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***International
transfer pricing
2013/14***

All information in this book, unless otherwise stated, is up to date as of 15 September 2012.

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Preface

It is my pleasure to present the 2013/14 edition of our International Transfer Pricing book. There have continued to be significant changes in the area of transfer pricing since our prior edition, with several new countries implementing either formal or informal transfer pricing documentation requirements and significant regulatory changes in many other countries over the past twelve months.

Part I of the book provides a general overview of the global approach to transfer pricing issues. Part II is devoted to a summary survey of specific requirements of the key countries with transfer pricing rules. This edition includes the addition of The Sultanate of Oman.

We anticipate that this will be another eventful year during which the subject of transfer pricing will continue to be at the centre of continuing controversy in corridors of power and newspaper editor's offices around the world. A combination of public debates on the ethics of tax planning, political and economic pressures, and increasingly well trained tax examiners will all contribute to a continuing increase in the number of transfer pricing disputes globally especially as an increasing number of tax authorities attempt to enforce their transfer pricing rules more aggressively. It is PwC's view that strategic dispute management (such as through dispute avoidance or alternative resolution techniques) on a global basis will become increasingly crucial in companies' efforts to sustain their global transfer pricing strategies.

We look forward to working with you in 2013 and beyond.

Best regards,



Garry Stone, Ph.D.
Global Transfer Pricing Leader
PwC (US)

Preface

This book provides general guidance to the reader on a range of transfer pricing issues. Technical material is updated with each new edition and this book is correct as at 15 September 2012. In hard copy form, this 2013/14 edition is the latest development of a work begun over two decades ago and is now in its fourteenth iteration.

In addition to this reference book, many of our readers also require real-time access to current information. Readers wishing to receive e-news alerts on current transfer pricing, dispute and controversy developments can register for this service at no charge by sending an email request entitled 'TP Insights registration' to pknadmin@us.pwc.com. Given the number of disputes and controversy issues involving transfer pricing matters readers may also be interested in a separate PwC service 'Tax Controversy and Dispute Resolution (TCDR) Alerts'.

The challenges facing multinational enterprises in preparing documentation to demonstrate compliance with transfer pricing rules across the globe in accordance with the expectations of each jurisdiction continue to grow. Most countries/territories have now established documentation rules that require companies to state clearly and with supporting evidence why their transfer pricing policies comply with the arm's-length standard. A large number of jurisdictions have also implemented strict penalty regimes to encourage taxpayers' compliance with these new procedures. Perhaps the biggest practical

difficulty facing taxpayers in their efforts to abide by these requirements are the subtle differences in transfer pricing documentation expected across the various tax jurisdictions. These conflicting pressures need to be reviewed and managed very carefully, both to meet the burden of compliance and to avoid costly penalties.

Many of the world's major tax jurisdictions have established aggressive audit teams to review compliance with these documentation requirements and are exhibiting a new found willingness to pursue transfer pricing adjustments through administrative appeals procedures and even to litigation. Non-compliance now comes with a significant risk of being assessed with material adjustments and penalties. For many years, companies accepted nominal adjustments as a small price to be paid to get rid of the tax auditor. In the current environment, however, adjustments have now become potentially so material that companies cannot simply write off assessed adjustments without recourse. These developments are reflected in the increasing use of mutual agreement procedures under bilateral double taxation agreements, or the Arbitration Convention within the European Union, in order to seek relief from double taxation and unsustainable proposed adjustments. This, in turn, necessitates a more controlled and organised approach by companies to handle the audits as they take place, to ensure the process is conducted efficiently and that any areas where the transfer pricing system is deficient are corrected rapidly.

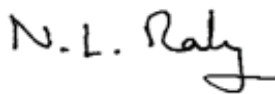
Today, a properly coordinated defence strategy is a basic necessity rather than an expensive luxury.

If these challenges were not enough, the subject of transfer pricing has become the centre of a new public controversy on the issue of whether the current rules permit multinational entities to pay less than their 'fair share' of the overall tax burden in some of the territories in which they operate. In addition to compliance with a very technical and complex set of statutes, case law, regulations and guidelines, taxpayers may now need to evaluate the potential impact of decisions related to transfer pricing in more subjective areas such as corporate reputation and public perception.

In this book, my fellow authors and I demonstrate that transfer pricing is a matter that is of fundamental importance to multinational enterprises. It is vital for every company to have a coherent and defensible transfer pricing policy, which is responsive to the very real climate of change in which companies are operating. A sound transfer pricing policy must be developed within a reasonable timescale and be invested in by both

company management and professional advisers. It needs to be re-examined regularly to allow for changes in the business, perhaps as the result of acquisitions or divestments of part of the group.

We have tried to provide practical advice wherever possible on a subject where the right amount of effort can produce significant returns in the form of a competitive and stable tax burden, coupled with the ability to defend a company against tax auditor examination. Naturally, no work of this nature can substitute for a specialist's detailed professional advice on the specific facts relevant to a particular transfer pricing issue. However, our hope is that, with the assistance of this book, the reader can contemplate inter-company pricing issues with greater confidence.



Nick Raby
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Nick Raby is the principal in charge of transfer pricing services for PwC in the Western Region of the United States, and has extensive experience in advising on transfer pricing and tax planning for multinational companies. His international experience includes six years in London, and three in Brussels and Amsterdam. Thank you to the many members of the PwC international network of transfer pricing specialists who have contributed to this book.

The author would also like to express his gratitude to the editorial team for this edition, which consisted of Elizabeth Sweigart and Dana Hart.

Table of contents

Part 1 – Developing defensible transfer pricing policies

Introduction	13
Categories of inter-company transfer ...	18
The work of the OECD	33
Establishing a transfer pricing policy – practical considerations	55
Specific issues in transfer pricing	79
Managing changes to a transfer pricing policy	109
Dealing with an audit of transfer pricing by a tax authority.....	123
Financial services	129
Transfer pricing and indirect taxes.....	146
Procedures for achieving an offsetting adjustment	163

Part 2 – Country specific issues

Africa Regional.....	173
Argentina	218
Australia.....	232
Austria	251
Azerbaijan	263
Belgium.....	268
Brazil	284
Bulgaria	298
Canada.....	303
Chile	324
China, People's Republic of.....	328
Colombia.....	346
Croatia	355
Czech Republic.....	359
Denmark	364
Dominican Republic	376
Ecuador.....	379
Egypt.....	385
Estonia	388
Finland.....	395
France	405
Georgia	429
Germany	433
Greece.....	446
Hong Kong	458
Hungary.....	464
Iceland	472
India	476
Indonesia	496
Ireland	503
Israel.....	516
Italy.....	520
Japan	536
Kazakhstan.....	547
Korea, Republic of	553

Latvia	562
Lebanon	569
Lithuania.....	572
Luxembourg	576
Malaysia.....	581
Mexico	596
Moldova	615
Netherlands	620
New Zealand	634
Norway	649
Oman, The Sultanate of.....	663
Peru	669
Philippines	677
Poland.....	683
Portugal	691
Qatar.....	701
Romania.....	705
Russian Federation.....	711
Saudi Arabia, Kingdom of.....	721
Singapore.....	726
Slovak Republic.....	735
Slovenia	739
Spain.....	745
Sweden	755
Switzerland.....	762
Taiwan	767
Thailand.....	774
Turkey	781
United Kingdom	792
United States	816
Uruguay	849
Uzbekistan, Republic of	864
Venezuela.....	866
Vietnam	873

Appendices

Appendix 1

Functional analysis questions	885
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Appendix 2

Examples of databases for use in identifying comparative information	892
Transfer Pricing country/ territory leaders	894

Glossary

Advance pricing agreements

(APAs): Binding advance agreements between the tax authorities and the taxpayer, which set out the method for determining transfer pricing for inter-company transactions.

Arm's-length principle: The arm's-length principle requires that transfer prices charged between related parties are equivalent to those that would have been charged between independent parties in the same circumstances.

Berry ratio: A ratio sometimes used in transfer pricing analyses, equal to gross margin divided by operating expenses.

Comparable profits method (CPM):

A transfer pricing method based on the comparison of the operating profit derived from related party transactions with the operating profit earned by third parties undertaking similar business activities.

Comparable uncontrolled price (CUP)

method: A method of pricing based on the price charged between unrelated entities in respect of a comparable transaction in comparable circumstances.

Competent authority procedure: A procedure under which different tax authorities may consult each other to reach a mutual agreement on a taxpayer's position.

Cost plus method: A method of pricing based on the costs incurred plus a percentage of those costs.

Double taxation treaty: A treaty made between two countries agreeing on the tax treatment of residents of one country under the other country's tax system.

Functional analysis: The analysis of a business by reference to the location of functions, risks and intangible assets.

GATT: General Agreement on Trade and Tariffs.

Inland Revenue: The UK tax authority.

Intangible property: Property that is not tangible, e.g. patents, know-how, trademarks, brands, goodwill, customer lists.

Internal Revenue Service (IRS): The US tax authority.

OECD: The Organisation for Economic Co-operation and Development.

OECD Guidelines: Report by the OECD on transfer pricing entitled 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations', published in July 1995, with additional chapters subsequently issued.

Patent: Legal protection of a product or process invented or developed by the holder of the patent.

Permanent establishment (PE): A taxable business unit. Exact definitions vary in different countries and according to different double taxation treaties.

Profit split method (PSM): A method of pricing where the profit or loss of a multinational enterprise is divided in a way that would be expected of independent enterprises in a joint-venture relationship.

Resale price method (RPM): A method of pricing based on the price at which a product is resold less a percentage of the resale price.

Royalty: A payment (often periodic) in respect of property (often intangible), e.g. a sum paid for the use of patented technology.

Tangible property: Physical property, e.g. inventory, plant, machinery and factories.

Thin capitalisation: A situation in which a company has a high level of borrowing relative to its equity base. The term is usually used when the high levels of debt are derived from related companies.

Trademark: A name or logo associated with a particular product.

Trade name: A name or logo associated with a particular company or group of companies.

Transactional net margin method (TNMM): A transfer pricing method based on an analysis of the operating profit derived by a business from a particular related party transaction or group of transactions.

Value added tax (VA): A tax on products or services charged at the point of sale.

WTO: World Trade Organisation.

Part 1: Developing defensible transfer pricing policies

1.

Introduction

At the eye of the ‘perfect storm’

Globalisation and the rapid growth of international trade has made inter-company pricing an everyday necessity for the vast majority of businesses. However, the growth of national treasury deficits and the frequent use of the phrase ‘transfer pricing’ in the same sentence as ‘tax shelters’ and ‘tax evasion’ on the business pages of newspapers around the world have left multinational enterprises at the centre of a storm of controversy. Tax authorities have made the regulation and enforcement of the arm’s-length standard a top priority (*see Chapter 7, Introduction*) for commentary on the audit approach to pricing matters in a number of countries). A key incentive for challenging taxpayers on their transfer prices is that the authorities see transfer pricing as a soft target with the potential to produce very large increases in tax revenues. Since there is no absolute rule for determining the right transfer price for any kind of international transaction with associated enterprises, whether it involves tangibles, intangibles, services, financing or cost allocation/sharing arrangements, there is huge potential for disagreement as to whether the correct amount of taxable income has been reported in a particular jurisdiction. While the existence of tax treaties between most of the world’s major trading nations might lead the casual observer to conclude that international transfer pricing is a ‘zero sum game’ where an adjustment in one jurisdiction will be matched by the granting of corresponding relief at the other end of the transaction, the reality is that transfer pricing controversies are expensive and time-consuming to deal with, not to mention full of pitfalls for the unwary, which frequently result in double taxation of income.

The impact of this focus by governments has been to create a very uncertain operating environment for businesses, many of whom are already struggling with increased global competition, escalating operating costs and the threat of recession. Add to this, accounting rule changes (which often create tension between the economist’s viewpoint that there are many different possible outcomes to any transfer pricing analysis, a number of which may be acceptable and some of which may not), with the accountants need for a single number to include in reported earnings and you have what many commentators have termed the ‘perfect storm’. This perfect storm threatens:

- the risk of very large local tax reassessments,
- the potential for double taxation because income has already been taxed elsewhere and relief under tax treaties is not available,
- significant penalties and interest on overdue tax,
- the potential for carry forward of the impact of unfavourable revenue determinations, creating further liabilities in future periods,
- secondary tax consequences adding further cost – for example the levy of withholding taxes on adjusted amounts treated as constructive dividends,
- uncertainty as to the group’s worldwide tax burden, leading to the risk of earnings restatements and investor lawsuits,

Introduction

- conflicts with customs and indirect tax reporting requirements,
- conflicts with regulatory authorities, and
- damage to reputation and diminution of brand value as a consequence of the perception of being a bad corporate citizen.

