base Erosion and Profit Shifting plan on 05.10.2015 [6]:

- Section D of Chapter 1 of the OECD Guidelines on Transfer Pricing to Transnational Companies and Tax Administrations affecting the arm's length principle;
- Guidance on transactions with commodities;
- Chapter 6 of the OECD Guidelines on Transfer Pricing to Transnational Companies and Tax Administrations, related to the control of transfer pricing in transactions with intangible assets, and intercompany transactions with low added value;
- Chapter 8 of the OECD Guidelines on Transfer Pricing to Transnational Companies and Tax Administrations, relating to cost sharing agreements;
- Directions for improving the application of the profit distribution method.

According to measures # 13 of the Base Erosion and Profit Shifting Plan, the three-level standard approach to tax control over transfer pricing includes the preparation and submission to the tax authorities of the following documentation since 01/01/2016 [5], which should allow the tax authorities to separate the added value creation chains in the transnational company, and also transfer of the tax base to the jurisdictions with a more favorable tax regime (Table 1).

Taxpayers are also advised to provide the tax authorities with more complete information on pricing in transactions with raw commodities, which include [6]:
- The methods of pricing used;
- Discounts, surcharges to the price of primary commodities;
- Agreements of third parties with final buyers;
- The date on which commodity prices are set (in the event that the date of fixing prices is unknown, the application of the "anticipated date" for determining the price is applied);
- Information on the raw commodity supply chain.

It is assumed that this information will be used by tax authorities to find comparisons and make adjustments to ensure compliance with the approved transfer pricing methods.

Particular attention is paid in the Base Erosion and Profit Shifting plan to transactions with intangible assets, the definition of which was absent in the OECD Transfer Pricing Guide for transnational companies and tax administrations. In the Base Erosion and Profit Shifting plan, an intangible asset is something that is not a tangible or financial asset than can be owned and used in commercial transactions, and when it is transferred in transactions between independent entities under comparable conditions, a payment would be executed for (patents, trademarks, know-how, information constituting a commercial secret) [6].

The Base Erosion and Profit Shifting Plan describes two categories of transactions with intangible assets [6]:
- Transactions on transfer of rights to intangible assets;
- Transactions for the sale of goods or for the provision of services on which the intangible assets of one party to the transaction have an impact (to avoid manipulating transaction risks in accordance with the principle of priority of content over the form, an action plan was developed to determine the transaction price taking into account the risks actually assumed by its participants. As a result, a transaction can be considered meaningless from a commercial point of view for one party to the transaction, which serves as a basis for changing its conditions in the process of tax control).

In the Base Erosion and Profit Shifting plan, there was appeared the concept of DEMPE-functions: actions to develop, improve, support, protect and use intangible assets, as a result of which the value of an intangible asset is established. An appropriate payment should be established for the use of an intangible asset or for obtaining ownership of it, otherwise, if a party to the transaction only finances the DEMPE functions, but does not control the risks, then the yield on such financing cannot exceed the yield on risk-free transactions [6].

The Base Erosion and Profit Shifting plan also introduces the concept of difficult to assess intangible assets which have the following characteristics [6]:
- There is no information on comparable transactions on these intangible assets;
- It is impossible at the time of the transaction to estimate future revenues from the intangible asset under the transaction with sufficient probability.

Due to the asymmetry of information between taxpayers and tax authorities, which consists in that tax authorities have no full information on hard-to-valuate intangible assets, and also in the time that has elapsed since the transaction was concluded, tax control of transactions with hard-to-valuate intangible assets becomes a challenge for tax bodies. As a result, when justifying the price applied in the transaction, the tax authorities can use information about how profitable the deal was with that hard-to-valuate intangible asset. At the same time, if a taxpayer proves the validity of its estimates and forecasts, taking into account the risks it has foreseen when establishing the transaction price, or otherwise proves that it could not foresee another scenario of the development of events, and if within 5 years from the commencement of commercial use of that hard-to-valuate intangible asset, the actual yield on the transaction with it differs from the forecasted indicator by no more than 20%, then the tax authorities cannot use the data on the profitability of the transaction with the that hard-to-valuate intangible asset [6].

According to the Base Erosion and Profit Shifting plan, the concept of intercompany services with low added value is introduced (Section D of Chapter 7 of the OECD Guidelines on Transfer Pricing to Transnational Companies and Tax Administrations), which refer to services that are not risky, do not lead to the creation of intangible assets and are not used for primary purpose activities of the holding. An optional simplified approach is prescribed for pricing in these services.

The concept of a cost sharing agreement is introduced, which means a contract between the parties on the distribution of costs and risks associated with the joint development, production, creation or acquisition of intangible and tangible assets, as well as services in which contribution of each party to the agreement must be proportional to the expected benefit of participation in the agreement. It is understood that each company participating in the agreement will benefit or acquire the right to use the results of R & D, otherwise a company that, for example, only engages in research and development, is not recognized as a party to the agreement, but only receives a fee for them at a price, corresponding to the market level.

As part of the implementation of the Base Erosion and Profit Shifting plan, the Organization for Economic Co-operation and Development published a Guide on Transfer Pricing and Reporting Documentation for each country on September 16, 2014, which replaced the OECD Guidelines on Transfer Pricing for Transnational Companies and Tax Administrations of July 27, 1995.