The need for adequate planning and documentation of transfer pricing policies and procedures

Typically the life cycle of a global transfer pricing policy involves an initial detailed analysis of the underlying facts and economics, evaluation and development of the proposed policy in relation to the groups' global tax planning objectives, a detailed implementation and monitoring plan, and the adoption of a defensive strategy, given the virtual inevitability that someone, somewhere will want to challenge the result. Probably the biggest challenge inherent in this whole process is the need to balance the conflicting goals of being able to achieve a very high standard of compliance with the numerous rules and regulations that have flourished in the many different jurisdictions in which a multinational may operate, with the need to manage the level of taxes paid on a global basis at a competitive level. In the current hostile environment there is no 'play safe' strategy – taxpayers must assume that they will be subject to challenge, no matter how conservative a philosophy they may initially adopt in their transfer pricing policies and procedures.

Most of the world's major trading nations now have detailed requirements for the documentation of transfer pricing matters, but even those that have not yet implemented specific requirements will expect taxpayers to be able to explain and produce support for the positions taken on local tax returns, and to show that they conform to arm's-length results. One important trend that is emerging is based on the realisation that in such a volatile area, the only clear path to certainty lies in advance discussions with the authorities. Tax rulings and advance pricing agreements (APAs), once thought to be solely the realm of the biggest and most sophisticated taxpayers, are increasingly being seen as an everyday defensive tool.

The planning process can also provide an excellent forum for gathering information about the business and identifying tax and commercial opportunities that have until now gone unnoticed. The development of a transfer pricing policy will involve financial, tax and operational personnel and, therefore, provides a useful opportunity for a varied group to communicate their respective positions and assess business priorities. Implementation is also an area that will require cross-functional cooperation within a multinational enterprise since success will ultimately be determined by an ability to ensure that the policies and procedures adopted are fully aligned with the underlying business activities and that the results are reliably reported on the books and records of the entities undertaking the transactions.

The importance of keeping policies and procedures up to date

A pricing policy cannot be established, set in stone and then ignored. If it is to have any value, the policy must be responsive to an increasingly dynamic and turbulent business environment and must be reviewed on an ongoing basis, at a minimum whenever the group's business is restructured or new types of transactions are contemplated. This should not be an onerous task if it is performed by appropriate personnel who are well-briefed on the aims of the analysis and any necessary amendments to the policy are implemented quickly. An updating of the transfer pricing policy should form part of the routine process of reviewing the overall business strategy. Regular and as-needed

policy updates can help to ensure that the policy continues to cover all inter-company transactions undertaken by the company, as well as produce arm's-length results and prevent unwelcome surprises.

Theory and practice

The theory on which a perfect pricing policy is based has been much discussed in recent years. This book, while recognising the need for theoretical guidelines, focuses on how to establish a successful transfer pricing policy in practice. This is achieved by explaining to the reader the broad principles to be applied in establishing transfer pricing policies that would be acceptable under the generally recognised Organisation for Economic Co-operation and Development (OECD) principles. The book also indicates, through a number of country studies, the areas in which such general practice might need to be amended slightly to meet the requirements of local country law. The degree to which such local amendments will need to be made will undoubtedly change over time and there can be no substitute for current advice from local experts in looking at such matters. In many cases, however, the general principles laid down in this text will satisfy the local law.

Transfer pricing is not just about taxation

In addition to evaluating the risks of tax controversies in advance, careful advance planning for transfer pricing also allows a multinational enterprise to consider implications beyond taxation. For instance, the effect on corporate restructuring, supply chain, resource allocation, management compensation plans and management of exposure to third-party legal liabilities must also be considered.

The implications of transfer pricing policies in the fields of management accounting and organisational behaviour have been the subject of an increasing volume of academic debate; for example, there may be a significant influence on the actions of managers who are remunerated by a bonus linked to local company operating profits. A change in a group transfer pricing policy that fails to recognise the impact that may be felt by individual employees may not bring about the behavioural improvements management wish to achieve.

Legal matters that fall under the corporate general counsel's office should also be taken into account. Matters such as intellectual property protection arising from cost sharing, treasury management issues arising from centralised activities such as cash pooling and areas of logistics and inventory management in co-ordination centre arrangements all require careful consideration. In some cases there may be conflict between the tax planner's desire to locate certain functions, risks and assets in one jurisdiction and the lawyer's need to have recourse to the legal system of another.

Ultimately, transfer pricing policy should benefit a company from a risk management as well as a business perspective. To this end, building a foundation of internal support by the multinational is imperative in order to enable compliance with tax regulations as well as effective management decision-making.

New legislation and regulations

The current framework for interpretation of the arm's-length principle dates back to the early 1990s when the US broke new ground with detailed regulations on intangibles, tangibles and cost sharing. These regulations evoked widespread reaction among the international community, with the regulations on the application

Introduction

of the ‘commensurate with income’ standard and the need for contemporaneous documentation in order to avoid specific transfer pricing penalties proving especially controversial. The OECD responded by publishing new guidelines that covered many of the same issues. Subsequently, many countries around the world introduced their own transfer pricing rules based on the principles set out in the OECD Guidelines, which in some cases include requirements that go beyond the regulations in the US.

Based on over a decade of experience in enforcement of these rules and regulations, the last few years have seen renewed legislative activity in a number of jurisdictions. The US has revisited the regulations pertaining to services, intangibles and cost sharing, and has developed new requirements such as the need to include the cost of stock-based compensation in cost sharing charges and charges for inter-company services as well as new transfer pricing methods to respond to perceived issues with the existing regulations pertaining to intangible transfers. In 2010 the OECD issued final revisions to the Guidelines, which included significant changes to the chapters dealing with the arm’s-length principle, transfer pricing methods and comparability analysis, and also finalised guidance on ‘*Transfer Pricing Aspects of Business Restructurings*’, which was included as a new chapter.

The future

Around the world legislative change continues unabated. Transfer pricing rules have recently been introduced or reformed in a number of countries, while many other countries are in the process of reviewing the effectiveness of their existing transfer pricing rules and practices. In parallel, revenue authorities are stepping up the pace of transfer pricing audits, presenting fresh challenges of policy implementation and defence to the taxpayer. Issues that may trigger a transfer pricing investigation may include:

- Corporate restructurings, particularly where there is downsizing of operations in a particular jurisdiction.
- Significant inter-company transactions with related parties located in tax havens, low tax jurisdictions or entities that benefit from special tax regimes.
- Deductions claimed for inter-company payments of royalties and/or service fees, particularly if this results in losses being claimed on the local tax return.
- Royalty rates that appear high in relative percentage terms, especially where intellectual property that is not legally registered may be involved.
- Inconsistencies between inter-company contracts, transfer pricing policies and detailed transaction documents such as inter-company invoices and/or customs documentation.
- Separation of business functions and related risks that are contractually assigned to a different jurisdiction.
- Frequent revisions to transfer pricing policies and procedures.
- Recurring year-end pricing adjustments, particularly where they may create book/tax differences.
- Failure to adopt a clear defence strategy.
- Simply having a low effective tax rate in the published financial statements.

It must be presumed that the pace of change will be maintained, and that it may even increase due to budgetary pressures on governments. A multinational enterprise must maintain continual vigilance to ensure that its transfer pricing policies meet the most up-to-date standards imposed by tax authorities around the world and also continue to meet its own business objectives.

The immediate future presents great challenges to both taxpayers and tax authorities. Taxpayers must cope with legislation that is growing by the day across jurisdictions, and which is often not consistent. For instance, safe harbour rules in one jurisdiction may represent a non-controversial alternative and yet could be countered in the other contracting country. Similar difficulties are encountered while dealing with the fundamental definition of arm's-length range, which continue to have differing legislative meanings and judicial interpretations. The onus is on the taxpayer to establish arm's-length transfer pricing by way of extensive country-specific documentation. Failure to do so will inevitably result in the realisation of some or all of the threats listed earlier. It is not enough for taxpayers to honestly believe they have the right answer – they will also need to be able to demonstrate that it is.

Tax authorities are to some extent in competition with their counterparts from other transacting jurisdictions in order to secure what they perceive to be their fair share of taxable profits of multinational enterprises. This frequently leads to double taxation of the same profits by revenue authorities of two or more transacting countries. Consequently, there is also an increasing trend towards tax authorities favouring the use of bilateral advance pricing agreements where they are available. Another trend being witnessed is the rise in the number of disputes going to the competent authorities for resolution under the mutual agreement procedures of bilateral tax treaties. On the other hand, transfer pricing is also an anti-avoidance issue and to this end, tax authorities have to work together to ensure that the increasing trade and commerce by multinational enterprises and their ability to allocate profits to different jurisdictions by controlling prices in intragroup transactions does not lead to tax evasion, for example through the use of non-arm's-length prices, the artificial use of tax havens and the use of other types of 'tax shelters'. Inevitably there will have to be trade-offs between these conflicting considerations.

2.

Categories of inter-company transfer

Introduction

Inter-company transactions take place through transfers of tangible and intangible property, the provision of services, as well as inter-company financing, rental and leasing arrangements, or even an exchange of, for example, property for services or the issue of sweat equity. It is important to note that it is the substance of the situation that always determines whether a transaction has taken place, rather than whether an invoice has been rendered. For instance, management services may be delivered through the medium of a telephone call between executives of a parent company and its subsidiary. In this example, a service has been performed that the provider had to finance in the form of payroll costs, phone charges, overheads, etc and the service itself is of value to the recipient in the form of the advice received. As a result, a transaction has taken place for transfer pricing purposes even though, at this stage, no charge has been made for the service. Transfer pricing rules typically require related entities to compensate each other appropriately so as to be commensurate with the value of property transferred or services provided whenever an inter-company transaction takes place. The basis for determining proper compensation is, almost universally, the arm's-length principle.

The arm's-length principle

Simply stated, the arm's-length principle requires that compensation for any inter-company transaction conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same. Although the principle can be simply stated, the actual determination of arm's-length compensation is notoriously difficult. Important factors influencing the determination of arm's-length compensation include the type of transaction under review as well as the economic circumstances surrounding the transaction. In addition to influencing the amount of the compensation, these factors may also influence the form of the payment. For example, a given value might be structured as a lump-sum payment or a stream of royalty payments made over a predetermined period.

This chapter summarises the various types of inter-company transfers and the principles that may be applied to determine the proper arm's-length compensation for these transactions. The application of the arm's-length principle is discussed in detail in Chapters 3 and 4.

Sales of tangible property – definition

Tangible property refers to all the physical assets of a business. Sales of raw materials, work in progress and finished goods represent a major portion of the transfers that take place between related parties, typically referred to as sales of inventory (see *Sales of inventory, on the next page*). However, it is important to bear in mind that

‘sales of tangible property’ can include all the machinery and equipment employed by businesses in their day-to-day activities as well as the goods they produce.

Sales of machinery and equipment

Machinery and equipment is frequently provided to manufacturing affiliates by the parent company. For example, this may be a means of providing support to an existing subsidiary or it may be in the form of the sale of complete manufacturing lines to a new company in a ‘greenfield’ situation. The equipment may have been purchased from an unrelated company, manufactured by the parent or might be older equipment that the parent (or another manufacturing affiliate) no longer needs. Tax rules generally require that the transferor of this equipment (whether new or used, manufactured or purchased) should receive an arm’s-length consideration for the equipment. This is generally considered to be the fair market value of the equipment at the time of transfer.

While the tax treatment of plant and machinery transfers is generally as described above, there can be circumstances where an alternative approach might be adopted. Such circumstances usually arise in connection with general business restructuring or, perhaps, when a previously unincorporated business (or an overseas branch of a company) is transferred into corporate form. A number of countries offer arrangements in their domestic law or under their treaty network to defer the tax charges that might otherwise arise as a result of an outright sale of assets at their fair market value. Another possibility to consider is whether there are any tax implications arising from the transfer of business as a whole, which is to say, the bundling of assets, related liabilities and goodwill or intangibles, as against the transfer of assets such as plant and machinery on a piecemeal basis.

Sales of inventory

Sales of inventory generally fall into three categories: sales of raw materials, sales of work in progress and sales of finished goods. Goods in each of these categories may be manufactured by the seller or purchased from third parties.

Tax rules typically require that arm’s-length prices be used for sales of inventory between affiliates. Ideally, arm’s-length compensation is determined by direct reference to the prices of ‘comparable’ products. Comparable products are very similar, if not identical, products that are sold between unrelated parties under substantially similar economic circumstances (i.e. when the market conditions affecting the transactions are similar and when the functions performed, risks borne and intangible assets developed by the respective unrelated trading parties coincide with those of the related parties).

Example

Assume that Widgets Inc. (WI), a US company, manufactures and sells in Europe through a UK subsidiary, Widgets Ltd. (WL). WL manufactures one product, Snerfos, using semiconductor chips that are produced by WI, transistors purchased by WI through a worldwide contract and packaging material that WL purchases locally from a third party. In addition, a testing machine, which is proprietary to WI, is supplied by WI.

Categories of inter-company transfer

In this situation, there are three inter-company sales of tangible property by WI to WL:

1. Sale of the testing machine.
2. Sale of semiconductor chips.
3. Sale of transistors purchased from unrelated parties.

In each case, an arm's-length price must be determined, invoices for the sales must be produced and payment on those invoices must be made by WL.

An important consideration in the context of determining comparability in the context of transfer of inventory is the level of investment in working capital between the related enterprises and the independent enterprises, which is driven by payment terms and inventory lead times. At arm's length, an uncontrolled entity expects to earn a market rate of return on that required capital. Accordingly, the effects on profits from investing in different levels of working capital warrant an adjustment to the transfer prices.

Transfers of intangible property – definition

When the profits of a corporation exceed the level that would otherwise be expected to arise, taking into account market conditions over a long period, the cause is the presence of what economists refer to as a 'barrier to entry'.

Barriers to entry are those factors that prevent or hinder successful entry into a market or, in other words, perpetuate some sort of monopoly control over the marketplace.

Sometimes these barriers to entry create an absolute monopoly for the owner or creator of the barrier. For example, Aluminum Company of America (ALCOA) owned the world's source of bauxite (vital in the production of aluminium) and, until the US courts forced ALCOA to divest itself of some of the supply, had an absolute monopoly in the production of aluminium. In another example, the pharmaceutical company Eli Lilly owned the patent on a drug sold as 'Darvon'. This patent was so effective that no competitor was able to develop a drug that could compete with Darvon until the patent expired.

Barriers to entry are recognised as 'intangible' assets in an inter-company pricing context. Examples of intangible assets include goodwill, patents, brands and trademarks, intellectual property, licences, publishing rights, the ability to provide services and many others. In general, intangible assets are non-physical in nature, are capable of producing future economic benefits, can be separately identified and could be protected by a legal right.

Those intangibles that produce a monopoly or near-monopoly in their product areas are sometimes referred to as 'super intangibles' and are the subject of much current interest in the transfer pricing arena. Ever since the Tax Reform Act of 1986 and the subsequent white paper, the question of the appropriate inter-company royalty rates for 'super intangibles' had remained a controversial issue in the US. (*See US chapter* for a detailed discussion of the current US regulations.) An intangible asset that does not produce a monopoly (i.e. situations where the product to that the intangible relates is sold in very competitive markets) is sometimes referred to as an 'ordinary' or 'routine' intangible.

Types of intangibles

In the transfer pricing world, intangible assets are commonly divided into two general categories. The first category consists of manufacturing intangibles, which are created by the manufacturing activities or the research and development (R&D) effort of the producer. Marketing intangibles – the second category – are created by marketing, distribution and after-sales service efforts.

Modes of transfer of intangibles

Intangibles can be transferred between related entities in four ways:

1. Outright sale for consideration.
2. Outright transfer for no remuneration (i.e. by way of gift).
3. Licence in exchange for a royalty (lump sum or periodic payment based on a percentage of sales, sum per unit, etc.).
4. Royalty-free licence.

As a general rule, transfers without remuneration are not accepted by the tax authorities of any country, except occasionally in the limited context of property owned and exploited from tax havens or business reorganisations that attract special tax reliefs. These exceptions are not considered further in this book. Transfers of intangibles through licences are very common and are the primary method of transfer discussed in this book.

Sales of intangibles are generally treated in the same way as sales of tangible property (i.e. the arm's-length standard requires that the selling price be the fair market value of the property at the time of sale). Some countries' tax authorities, notably the US, require that an assessment of whether a transaction is arm's length meet certain requirements. For the transfer of an intangible asset, US tax law requires that the consideration paid be commensurate with the income generated or expected to be generated by the intangible asset. This may require additional support, beyond an assessment of fair market value that by itself does not consider the income potential of the transferred intangible.

Manufacturing intangibles

Patents and non-patented technical know-how are the primary types of manufacturing intangibles. A patent is a government grant of a right that guarantees the inventor that his/her invention will be protected from use by others for a period of time. This period varies from one country to another and, to a lesser extent, according to the product. Patents can be either very effective barriers to entry or quite ineffective barriers. Very effective barriers create an absolute monopoly for the owner for the life of the patent and are exemplified by product patents. Ineffective barriers are created by patents that can easily be 'designed around' or cover only minor aspects of a product, such as process patents.

When transferring patents to affiliates, it is vital to understand the degree of monopoly power conveyed by the patent. This is critical to the determination of the arm's-length compensation due to the transferor because patents that provide more protection to the owner are more valuable than patents that provide less protection.

Technical know-how is the accumulated specific knowledge that gives a manufacturer the ability to produce a product. In some industries, technical know-how is worth

Categories of inter-company transfer

very little, so that when it is transferred between unrelated parties the royalty rate is extremely low. In other industries, technical know-how is highly valuable.

Example

Consolidated Wafers Ltd. (CWL) designs and manufactures semiconductors. Its research and development (R&D) department has designed a memory chip that is significantly faster and uses less power than any other chip on the market. CWL has an absolute monopoly on the production of this chip until a competitor 'reverse engineers' the chip and markets a clone. At that time, CWL's ability to remain successful in the market will be determined by its ability to produce high-quality chips at lower cost (higher yield) than its competitors. Typically, in the semiconductor industry, this process may take less than two years.

The manufacturing intangibles cited in this example are of different value at different points during the life of the product. At the outset, the design of the chip explained its success in the marketplace. The design was proprietary but not patented. After the competition began marketing its own version of the chip, the manufacturing intangible of greatest value to CWL was its ability to improve the quality of the product and reduce the cost of manufacturing the product, both critically important factors in this industry.

In determining the value of the intangibles in this example, it is important to note the length of time during which the original design created an absolute monopoly for CWL. Intangibles that sustain monopoly positions over long periods are far more valuable than intangibles that create monopoly positions for much shorter periods. The longer the monopoly continues, the more time the owner of the intangible has to exploit the monopoly position and to develop value in the form of technical know-how or selling intangibles such as trademarks, which will protect an imperfectly competitive market position after the expiration of the patent.

Furthermore, in this example, the ability to produce a high-quality and low-cost product is extremely valuable in the long run, because without this ability, CWL would not be able to compete in the marketplace. There are countless examples of these types of intangibles in the modern world.

Marketing intangibles

Marketing intangibles include, but are not limited to, trademarks and trade names, corporate reputation, the existence of a developed sales force and the ability to provide services and training to customers.

A trademark is a distinctive identification of a manufactured product in the form of a name, logo, etc. A trade name is the name under which an organisation conducts its business. Trademarks and trade names are frequently treated as identical, although one (trademark) is a product-specific intangible, while the other (trade name) is a company-specific intangible. A product-specific intangible applies to a particular product and has zero value at the time the product is marketed for the first time under that name. Its value is developed by the marketing/sales organisation over the life of the product. This is important for inter-company pricing because trademarks typically have little or no value when a product is first introduced into a new market (even though it may have high value in the markets into which the product is already being sold).

A company-specific intangible is one that applies to all products marketed by a company. For example, 'Xerox' applies to photocopiers manufactured and sold by the Xerox Corporation. In fact, the very word 'xerox' has become a synonym for 'photocopy' in many markets. However, the power of the brand name means that this type of intangible includes new, as well as existing, products and has value in most markets at the time the products are introduced into these markets.

Corporate reputation represents the accumulated goodwill of a corporation and is sometimes used as a synonym for trade name. A company with a strong corporate reputation will have a developed sales force. This means that a trained sales force is in place and is familiar with the company, its customers and its products, and can sell products effectively. This in turn involves pre-sales and post-sales activities. Pre-sales services entail generating interest in prospective customers, establishing proof of concept, making effective product demonstrations and thereby leading to closing a sale, which can be critical in industries such as healthcare, insurance and software. Service to customers after a sale and training of customers in the use of a product are extremely important in some other industries. In fact, in some industries, this intangible is the one that keeps the company in business.

Example

Deutsche Soap, AG (DSAG) is in the business of manufacturing and selling a line of soap products to industrial users. Its products are not patented and the manufacturing process is long-established and well-known. It sells to industrial customers that rely on DSAG for technical assistance and advice regarding difficult cleaning problems. DSAG's sales force is on 24-hour call to assist customers within 30 minutes of a request. DSAG has developed training programmes and a service manual that it provides to its sales force.

DSAG has decided to establish a wholly owned subsidiary in France. The subsidiary will purchase products manufactured by DSAG (in Germany) and will be responsible for sales and services in the French market. DSAG intends to train the French subsidiary's sales force and to provide a copy of the service manual for each member of its French sales force.

From an inter-company pricing standpoint, the intangible of value is the ability to provide service to the customer. The transfer of this intangible to the French subsidiary should be accompanied by an arm's-length payment to the German parent.

Hybrid intangibles

In the modern world, it is difficult to classify every intangible neatly as either a manufacturing or a marketing intangible. Some intangibles can be both. For example, corporate reputation may result from the fact that a company has historically produced high-quality products which were at the 'leading edge' in its industry. The reputation that results from this is clearly a manufacturing intangible.

In another example, suppose that corporate reputation of a particular company results from its advertising genius, so that customers and potential customers think of the corporation as, for example, 'The Golden Arches' (McDonalds) or the company that 'taught the world to sing' (Coca-Cola). In this case, corporate reputation is a very powerful marketing intangible. In such cases, a significant portion of the value of the corporation is attributed to the trade name itself, such as BMW.

Categories of inter-company transfer

Further complexity arises when software is the product in question. It is not clear whether software is a product to be sold or an intangible to be licensed (and there may well be withholding tax and sourcing of income implications to be considered, in addition to pricing considerations). The transfer of software to customers has elements of both a sale and a licence in most instances.

If software is determined to be an intangible, the question is then whether it is a manufacturing or a marketing intangible. Whatever the answer, the important question for inter-company pricing purposes is: Which legal entity developed the value of the intangible? The developer must receive an arm's-length remuneration for the use of its property from any user of the intangible.

There can be differences of opinion on this issue, stemming from whether a particular product succeeds in a specific, new market because of the technology, giving rise to manufacturing intangibles or the sales efforts, resulting in the creation of marketing intangibles. The recently settled GlaxoSmithKline dispute regarding the drug Zantac is a case in point.

The provision of services – definition

Services that are provided to related parties range from the relatively commonplace, such as accounting, legal or tax, to complex technical assistance associated with transfers of intangibles. The proper handling of service fees is a difficult inter-company pricing issue (considered more fully in Chapter 5). In general, each country requires that arm's-length charges be made for any service rendered to an overseas affiliate. In many countries, 'arm's length' is defined as the cost of providing the service, often with the addition of a small margin of profit. Furthermore, only arm's-length charges for services that are directly beneficial to the affiliate can be deducted by an affiliate in its tax return. (The difficulty in determining whether a service is directly beneficial can be a major issue.)