3. Results and Discussion

According to the new Guidance of the Organization for Economic Cooperation and Development, transnational corporations will form global reporting on transfer pricing, and tax authorities will be able to conduct a better analysis of the risks of understatement of the taxable base, since earlier the tax authorities have repeatedly expressed the opinion that the reporting provided by transnational corporations is not sufficiently informative and does not allow them to trace the entire sequence of their operations on a global scale [7].

That is why the following principles for the compilation of new transfer pricing documentation have laid down in the new Guidelines on Transfer Pricing and Reporting Documentation for each country of the Organization for Economic Cooperation and Development [7]:
- An assessment by a transnational company of the compliance of its operations with the "arm’s length" principle;
- Providing the tax authorities with sufficient information to carry out tax control and audit transfer pricing, as well as risks of understating the tax base in the course of performing transactions by a transnational company.

The purpose of these innovations is to create transfer prices corresponding to prices created in the course of real value creation, so that the understatement of the tax base, tax evasion with the use of schemes with intangible assets and intra-group transactions could not be allowed. Thus, the result of the newly introduced rules for controlling transfer prices is the idea of an "accurate description of a controlled transaction", according to which the content of the analyzed transaction takes precedence over the form, that is, the contractual terms of the transaction are analyzed and compared with the actual actions of the parties [8-10].

4. Summary

Thus, the specified above scheme of the tax control system for transfer pricing, taking into account innovations under the Base Erosion and Profit Shifting plan, needs to be finalized and separate block of interaction with the state control authorities should be provided in the form of presenting them a local file, a report on the countries and a master file for more complete and correct control of transactions (Fig. 2). In this scheme, the documentation block is separated from the state block of tax control transactions between interdependent entities within the implementation of the Base Erosion and Profit Shifting plan, as it is part of the international tax exchange between countries.

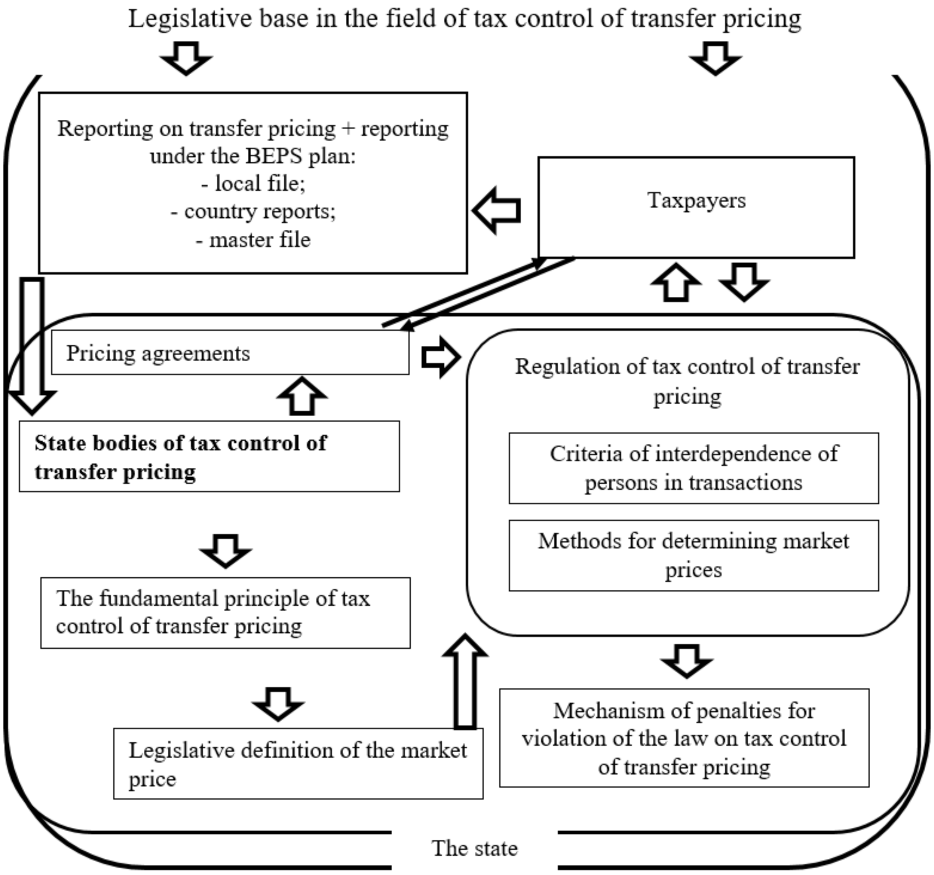

Fig. 2. The system of tax control over transfer pricing taking into account the Base Erosion and Profit Shifting plan

5. Conclusions

The Base Erosion and Profit Shifting plan is one of the strategic directions for the development of the Russian tax legislation in accordance with the "Main Directions of the Tax Policy of the Russian Federation for 2016 and the Planning Period of 2017 and 2018", therefore considerable attention is paid to the development of the exchange of information on financial transactions with foreign countries for the purposes of tax control over the transfer pricing. Further research is seen by the authors of the paper in the consideration of instruments of tax control over transactions between interdependent entities in the Russian Federation.

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