Examples of types of service

Five types of service may be provided to related parties:

1. The service can be a routine service, such as accounting or legal services, where no intangible is transferred. In situations such as this, the price charged in arm's-length relationships is invariably based on a cost-plus formula where the 'plus' element varies greatly with the value added of the service and the extent of competition within the market. In the inter-company context, many countries allow reimbursement on a cost-plus basis, though with a relatively small and steady uplift for services that are regarded as being low risk and routine. However, a minority do not allow the inclusion of a profit or have restrictive rules.
2. The service can be technical assistance in connection with the transfer of an intangible, either manufacturing or marketing, but usually a manufacturing intangible. Typically, in arm's-length relationships, a certain amount of technical assistance is provided in connection with a licence agreement (at no extra charge). If services in excess of this level are needed, arm's-length agreements usually allow for this at an extra charge, typically a per diem amount (itself determined on a cost-plus basis) plus out-of-pocket expenses.
3. The service can be technical in nature (pertaining to manufacturing, quality control or technical marketing), but not offered in connection with an inter-company

transfer of the related intangibles. In this situation, only the services provided are paid for on an arm's-length basis.

4. When key employees are sent from their home base to manage a new facility, some tax authorities have tried to assert that there is a transfer of intangibles. For example, when a new manufacturing plant is established outside the home country, it is not unusual for a parent company to place a key manufacturing employee in that plant as plant manager to get it established and to train a local employee to take his/her place. Such a relationship may exist for three to five years. The tax authority may take the position that the knowledge and experience in the head of that employee is an intangible, owned by the parent company, which should therefore be compensated by the subsidiary for the use of the intangible asset. However, in arm's-length relationships between unrelated parties, such as a new manufacturing plant could easily recruit a plant manager from existing companies in the industry. In such a case, the plant manager would be paid a market-determined wage and no royalty would be payable to any party. Therefore, it would appear that no royalty is appropriate in the context of the multinational group, although a service charge might be needed to cover the cost of the assignee.
5. A combination of (1) to (4) above could exist where the offshore affiliate requires the expertise of the parent in order to manage its own affairs, including determining its strategy. In this situation, the substance of the relationship is that the parent company is managing the offshore affiliate with little or no local input. The substance of the relationship is such that the parent company tax authority can easily show that the amount of profit allowed to the offshore affiliate should be minimal in that it is performing a service for the parent (e.g. through a contract manufacturer arrangement or a manufacturer's representative arrangement).

The problem of 'shareholder' services

From a transfer pricing point of view, activities conducted by a parent company (or perhaps a company that provides coordination of services within a group) are not always such that a charge should be made to the other companies involved. This is because they might be performed for the benefit of the parent company in its role as shareholder, rather than to provide value to the subsidiaries. This category of services has been defined in Chapter VII of the OECD Guidelines as 'shareholder services' (a narrower definition than the 'stewardship' discussed in the earlier OECD reports). Chapter VII was added to the guidelines in 1996. In reviewing a transfer pricing policy for services, it is very important to examine this issue thoroughly to see whether the services rendered by a parent company can directly benefit one or more recipients, can duplicate services performed by the subsidiaries, or can represent shareholder activities and, if so, whether the subsidiary will succeed in obtaining a tax deduction for the expense if a charge is made.

Directly beneficial services are those that provide a benefit to the recipient. For example, if a parent prepares the original books and records for a related company, this accounting service is directly beneficial to the recipient because it allows the recipient to produce its financial statements. Whether an intragroup service has been rendered so as to warrant the payment of an inter-company charge depends on whether the activity provides the related entity with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in similar circumstances would have been willing to pay for the activity if it was performed by a third party or would have performed the activity in-house. In the

Categories of inter-company transfer

absence of any of these conditions being met, the activity would not be regarded as an intragroup service.

Duplicate services are those that are initially performed by a company and duplicated by an affiliated entity, often the parent company. An example would be a marketing survey of the local market, which is completed by the subsidiary but redone by the parent (because it did not trust the subsidiary's work, for example). In cases of this type, the parent cannot bill its costs to the subsidiary for this service. However, if it can be shown that the subsidiary requested the service to ensure that its marketing survey was correct (i.e. that the parent's input added value to the subsidiary), the position would be different.

Shareholder services are those that are incurred to protect the shareholder's interests in its investment and relate to activities concerning the legal structure of the parent company, reporting requirements of the parent company or costs of capital mobilisation. These services can be distinguished from stewardship services, which is a more broad term, referring to a range of intergroup activities performed, for which a careful evaluation is required to determine if an arm's-length payment is normally expected. This determination will depend upon whether, under comparable facts and circumstances, an unrelated entity would have been willing to pay for a third party to provide those services or to perform them on their own account.

For instance, a service provider may be required to act according to the quality control specifications imposed by its related party customer in an outsourcing contract. To this end, the parent company may depute its employees as stewards to the related subsidiary. Stewardship activities in this case would involve briefing of the service provider personnel to ensure that the output meets requirements of the parent company and monitoring of outsourcing operations. The object is to protect the interests of the service recipient (i.e. the parent company). In such a case, it is evident that the parent company is protecting its own interests rather than rendering services to the related entity. Consequently, a service charge is not required to be paid to the parent company that is in receipt of outsourcing services.

Examples of these various types of expenses are included in Table 2.1.

Table 2.1 Costs often incurred by a parent company

Typical stewardship expenses	Typical beneficial expenses
The cost of duplicate reviews or performance of activities already undertaken by the subsidiary	The cost of preparing the operating plans of a subsidiary, if it is not a duplicate function
The cost of periodic visitations to the subsidiary and general review of the subsidiary's performance carried out to manage the investment	The cost of reviewing/advising on personnel management plans and practices of a subsidiary, if it is not a duplicate function
The cost of meeting reporting requirements or the legal requirements of the parent-shareholder, which the subsidiary would not incur but for being part of the affiliated group	The cost of supervising a subsidiary's compliance with local tax and legal requirements, if it is not a duplicate function

Table 2.1 Costs often incurred by a parent company

Typical stewardship expenses	Typical beneficial expenses
The cost of financing or refinancing the parent's ownership of the subsidiary	The cost of conducting an internal audit of a subsidiary if the audit is required by the local laws of the subsidiary's country and it is not a duplicate review

Example

Beautiful Unique Bathtubs SA (Bubble) is a French company that manufactures bathtubs in France for resale to related companies throughout Europe. Bubble developed the manufacturing intangibles associated with the production of the bathtubs and completes the entire manufacturing process in its plants in France and Sweden. The technology involved is unique in that the bathtub produces its own bubbles when the surface is wet. This process has been licensed to an unrelated Canadian company in exchange for a royalty of 5% of sales. Ten workdays of technical assistance are provided to the Canadian company free of charge.

A licence agreement to manufacture bathtubs in Sweden has been entered into between the French and Swedish affiliates, wherein the French parent agreed to provide its technology and 10 workdays of consulting regarding the implementation of the technology in return for a royalty of 5% of sales. During the current year, Bubble's technicians have spent 15 workdays assisting the Swedish subsidiary's manufacturing employees.

In addition, Bubble has developed a unique marketing approach that it allows related parties in the UK, Sweden, Ireland and Italy to use in their selling efforts. This marketing strategy was developed in France and is modified by each sales subsidiary for the local cultural peculiarities existing in each country. Finally, Bubble's president visits each subsidiary quarterly to review performance.

In this example, three types of service are provided by the French company:

1. Technical assistance to the Swedish subsidiary in connection with the utilisation of the manufacturing technology.
2. Marketing assistance to all selling subsidiaries.
3. The president's quarterly review.

The five days of technical assistance over the amount normally provided to third parties should be charged to the Swedish subsidiary, probably on a cost-plus basis. The cost of rendering the marketing assistance must be charged to the selling affiliates on a cost-plus basis. However, before concluding that this is the current approach, it would be necessary to consider whether the marketing strategy developed in France is in fact critically important to the subsidiaries and is therefore an intangible being licensed (for local modification) to each country. This would be more akin to a franchise, in which case it is the value of the licence to the subsidiary which needs to be established and a royalty charged, and the cost of maintaining the strategy in France becomes irrelevant.

The president's quarterly review is not of direct benefit to the subsidiaries and should therefore not be billed to them, because it represents shareholder expenses.

Categories of inter-company transfer

Financing transactions

The arm's-length principle generally applies to financing arrangements between affiliated parties as for other related party transactions. To ensure arm's-length terms are in place, it is necessary to analyse the various forms of finance that are being provided by one related party (often the parent company) to another.

A number of factors are relevant in the context of related party debt:

- The rate of interest on the loan (including whether it is fixed or floating).
- The capital amount of the loan.
- The currency.
- The credit worthiness of this borrower (including whether any guarantees have been provided in connection with the loan).

Tax authorities may review whether a third party would charge the rate of interest set between the related parties or whether that rate is too high or low (*see Interest on loans, Chapter 5*). Furthermore, the tax authority in the borrower's country may question whether a third party would have been willing to lend the funds at all. In assessing the answer to the latter question, the local revenue authority will have reference to the debt-to-equity ratio of the borrower.

If it is considered that the interest rate is too low, the tax authorities in the lender's country may deem additional interest income to arise and tax this notional income accordingly.

If it is considered that too much interest is being paid by the borrower (because the rate is too high and/or because the amount of the debt is too great) the following consequences may ensue:

- Tax deductions for interest accrued or paid may be denied, increasing the local tax burden.
- Interest paid may be recharacterised as dividends, which may result in additional withholding taxes being due.

If it is considered that an entity has related party debt in excess of the amount that a third party would lend, the borrower is said to be thinly capitalised. Many countries, particularly the developed nations, have special thin capitalisation rules or practices. A detailed analysis of these rules, as they apply in each jurisdiction, is beyond the scope of this book (although a number of examples are included in the country commentaries). However, it is crucial to review any specific rules and practices (including any safe harbour debt-to-equity ratios) applicable in the relevant countries before international financing structures are established.

Financing short-term capital needs

A company's short-term capital needs are typically greatest when it is first formed or undergoing rapid expansion. A parent company that has established a new subsidiary needing to finance its short-term working capital may use:

- inter-company payables and receivables,
- advances of capital from a related party,
- extended credit for inventory purchase or sales, and
- related party guaranteed loans.

The long-term, strategic funding of R&D costs is often a very important issue to be considered as groups expand. A possible way of spreading the expenditure to be directly financed by profits earned overseas is cost-sharing.

Even where no specific thin capitalisation rules apply, a revenue authority may attempt to challenge interest deductions on related party debt where a very high debt-to-equity ratio exists under other general anti-avoidance provisions. There may also be regulatory end-use restrictions preventing the usage of long-term borrowings to finance working capital requirements.

Example

TLC Inc. (TLC) is an American company that has recently established a new subsidiary in the UK (TLUK). TLC manufactures a special line of pillows that lull small children to sleep within 10 minutes of lying down. The pillows are successful in the US market but have just been introduced in the UK market and are not currently selling very well – (little English children never have problems sleeping!). The parent company sells the pillows to TLUK, which is responsible for marketing and distribution. The overhead expenses of the subsidiary are greater than the current sales revenue, and serious cash-flow problems exist in the UK. These problems can be addressed as follows:

- **Inter-company payables and receivables**

The parent company may invoice TLUK for the pillows but not collect the receivable until the subsidiary can afford to make the payment. If the period of time involved is short (no longer than the payment terms ordinarily granted to distributors in this industry), this is an acceptable way of financing the receivable. However, in many countries (the US in particular), an inter-company receivable outstanding for a longer period of time than is commercially appropriate is reclassified as a loan and deemed interest accrues on it.

- **Advance of capital**

TLC may loan the funds required to finance the short-term needs of the subsidiary and collect interest on that loan. This method is acceptable unless the amount of debt owed by TLUK is sufficiently greater than the equity of the subsidiary, such that the local tax authority can argue that the subsidiary is thinly capitalised. In these situations, the tax authority may recharacterise all or part of the loans as if they were equity. In this case the parent is taxed at the subsidiary level as if it did not receive interest for use of those funds, but rather inter-company dividends in respect of equity capital. This recharacterisation means that no tax relief is obtained by TLUK on the 'interest'. Furthermore, the tax treatment of interest is often different from dividends with respect to withholding taxes/imputation tax credits, etc.

- **Parent guaranteed bank loans**

TLC may guarantee a loan that is granted to the subsidiary by a third party (e.g. a bank). A loan guarantee fee may be required to be paid by the subsidiary to the parent for having provided the guarantee. The loan itself is primarily the responsibility of the subsidiary and must be repaid by the subsidiary. This may potentially cause a thin capitalisation problem for the subsidiary if it could not have obtained the loan without the parent's guarantee, although in practice the risk of tax authority attack is generally much less than where the loan is made directly from the parent company to the subsidiary.

Categories of inter-company transfer

Market penetration payments

An alternative to the financing schemes discussed in *Financing transactions and Financing short-term capital needs sections, earlier*, is to use a market penetration or market maintenance mechanism. In this situation, the manufacturing company treats the related selling company's market as its own in the sense that the manufacturer wishes to expand its sales into a new market. Because its products have not previously been sold in the new market, it must penetrate the market through marketing (e.g. advertising or through a reduction in price to customers – below the price that is expected to be charged after achieving the desired level of sales). These costs are the costs of the manufacturer rather than the distributor.

Market penetration payments can be made in one of two ways. A lump-sum payment (or a series of periodic subvention payments) can be made to cover the market penetration costs or, alternatively, transfer prices can be reduced for the market penetration period. Effectively, the payment for market penetration or subvention payments converts the selling company into a routine distributor, assuming less-than-normal business risk and leaving it with a normal profit margin. Documentation is a key issue in defending this approach, and great care must be taken to ensure that any lump-sum payment will attract a tax deduction for the payer. A reduction of transfer prices must be viewed as a temporary reduction of prices only; it cannot be allowed to become permanent, because the profits of the subsidiary would eventually become excessive and cause transfer pricing problems in the future.

Market maintenance occurs when a company is threatened by competition and must respond, either through reducing prices to customers or by significantly increasing marketing activity, if it is to maintain its market share. The cost of this activity can be funded in the same way as market penetration, that is, either through a lump-sum payment or through a reduction of the transfer price.

Cost-sharing

Cost-sharing has frequently been used by companies that need to finance a major R&D effort but cannot fund it in the company that must perform the activity. For example, in a group where the parent company houses the R&D department, funding R&D locally may become a problem if domestic profits fall. However, if the group has profit in other locations, it may decide to institute a cost-sharing agreement with its subsidiaries to allow profitable subsidiaries to fund the R&D activity of the group. The establishment of cost-sharing arrangements has a major long-term impact on a group's profitability and tax strategy, country by country, in that the companies contributing to the research will obtain an interest in the knowledge created and thereby be entitled to a share in profits derived from it. Furthermore, a buy-in payment may be required when companies come into the cost-sharing arrangement. Participating companies wishing to exit from a pre-existing cost-sharing arrangement would correspondingly have to receive a buyout payment representing the value of their share in the intangible developed until date of opting out.

Financing long-term capital needs

Long-term capital needs can be financed through:

- Mortgages.
- Lease financing.
- Capital stock.

- Long-term debt (inter-company or third party).
- The issue of equity to shareholders and bonds or other financial instruments in the marketplace (this activity with third parties is not covered further).

Mortgages

The purchase of land can be accomplished through a lump-sum payment or through a mortgage. Use of a mortgage means that the total cash outlay for the land is spread over a period of years. Usually, the interest rate on mortgages is lower than for unsecured loans (whether short- or long-term), so that it is cheaper to raise funds through this mechanism than through other types of debt financing.

In the event that the mortgage is obtained from a related party, the interest rate and terms should normally be the same as would have been obtained from an unrelated party.

Lease financing

A subsidiary may lease capital equipment from a related or unrelated party. This means that the subsidiary does not make a lump-sum payment for the asset but spreads its cost over a number of years and may not necessarily take all the risks of ownership. If the lease is obtained from a related party, the interest rate and terms must be the same as would have resulted had the lease been obtained from an unrelated party. One consideration would be structuring the lease as an operating lease (where the substantial risks and rewards relating to the asset remain with the lessor) or a finance lease (where the eventual ownership of the asset transfers to the lessee) and pricing the lease rental accordingly.

Capital stock

The parent can provide capital to a subsidiary through purchase of capital stock in the subsidiary. This is probably the most straightforward method of financing the long-term needs of a subsidiary but is relatively difficult to adjust quickly to meet changing needs. In particular, many jurisdictions have rules making it difficult for a company to reduce its equity base.

The dividend policy between subsidiary and parent is usually the only area of inter-company transactions that does not attract significant interest from tax authorities (although they sometimes challenge inter-company payments to a parent company, such as royalties and interest in circumstances where no dividends are paid on ordinary capital or where they consider the company to be thinly capitalised).

From a planning perspective, it can sometimes be preferable to issue shares at a premium rather than issue more shares at the same nominal value. This is because many jurisdictions allow the repayment of share premium, while a reduction of share capital often requires relatively complex and formal legal proceedings or may not be possible at all. The flexibility gained will probably weaken the balance sheet somewhat where such arrangements exist. It is also worthwhile exploring the possibility of issuing redeemable preference shares or similar quasi-equity instruments, which would enable early redemption or other simpler forms of capital reduction or equity repurchase. Preference shares are broadly similar to equity shares in terms of the treatment of dividend payout, but have priority in matters of profit and capital distribution.

Categories of inter-company transfer

Long-term inter-company loans

A parent company usually has the flexibility to lend funds to subsidiaries directly in the form of loans, whether secured or unsecured. Most parent company jurisdictions require that the parent charge an arm's-length rate of interest on the loan based on the term of the loan, the currency involved and the credit risk associated with the subsidiary (*see Interest on loans, Chapter 5*).

At the subsidiary level, tax deductions are normally available for interest expense. However, thin capitalisation is increasingly an area that is scrutinised by tax authorities, so particular attention must be given to the gearing levels acceptable in the borrowing country. Careful attention must also be given to any double taxation agreement in force between the countries involved.

Other financing techniques

The methods of determining an appropriate price for the financial transactions discussed in *sections Financing transactions through Long term intercompany loans, above*, apply equally to the more sophisticated financing techniques, such as deep discounted loans, hybrid financing arrangements (where the instrument is taxed on an equity basis in one country and as debt in the other), swaps, etc. In all these situations, the correct remuneration for the parties involved can be determined only by a careful analysis of the various obligations and risks of the parties to the transaction and how these would be compensated in an arm's-length situation. This analysis is essentially the same as that which a bank does in setting the terms of special arrangements with its customers or the market processes that eventually determine how a quoted financial instrument is valued on a stock exchange.

Flexibility in managing capital needs

It is important to bear in mind that cash is easily moved from one place to another. A multinational will have opportunities to raise external capital from shareholders or from institutional backers and banks, probably in a number of different countries, and will similarly be generating profits across a wide spread of territories. While the remarks in the *sections Financing transactions through Other financing techniques, above* generally refer to the financing of subsidiaries by the parent, there may well be opportunities to arrange finance between subsidiaries across the group, perhaps through a special entity taxed on a low basis, such as a Belgian Coordination Centre. Similar principles apply in these circumstances.

3.

The work of the OECD

Introduction

The Formation of the OECD

According to its Convention, the Organisation for Economic Co-operation and Development (OECD) was established in 1961 in order to establish policies within its member countries that would:

- achieve the highest maintainable economic growth and employment and a sustained rising standard of living in member countries
- result in sound economic expansion, and
- contribute to the expansion of world trade on a multilateral, non-discriminatory basis.

A list of the OECD member countries is set out at the end of this chapter.

The OECD report and Guidelines on transfer pricing

The tax authorities in the United States and a handful of other countries started to pay considerable attention to transfer pricing in the 1960s and 1970s.

As part of their general remit, the OECD member countries recognised that it would be helpful to provide some general guidance on transfer pricing in order to avoid the damaging effects that double taxation would have on international trade. The result was the OECD report and Guidelines on transfer pricing which were first issued in 1979 and were subsequently revised and updated in 1995 and again in 2010.

The importance of transfer pricing and the need for regulations and/or guidelines intensified in 1990 when an investigation for a US congressional committee found that the Japanese distribution subsidiaries of US groups reported profits of roughly 7% in Japan while the average for US subsidiaries of Japanese groups were -0.2%. The 'Pickle Hearings' (named after a member of that committee) attacked foreign (and specifically Japanese) groups alleging tax avoidance using transfer pricing.

Following the Pickle Hearings, the IRS promptly challenged US distribution subsidiaries of foreign multinationals that reported losses or lower profits. In those cases where there were losses, the argument the IRS used was, very broadly, that distributors do not make sustained losses – they renegotiate prices with their suppliers, switch to distributing profitable products or go out of business.

It was against this background that the United States introduced the comparable profits method (CPM) in proposed regulations in 1992, just as the OECD was engaged in prolonged discussions that resulted in the 1995 update of the OECD Guidelines.

The work of the OECD

On 22 July 2010 the OECD published revised Chapters I – III of the OECD Guidelines covering the arm's-length principle, transfer pricing methods and comparability analysis. At the same time, final guidance on the Transfer Pricing Aspects of Business Restructurings was issued, which is now incorporated into the OECD Guidelines as a new Chapter IX.

To summarise the main points, the 2010 OECD Guidelines:

- Reaffirm the position of OECD member states that the arm's-length principle is the fairest and most reliable basis for determining where profits fall to be taxed and reject alternatives such as global formulary apportionment (Chapter I).
- Remove the hierarchy of methods contained in earlier versions of the OECD Guidelines which had expressed preference for the use of traditional transaction-based methods in favour of a new 'most appropriate method rule' (Chapter II).
- Elevate the standing of the transactional net margin method (TNMM) to be on an equal footing with other transfer pricing methods and provide detailed guidance on the use of profit level indicators (PLIs) including return on sales, return on cost, return on capital or assets and the Berry ratio (i.e. mark-up on operating expenses) (Chapter II).
- Provide additional guidance on the use of the profit split method (Chapter II).
- In addition to the five comparability factors that were added in 1995, place greater emphasis on data analysis and the use of adjustments and statistical methods to draw conclusions, including – for the first time – endorsement of the use of an interquartile range (Chapter III).
- Introduce a typical nine-step process for performing a transfer pricing comparability analysis (Chapter III).
- Introduce new principles on disregarding or re-characterising certain restructuring transactions, reallocation of risk and compensation for the restructuring itself (Chapter IX).

As a result of the changes, taxpayers should expect to see the following from taxing authorities:

- Increased challenges on the comparability of data used to support the application of one-sided methods (i.e. the TNMM, the resale price method, and the cost plus method).
- Greater focus on the potential use of internal comparables.
- Additional pressure to consider the profit split method.
- Closer examination of the processes followed to establish or document their transfer prices.
- Requests to explain the options realistically available to the parties to a transaction in the context of a restructuring.
- Examination of capability to control risks by the party which has been assigned the risks in the restructuring.
- More focus on intangibles.

New OECD initiatives

Reflecting a much higher level of activity by the OECD, a number of new initiatives have resulted in pronouncements that potentially have significant impact on transfer pricing matters. In December 2006 final versions of Parts I, II and III of the *Report on Attribution of Profits to Permanent Establishments* (PE Report) dealing with general considerations in relation to the taxation of permanent establishments and application

of these principles to banks and in the context of global trading were issued. This was followed on 22 August 2007 by a revised Part IV dealing with insurance. A final version of the combined parts to the PE Report was finally issued on 17 July 2008. The 2008 PE Report then spawned a project to update Article 7 and the Commentary to that Article, resulting in the revised text of the old Article 7 and associated commentary, as well as a new Article 7 included in the 2010 update to the OECD Model Tax Convention. Also in 2010, an amended and updated version (but not fundamentally altered from 2008) of the PE Report was issued in order to reflect any necessary minor amendments to make the report consistent with the new Article 7.

The OECD has recently launched new projects on the transfer pricing aspects of transactions involving intangibles (25 January 2011) and on the administrative aspects of transfer pricing (9 March 2011). Regarding the intangibles project, it aims at a substantial revision and clarification of the current Chapter VI 'Special Considerations for Intangible Property' of the OECD Guidelines, as well as a consistency check of Chapters VII 'Special Considerations for Intra-Group Services' and VIII 'Cost Contribution Arrangements', in order to ensure that the terminology and concepts in all Chapters are applied consistently. The project focuses on issues, such as, definitional aspects of intangibles, valuation and guidance on specific transaction categories involving intangibles (e.g. R&D activities, marketing intangibles and service provision using intangibles). On 6 June 2012, nearly one and a half years ahead of the original timeline, the OECD published the first public Discussion Draft, Revision of Chapter VI of the OECD Guidelines. The early availability of the Discussion Draft underscores the immense progress the OECD has made on the intangibles projects since the kick off meeting held jointly with business commentators in November 2010. The comment period following the release of the Discussion Draft ended 14 September 2012.

The arm's-length principle

Under the arm's-length principle, related taxpayers must set transfer prices for any inter-company transaction as if they were unrelated entities but all other aspects of the relationship were unchanged. That is, the transfer price should equal a price determined by reference to the interaction of unrelated firms in the marketplace.

This concept is set out definitively in Article 9 of the OECD Model Tax Convention, which forms the basis of many bilateral tax treaties. The OECD Guidelines acknowledge that it is often difficult to obtain sufficient information to verify application of the arm's-length principle in practice but state that it is the best theory available to replicate the conditions of the open market. The OECD Guidelines then focus on best practice in determining the equivalent of a market price for inter-company transactions within multinational groups.

Guidance for applying the arm's-length principle

The arm's-length principle is usually applied by comparing the 'conditions' (e.g. price or margin) of a controlled transaction with those of independent transactions. The OECD Guidelines allow the use of inexact comparables that are 'similar' to the controlled transaction but not the use of 'unadjusted industry average returns'. The factors that should be considered when assessing the comparability of a transaction include:

- The specific characteristics of the property or services.

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- The functions that each enterprise performs, including the assets used and, most importantly, the risks undertaken.
- The contractual terms.
- The economic circumstances of different markets, for example, differences in geographic markets, or differences in the level of the market, such as wholesale vs. retail.
- Business strategies, for example, market penetration schemes when a price is temporarily lowered.

For instance, if a subsidiary corporation manufactures a sports shirt and then sells that shirt to its foreign parent for distribution, it must establish an inter-company price for the shirt. Under the arm's-length standard, this inter-company price should be determined by analysing what comparable sports shirt manufacturers receive when they sell shirts to unrelated distributors. Although there are several acceptable methods for determining arm's-length price, each is based on a comparable transaction.

Analysis of transactions

The OECD Guidelines set out how transactions should be analysed when determining or reviewing transfer pricing.

- The tax authorities should review the actual transaction as structured by the related parties (however, *see Recent developments at the OECD*, below in relation to business restructuring).
- Although the OECD Guidelines prefer a review of transfer pricing on a transaction-by-transaction basis, they acknowledge that this is not often practical, and so a combination of transactions may be examined.
- It is not always possible to use a single figure, for example, as a price or margin; instead, a range of prices may be more appropriate.
- The OECD Guidelines suggest examining data from both the year in question and previous years.

Transfer Pricing Methods

The OECD Guidelines comment on various pricing methodologies, with examples of their application, under a number of headings. Prior to the 2010 revision the OECD Guidelines expressed a preference for the use of 'traditional transaction methods' as being the most direct price comparisons as compared to more indirect profit based methods.

The OECD Guidelines now explicitly require the selection of the most appropriate method, taking into account the strengths and weaknesses of the OECD recognised methods. The selection of the method needs to consider several elements, including the availability of reliable information needed to apply the selected method. Although what is ultimately important is that the most appropriate method is selected, the OECD Guidelines states that if the CUP method and another transfer pricing method can be applied in an equally reliable manner, the CUP method is preferred.

The OECD Guidelines (Chapter III) also provide a description of a typical process when performing comparability analysis, which is considered an accepted good practice but is not compulsory. This nine step process is a good illustration of not only the considerations necessary when selecting the most appropriate method, but also understanding the overall comparability analysis.

Comparable uncontrolled price method

The comparable uncontrolled price (CUP) method offers the most direct way of determining an arm's-length price. It compares the price charged for goods or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction. The OECD acknowledges that it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price, but states that this should not routinely preclude the application of the CUP method. The extent of the OECD's support for the CUP method can be seen from the comment that 'every effort should be made to adjust the data so that it may be used appropriately in a CUP method'.

Using the CUP method for sales to affiliates, potentially comparable sales include sales made by a member of the controlled group to an unrelated party, sales made to a member of the controlled group by an unrelated party, and sales made between parties that are not related to each other. Any of these potential CUPs may provide an arm's-length price for use in the sale between related parties if the physical property and circumstances involved in the unrelated party sales are identical to the physical property and circumstances involved in the sales between the related companies.

Transfer pricing regulations in most countries allow CUPs to be adjusted if differences between the CUP and the related party transaction can be valued and have a reasonably small effect on the price. Examples of adjustments that are commonly allowed include differences in:

- the terms of the transaction (for example, credit terms)
- the volume of sales, and
- the timing of the transaction.

Differences in respect of which adjustments are difficult or impossible to make include the:

- quality of the products
- geographic markets
- level of the market, and
- amount and type of intangible property involved in the sale.

Example

Far East Steel Ltd (FES), a Japanese company, manufactures steel ingots in the Far East and ships them to related and unrelated foundry businesses in the UK. The ingots that FES ships to its unrelated and related party customers are identical in every respect. Moreover, the terms and conditions of the sales are also identical, except that the related party customers are given payment terms of 90 days as opposed to only 45 days for unrelated party customers. Based on this information, it is determined that the unrelated party ingot sales represent a CUP for the inter-company transfer price. The difference in payment terms must be taken into account, however, before the actual arm's-length inter-company price can be determined.

Based on prevailing interest rates, it is determined that the difference in payment terms is worth 0.5% of the ingot price. Adjusting the unrelated party price for this difference, it is established that the inter-company price should reflect the unrelated party price plus 0.5%.

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Example

Gluttony Unlimited, a UK company (GUK), manufactures a type of cheese that is calorie and cholesterol-free when eaten while drinking fine French wine. The cheese is sold to related companies in Germany and the United States and to an unrelated company, Guilt Free Parties (GFP), in France. A transfer price is needed for GUK's sales to its affiliates. GFP is a sponsor of cheese and wine parties in France. Individuals ask GFP to organise and conduct these parties and to provide the cheese, wine and other food and utensils needed to sponsor the event.

GUK's subsidiaries in Germany and the United States are distributors of the cheese to unrelated grocery stores and to wine and cheese party sponsors throughout their respective countries.

The price charged to GFP by GUK does not qualify as a CUP in this instance because the 'level of the market' is different (i.e. the German and US affiliates sell to a higher level of the distribution chain than does GFP). Typically, these differences cannot be valued and, as a consequence, no CUP exists.

Resale price method

An arm's-length price is determined using the resale price method by deducting an appropriate discount for the activities of the reseller from the actual resale price. The appropriate discount is the gross margin, expressed as a percentage of net sales, earned by a reseller on the sale of property that is both purchased and resold in an uncontrolled transaction in the relevant market. Whenever possible, the discount should be derived from unrelated party purchases and sales for the reseller involved in the inter-company transaction. When no such transaction exists, an appropriate discount may be derived from sales by other resellers in the same or a similar market. The OECD Guidelines recognise that there are problems in obtaining comparable data, for example, where there is a considerable period of time between the comparable transaction and the one under review within the group, where movements within the economy (i.e. foreign exchange rate, interest rate, recession or boom) generally would cause possible distortion.

As with the CUP method, it is possible to adjust the discount earned by the reseller to account for differences that exist between the related transaction and the comparable unrelated transaction.

Example

Shirts Unlimited (SU), an Italian company, manufactures and sells sports shirts. Manufacturing takes place at the parent company's factory in Italy. Subsidiaries in Germany, France and the UK serve as distributors in their respective markets. Through a search of comparable distributors of sports shirts, it is determined that independent distributors earn gross margins of 25%. There is one major difference between the related party distributors and the independent distributors – the independent distributors also design the shirts, whereas the related party distributors do not. Upon further investigation, it is learned from independent distributors that they typically charge a 3% (on sales) royalty for designing shirts. Based on this information, the comparable resale price margin is adjusted for the design function. Therefore, the gross margin to be earned by the related party distributors is reduced from 25% to 22% to account for the absence of a design function.

Cost plus method

The cost plus method is one of the methods typically applied in analysing the activities of a contract manufacturer (see Chapter 4, *Contract manufacturers and fully fledged manufacturers*) or when determining the arm's-length charge for services. It can also be applied to fully-fledged manufacturers, although the mark-up, as well as the cost base, may be different from that utilised in the case of a contract manufacturer.

The cost plus method determines the arm's-length price by adding an appropriate mark-up to the cost of production. The appropriate mark-up is the percentage earned by the manufacturer on unrelated party sales that are the same or very similar to the inter-company transaction. The cost base for both the comparable company and the one under review must be carefully analysed to ensure that the costs to be marked up are consistently defined. Thus, as with the resale price method which is also premised on using gross margins as the basis for comparison, a careful comparative review of the accounting policies is as important as the determination of the mark-up, particularly with a view to identifying any potential mismatches of expense categorisation between cost of goods sold and administrative expenses when comparing the financial results of the taxpayer and the comparables.

When determining the mark-up to be applied in the contract manufacturing case, it is important to note that the goods transferred under the comparable transaction need not be physically similar to the goods transferred under the inter-company transaction. For example, a contract manufacturer should be compensated for the manufacturing service provided rather than for the particular product manufactured.

When determining arm's-length mark-ups for fully-fledged manufacturers (i.e. manufacturers that operate with a greater degree of independence and which carry out more sophisticated activities) the nature of the product that is manufactured will probably be of much greater significance to the analysis. Mark-ups earned by manufacturers could vary considerably from one product to another because of manufacturing intangibles that may have been developed by the fully-fledged manufacturer. As a result, identifying a comparable for the fully-fledged manufacturer may be extremely difficult unless the company manufactures and sells the products in question to unrelated companies at the same level of the market as the affiliates to which the related party sales are made (i.e. an internal comparable exists).

Example

A UK company, Glass Shapes Ltd (GSL), is a specialist glass manufacturer. The company conducts all of its research and development (R&D) and manufacturing activities in the UK. After the glass has been produced, it is shipped to the manufacturer's Irish affiliate where it is shaped, utilising a special technical process developed by the UK company. The shaping process is not complex, nor does it require highly skilled labour. When the unfinished glass arrives at the plant, the Irish personnel examine the accompanying work order and immediately begin processing the glass. The Irish affiliate never takes title to the glass; rather, the unfinished glass is consigned to it.

In this case, the Irish affiliate is a contract manufacturer. It performs limited manufacturing activities and engages in no production scheduling, materials purchasing, or technical service. Moreover, it bears no raw material or market risk. When the shaping process is complete, the Irish affiliate ships the completed products

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to the UK parent for sale in the UK market. In addition to this service provided to the UK parent, the Irish affiliate also provides similar services to unrelated companies.

Since the UK company uses no other contract manufacturer, a CUP does not exist from the UK standpoint. However, as the Irish affiliate is also performing manufacturing services for unrelated companies, comparable information will be available from these transactions. Specifically, the mark-up the Irish affiliate earns on services provided to unrelated companies can potentially be used to apply a cost plus method to the related party transaction.

Cost plus method – capacity adjustments

Regardless of whether the manufacturer is a contractor or a fully-fledged manufacturer, several issues must be considered when evaluating a comparable transaction. These issues include capacity, technology owned by the manufacturer, volume and geographic market.

In many cases capacity issues are important in determining the appropriate cost base. For example, if a contract manufacturing plant is operating at 50% capacity, the question of whether all the overhead costs should be included in the cost base in determining the fee received by the contract manufacturer is critically important. If those costs are excluded, the contract manufacturer may report negative income; if instead, all overhead costs are included, the fee paid to the contract manufacturer may be so high that the cost base of the product exceeds the market price. The correct answer is determined by the nature of the relationship between the parties. Typically, in arm's-length relationships between unrelated parties, a contract manufacturer would not devote its entire productive capacity to a single customer, so that capacity utilisation problems are not the responsibility of any single customer. However, if a contractor agrees to maintain a certain productive capacity to be available to a given customer at any moment, that customer should pay for the cost of maintaining that capacity, whether it is used or not.

Example

As an example, if we take the facts of GSL (*see previous Example*) but change the assumption such that the Irish affiliate dedicates 100% capacity to GSL through a long-term contract, then the fee for charges to GSL must take account of all the overhead accruing on a long-term basis. As a result, GSL and its Irish affiliate must budget to maintain the subsidiary in an appropriately profitable position.

Where there are significant differences in the cost base due to geographic market differences, it will be important to conduct a thorough review of the existence of location savings and which parties to the transaction should be the beneficiary of such savings.

Profit split method

This method establishes transfer pricing by dividing the profits of a multinational enterprise in a way that would be expected of independent enterprises in a joint-venture relationship. It might be appropriate to use this method for highly integrated operations for which a one-sided method would not be appropriate. The profit split method may also be the most appropriate method in cases where both parties to the transaction make unique and valuable contributions to the transaction. The OECD Guidelines state that expected profits should be used rather than actual profits, in

order to avoid the use of hindsight. Many multinational enterprises (MNEs) have responded to this by including a year-end 'true up' calculation as part of their inter-company agreements.

To compute arm's-length prices using the profit split method, it is necessary to know how profits would be split between unrelated parties based on the same facts and circumstances as in the related party situation. Because this information is almost never publicly available, a 'comparable profit split' derived from formulae used by third parties is rarely possible. More frequently this method relies on the judgment of the user to determine an appropriate profit split formula that reflects the relative contributions of tangible and intangible assets made by each of the parties to the transaction (in the terminology adopted in the US regulations this is known as a residual profit split).

For this method, it is necessary to compute the revenues and costs of each legal entity involved in the transaction. For example, if, for a given geographic market, an MNE conducts R&D and manufacturing in one legal entity and marketing and distribution is conducted in a second, the revenues and costs in each entity relevant to the specific geographic market must be computed. This can be extremely difficult, and may lead to extensive disclosure requirements in order to ensure that transfer pricing documentation standards are met.

Typically, the profit split analysis is conducted at the operating income level, although sometimes it is applied at the gross profit level. In each instance, the income in question must be solely the income attributable to operations (i.e. non operating income should be excluded from the analysis).

The extent to which a profit split method should be used to test a result achieved by the CUP method or a one-sided method has been subject to significant international debate. Some tax authorities have made attempts to perform a sanity check of a result achieved from a CUP method or a one-sided method using a profit split method. However, the OECD Guidelines' clear position is that secondary methods are not required, and the application of a profit split method requires both parties to make unique and valuable contributions to the transaction (which would not be present when applying a one-sided method).

The 2010 revised OECD Guidelines include a significant amount of new guidance on the practical application of the profit split method, which led to concerns that this reflected a greater endorsement of the profit split method. However, the OECD has indicated that the intention of the working party was that the (2010) revised OECD Guidelines did not represent a greater endorsement of the profit split method.

Example

Wheels AG (WAG) is a German company that manufactures luggage carriers that are lighter than those sold by its competitors. Key parts are manufactured at the parent company and sold to a subsidiary located in the UK. The UK subsidiary, via its self-funded research and development activities, developed unique and highly valuable technologies which make the luggage even lighter. The UK subsidiary also assembles the finished luggage carriers and markets and distributes the products in the UK market. It has been in existence for 15 years. No comparables are available that would allow the application of the CUP, or one of the one-sided methods; so WAG has decided to utilise a profit split method to determine transfer prices.

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Table 3.1 Wheels AG's sales in the UK market (1992)

	WAG	WUK	Consolidated
Sales	75	100	100
Cost of sales	(60)	(75)	(60)
Gross profit	15	25	40
Selling	0	(20)	(20)
General and administrative expenses	(1)	(8)	(9)
Operating income	14	(3)	11

The first step in the application of the profit split method is to produce basic income statement data for the transaction, as follows: The profit split at the gross profit level is 15/40 or 37.5% for WAG and 25/40 or 62.5% for WUK. The profit split at the operating income level is 127% for WAG and negative 27% for WUK. It is obvious that the transfer prices used here produce an inequitable profit split and are unlikely to be acceptable to the UK tax authority.

Transactional net margin method

This method was the OECD's response to the US CPM. The TNMM looks at the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer makes from a controlled transaction. In substance, it is similar to the US CPM, although there has been considerable debate as to the extent to which they are the same in practice. Neither method requires the same level of comparability in product and function as is required for the traditional methods. However, the OECD Guidelines express concern that there should be sufficient comparability in the enterprises being compared so that there is no material effect on the net margins being used or adjustments to be made.

It is interesting to note that the debate over the US CPM was an important driver of the revision to the earlier OECD work on transfer pricing. There was some concern outside the US that the CPM would be used in inappropriate circumstances. Under the TNMM, the focus is initially on transactions (rather than business lines or perhaps the operating income of a company) and the argument is that this imposes a greater discipline to look closely at the inter-company transactions and to justify why they may be aggregated together for the purposes of the analysis. Under the US CPM there is a requirement that is similar in effect that requires the taxpayer to consider whether the test is being applied to an appropriate business unit.

This is obviously an area in which taxpayers can easily find areas of disagreement if they chose to do so. In practice, by focusing on areas of commonality of approach, it is often possible to establish transfer pricing policies and procedures that satisfy the requirements of both the US CPM and the OECD TNMM.

Although before 2010 such profit based methods were described as 'methods of last resort' under the OECD Guidelines, in practice they were widely used largely because of the availability of comparable data at the net profit level based on the published financial statements of independent companies. Now, the OECD Guidelines place the application on the TNMM on equal footing as the traditional methods, and furthermore recognise the notion of comparability defects, and that the application of the TNMM should not be excluded solely because of the existence of comparability defects.

Return on assets

Return on capital (i.e. equity) is generally the economist's preferred rate-of-return measure but it is often difficult to use this measure directly in an inter-company pricing framework. This is because the capitalisation of a subsidiary will usually be determined by the parent company in the light of internal group financing requirements and not by the market forces of banks, shareholders and bond holders, who effectively control the capitalisation of a quoted company. The overall capitalisation of a wholly owned subsidiary is therefore not necessarily arm's-length.

As a substitute for return on equity, return on assets (ROA) is frequently used as a PLI, as is now recognised in the 2010 update of the OECD Guidelines. In the United States, ROA is frequently selected as an appropriate PLI in an analysis that applies the CPM, and in many other countries it has historically been similarly applied as part of a transactional net margin or cost plus method analysis.

For example, such analyses are frequently applied to manufacturing activities. When using ROA, the definition of assets utilised in the manufacturing activity can be a potential area of difficulty. Return on the net book value (NBV) of all assets may be used in some situations. In this case, the numerator is the operating income before interest and taxes. The denominator is the NBV of all assets reported on the balance sheet that are utilised in the manufacturing activity, excluding financial and non-operating assets.

In addition, the age of the plant and equipment must be considered when comparing the ROA in a related party with those earned by independent companies. For example, if the manufacturing company within a multinational group has a new plant with very high depreciation expense, its ROA may not represent a valid comparison with independent companies that operate with old, fully depreciated plants (or vice versa), unless the assets are all revalued to a current basis.

Example

Clipco SA, a Belgian company, manufactures and sells razors. Its R&D activity is conducted at the parent company in Belgium; its manufacturing is done by a subsidiary in Ireland and its distribution is done by a subsidiary in Germany. The Irish manufacturing process is capital intensive. Financial statements are available which allow a typical ROA to be computed for the manufacturing activities. Specifically, financial statements for manufacturing companies that produce razors for sale to unrelated distributors are available. Furthermore, no publicly available information exists which can be used to apply the CUP, resale price or cost plus methods to determine transfer prices between the Irish and German subsidiaries, and the profit split method is not considered appropriate given the nature of activities being performed by the Irish manufacturer.

The balance sheets reveal that liquid assets (cash, short-term investments and accounts receivable) for Clipco's Irish subsidiary represent 40% of total assets while the same assets for the independent manufacturers represent only 10% of total assets – these are excluded from the calculation. Further analysis reveals that the plants (related and independent) are approximately the same age and the accounting principles utilised in constructing the balance sheets are similar. The ROA is calculated and this ratio is used to determine transfer prices for Clipco's Irish subsidiary's sales to Clipco-Germany.

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Berry ratio compared to return on sales (ROS)

ROS has traditionally been the primary PLI applied to the profitability of distribution operations in order to evaluate the arm's-length nature of the underlying inter-company pricing arrangements in many countries. In contrast, the Berry ratio focuses on comparing the gross profitability of an activity and operating expenses necessary to carry it out (i.e. gross profit divided by operating expenses). In substance the Berry ratio may thus be seen as a cost plus method applied to selling entities. It has been frequently used as a PLI for the application of the US CPM to certain categories of distribution activities.

By way of illustration, consider the case of a parent company that has performed all the R&D required to bring a product to market and has also manufactured the product. A related entity is responsible for arranging the sale of the goods to the end customer and maintains a local sales office for this purpose. The distributor may either directly sell the goods to the customer or may be compensated by way of a sales commission paid by the manufacturer. In this situation, the 'simple' entity is the selling entity and the 'complex' entity is the manufacturer.

To compute the Berry ratio, it is necessary to determine the mark-up that a typical distributor earns on selling, general and administrative (SG&A) expenses which it incurs in the process of providing sales services on behalf of the manufacturer. Specifically, the Berry ratio is calculated as the ratio of gross profit to operating costs and is used to mark-up the SG&A costs of the selling affiliate in the inter-company transaction. All remaining income is attributed to the manufacturing entity.

It is noted that in practice a transactional method such as the RPM or cost plus will often have to be applied during the company's budgeting process in order to insure that the actual invoice pricing of the goods on a day-to-day basis will achieve the desired overall Berry ratio target established for the company's financial year.

The advantages of the use of the Berry ratio include the ease of administration and the lack of concern for the size of the distributors used as comparables. Its use is appropriate when the distribution activity in question consists of a limited range of functions and risks, and may be properly characterised as the provision of a service to the manufacturer. In contrast, distributors that operate with a higher degree of independence, that may own intangible assets, or which conduct value added activities in addition to mere resale of tangible goods may be better evaluated by use of ROS. As in all matters relating to the choice of an appropriate PLI, a comprehensive functional analysis is essential in making these distinctions in functionality, levels of risk taking and assets employed, and insuring that a valid comparison is made with third party comparables that exhibit similar characteristics.

Although the OECD Guidelines now makes reference to the use of the Berry ratio as a PLI, the Guidelines also identify specific criteria which should be met in order for the Berry ratio to be considered appropriate.

Example

US Pills Inc. (USP) is a US pharmaceutical company that has begun to manufacture a new drug in a subsidiary located in Sweden. The parent developed and patented the drug in the United States and has licensed the Swedish subsidiary to manufacture it. The parent purchases the drug from its subsidiary and distributes it in the United

States. The final US sales price for the drug is 2 United States dollars (USD) per tablet. Sales of the drug are expected to be 600 million tablets per year. The distributor's operating costs are USD 14.4 million per year.

To determine the transfer price, the Berry ratio for US distributors is computed and found to be 125%. This means that the operating costs of the distributor are marked up by 25% to determine transfer prices (i.e. the distributor's gross margin is USD 18 million per year). Using this gross margin, the price of the tablets to the distributor is USD 1.97 per tablet.

This analysis implies that the distributor will earn a gross margin equal to 1.5% of sales. The Berry ratio method will be acceptable in this case only if the functional analysis has clearly established that the distribution activity does not involve the use of any locally developed intangible assets, involve any local 'value added' functions, or exhibit any other unique characteristics that the tax authorities may consider should attract a higher rate of return.

Again, careful analysis of the facts and circumstances is critically important. It is often found that distributors that are members of MNEs perform different functions from independent, entrepreneurial distributors. One area that can be particularly complex to analyse, for example, concerns advertising expenses. It is important to understand how these are dealt with in both the controlled and uncontrolled transactions under review and this may be very difficult to establish from public sources for comparable businesses.

The nature of the sale is also important. For instance, it will be important to consider the impact the distributor actually has on the customer in comparison with the customer's desire to buy the product (from the parent). Stated differently, can it be demonstrated that independent local activities of the distributor can drive a pricing differential in the market? If the answer to this question is 'yes', then use of the Berry ratio may not be appropriate.

Non-arm's-length approach: global formulary apportionment

A global formulary apportionment allocates the global profits of a multinational group on a consolidated basis among the associated enterprises, using a preset formula. The OECD Guidelines review the argument for this to be a suitable alternative to the arm's-length principle. Those arguing in favour asserted that it would provide more administrative convenience and certainty for taxpayers. Whatever the difficulties in applying the arm's-length principle in practice, the debate led by the OECD has been unable to produce any justifiable substitute to the arm's-length principle which would produce a more manageable and stable fiscal climate for MNEs. The OECD Guidelines identify numerous practical problems associated with the idea of using an inflexible predetermined formula as the basis of setting transfer prices, and consequently member countries rejected global formulary apportionment and confirmed that they should retain the arm's-length principle as the best available approach to the analysis of inter-company transfer pricing.

The work of the OECD

OECD commentary on other matters impacting transfer pricing

Safe harbours

Establishing transfer prices is a fact-intensive, judgmental process. This could be alleviated by establishing a simple set of rules (a safe harbour) under which tax authorities would automatically accept the transfer prices. Safe harbours would reduce the compliance burden and provide certainty both for taxpayers and tax administrations. However, there are some problems that need to be addressed if safe harbours are to be used, including:

- A risk of double taxation and mutual agreement procedure difficulties.
- Tax planning opportunities for taxpayers.
- Potential discrimination and distortion of competition.

On balance, the OECD does not recommend the use of safe harbours. However, as mentioned above, this issue, as well as other simplification measures, is currently being revisited by the OECD in the new project on the administrative aspects of transfer pricing. This is also related to the work of the United Nations on transfer pricing in the context of developing nations and the recognition that, often, these countries lack capacity to deal with transfer pricing compliance and administration.

Advance pricing agreements (APA)

An advance pricing agreement sets out appropriate criteria (e.g. a method, comparables and critical assumptions) for determining transfer pricing over a fixed period. APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure (MAP) under art. 25 of the OECD Model Tax Convention. An APA can help taxpayers by providing certainty through the establishment of the tax treatment of their international transactions. Currently, an increasing number of OECD member countries have adopted APAs in their transfer pricing legislation and the number of APAs has consistently increased. For this reason, the Committee on Fiscal Affairs continues to monitor the use of APAs. APAs are discussed in some detail in Chapter V of the OECD Guidelines, as well as in an annex on APAs, issued by the OECD in 1999.

The annex explains that the OECD encourages the use of bilateral APAs achieved through the MAP provisions of tax treaties, and so focuses on such bilateral processes in the annex. The aim of the annex is to encourage consistency between APA procedures by looking at: issues arising from the application process; the scope of APAs; behaviour of the taxpayer and the Competent Authorities (i.e. tax officials who administer the MAP for each state); the content of APA proposals; and implementation issues, such as critical assumptions on which the APA is based and monitoring of the agreement.

Documentation

The OECD Guidelines provide direction for tax authorities on the development of rules and procedures on documentation. Each taxpayer should try to determine transfer pricing, 'in accordance with the arm's-length principle, based upon information reasonably available at the time of the determination'. The information needed will vary depending upon the facts and circumstances of the case. In fact, as will be seen from the country commentaries later in this book, there are numerous different regulatory approaches to the issue of transfer pricing documentation. Compliance with

the rapidly growing range of requirements is becoming a considerable challenge to international business.

The mutual agreement procedure and corresponding adjustments

Tax authorities consult with each other in order to resolve disputes about the application of double tax conventions and agree to corresponding adjustments following transfer pricing examinations. The OECD Guidelines note the concerns of taxpayers about these procedures and recommend:

- extending domestic time-limits for the purposes of making corresponding adjustments
- reducing the time taken for mutual agreement proceedings
- increasing taxpayer participation
- the publication of domestic rules or procedures, and
- the suspension of collection of tax during the procedure.

Secondary adjustments

In addition to the transfer pricing adjustment, some countries have a second adjustment based upon a constructive transaction for the transfer of the excess profit, for example, constructive dividends. The Committee on Fiscal Affairs has decided to study this issue further in order to develop additional guidance in the future.

Authority of the OECD Guidelines

The OECD Guidelines, as their name suggests, do not have any direct legal force in the member countries, unless a given country has incorporated them into its domestic legislation. In any event, they do have a major influence on the tax authorities of the OECD countries (and increasingly on non-member countries), particularly those that do not have detailed transfer pricing regulations and, traditionally, have followed the OECD Guidelines. In particular, OECD countries tend to rely on the OECD Guidelines as a basis for resolving matters submitted to the competent authorities under the treaty mutual agreement process. The Council of the OECD, when publishing the OECD Guidelines, recommended that:

- Tax administrations follow the OECD Guidelines when determining taxable income.
- Tax authorities should encourage taxpayers to follow the OECD Guidelines.
- Governments should further develop co-operation between the tax authorities.

Increased co-operation between tax authorities

One result from the process of agreeing the OECD Guidelines has been the increasing internationalisation of the review of MNE's transfer pricing. This is because the tax authorities have improved their communication procedures through having more discussions in the forum of the OECD, which in turn has resulted in a significant increase in the use of the exchange of information article included in most bilateral tax treaties. The bilateral co-operation set out in the OECD Model Convention takes a multilateral dimension with the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, created under the auspices of the OECD and the Council of Europe and amended with effect as of 1 June 2011, is particularly relevant in transfer pricing as it provides for a single legal framework for joint tax audits, which are increasingly being pursued by tax authorities. The amended version of the Convention applies to members of the OECD and the Council of Europe and non-members, as

The work of the OECD

a way to foster co-operation with developing countries and create a multilateral approach to exchange of information.

In addition, there is, today, a wide network of signed Agreements on Exchange of Information on Tax Matters between OECD and non-OECD countries, based on the Model developed by the OECD Global Forum Working Group on Effective Exchange of Information. The Model grew out of the OECD work on harmful tax practices. These initiatives are applicable to all cross-border tax matters, however, given the particular focus by tax authorities on transfer pricing issues, the increase in co-operation between tax authorities is particularly relevant for transfer pricing.

Member countries of the OECD

The current OECD member countries are: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

Russia is currently engaged in open discussions for membership with the OECD. Additionally, the OECD has enhanced agreements with Brazil, China, India, Indonesia and South Africa.

Recent developments at the OECD

As noted above, the OECD has recently taken on a number of significant projects which potentially mark a major expansion of the role and influence of the OECD in international tax and transfer pricing matters.

New Article 7 (Business Profits) of the OECD Model Tax Convention and Report on Attribution of Profits to Permanent Establishments

On 22 July 2010 the OECD released a new Article 7 (Business Profits) of the OECD Model Tax Convention and related commentary changes. Together with the OECD's issue of the Report on the Attribution of Profits to Permanent Establishments, the intention is to reflect certain changes and clarifications in the interpretation of Article 7.

With these changes, the OECD intends to achieve greater consensus in terms of interpretation and application of the guidance on the attribution of profits to PEs in practice among OECD and non-OECD countries. The revised Commentary describes the 'central directive' of Article 7 as being the separate entity approach under which the profits attributed to a PE should be those that it would have realised if it had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and dealings wholly independently from the rest of the enterprise. The Commentary embodies the authorised OECD approach set out in the Report, a two step approach in which the PE is, first, hypothesised as a functionally separate entity from the rest of the enterprise of which it is a part; and second, the appropriate compensation is determined by applying by analogy the OECD Guidelines' arm's-length principle, including its comparability analysis of dealings between the PE and the rest of the enterprise. In a non-financial services business, risks and assets are allocated between the home office and the PE based on the location of 'significant people functions'. In a financial services business, the location of 'key entrepreneurial risk taking functions' will be determinative. The 'force of attraction' principle under

which income arising in the territory may be fully taxable even if it is not attributable to the PE is rejected.

The main developments included in the Commentary may be summarised as follows:

- The calculation of profits attributable to a dependent agent should be consistent with the two stage approach described above.
- The deduction of expenses incurred in the operation of a PE should be allowed.
- Recognition of the attribution of an arm's-length amount of interest to a PE based on attributing an appropriate amount of 'free' capital in order to support the functions.
- Encouragement of taxpayers to produce contemporaneous documentation in order to reduce the potential for controversies.
- Emphasis is placed on arbitration as a means of resolving disputes.

Transfer Pricing Aspects of Business Restructurings

On 4 August 2010 the OECD released a final paper on the Transfer Pricing Aspects of Business Restructurings which is now incorporated into the OECD Guidelines as Chapter IX. Chapter IX combines the four issue notes (which was present in the Discussion Draft) into a single, four-part chapter which is to be read as a whole. This represented a lengthy process of drafting and consultation from the time the Discussion Draft was first released in September 2008, and the final text of Chapter IX has been welcomed as a significant improvement over the original 2008 draft.

The OECD acknowledges that there is no legal or universally accepted definition of business restructuring, but in the context of Chapter IX, business restructuring is defined as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-border transfers of valuable intangibles, or may involve the termination or substantial renegotiation of existing arrangements.

The new chapter covers the transfer pricing consequences of internal business reorganisations designed to shift risks, intangible property and income among members of a multinational group of corporations. The following issues are addressed:

Part 1 – Special consideration for risks. States that the reallocation of risks should be respected to the extent that it has economic substance. Additionally, an assessment of the economic significance of the risks and the impact on the transferor's profits should be conducted and arrangements not commonly seen between independent parties should not automatically mean that it is not at arm's-length.

Part 2 – Arm's-length compensation for the restructuring itself, states that a profit/loss potential is not an asset in itself but a potential that is carried by some rights or assets. This area was subject to significant debate during the consultation and the finalised chapter states that:

- An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction of its profit potential. The arm's-length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. The question is whether there is a transfer of something of value (rights or other assets) or a termination or

The work of the OECD

substantial renegotiation and that would be compensated between independent in comparable circumstances.

- If there is a transfer of rights or other assets of a going concern, the profit potential should not be interpreted as that would occur if the pre-restructuring arrangement would continue indefinitely.
- There is to be no presumption that a termination should give rise to an indemnification. This depends on rights, other assets and 'options realistically available'. The guidance clarifies that this concept has primary application in pricing decisions, and considers that the options available at the individual level may be relevant in applying the arm's-length principle to a business restructuring.

Part 3 deals with the remuneration of post-restructuring controlled transactions, and states that the Transfer Pricing Guidelines should not apply differently to post-restructuring transactions compared to transactions that were structured as such from the beginning.

Finally, Part 4 concentrates on the recognition of actual transactions undertaken and again was another area that generated significant interest among taxpayers and practitioners.

In response to concerns in the business community the OECD Guidelines are now clear that the circumstances in which transactions may only be disregarded or recharacterised should be 'rare' or 'unusual' such as when there is a mismatch between substance and form. The mere fact that an associated enterprise arrangement is not seen between independent parties is not evidence that it is not arm's-length. Nevertheless, the new chapter significantly widens government authority to challenge business restructuring transactions.

Other important issues addressed in Chapter IX include changes to the commentary on taxpayer allocation of risk, such that mismatches between the contractual location of risk and the location in which control over risk is exercised are now more likely to be addressed through pricing adjustments rather than through recharacterisation of a transaction. However, a tax administration 'is entitled to challenge a contractual allocation if it is not consistent with economic substance'. In respect of transfers of profit potential, the OECD Guidelines are clear that a mere decrease in the expectation of future profits does not necessarily create the need for compensation under the arm's-length standard, but concerns have already been expressed that the use of the term 'something of value' in the context of asset transfers is too vague and that there is insufficient guidance on the transfer of a going concern, which is broadly defined as a 'transfer of assets bundled with the ability to perform certain functions and bear certain risks'. As mentioned above, the OECD has commenced a project on the transfer pricing aspects of intangibles, and it is to be hoped that further clarification will emerge during this process.

Perhaps the most controversial aspect of the new chapter is the concept of 'options realistically available' which is now prominent in the OECD Guidelines. This should be considered at the individual entity level and implies that the alternatives theoretically available to each party should be taken into account in determining appropriate levels of compensation to be paid. The final version of the OECD Guidelines clarifies that the primary purpose of the concept is in its application to pricing decisions rather than recharacterisation, and that while a realistically available option that is clearly more

attractive should be considered there is no requirement to document all hypothetical options. The use of hindsight is prohibited.

Discussion Draft of Chapter VI ‘Special Considerations for Intangible Property’ of the OECD Guidelines

Arriving almost a year and a half prior to the anticipated release date, the Discussion Draft of Chapter VI attempts to clearly articulate the thinking of the OECD with respect to the complexities surrounding the inter-company transfers of intangibles. One area of interest for taxpayers is the definitional aspects of intangibles. The Discussion Draft stresses that the corner stone of transfer pricing analyses should be based on how unrelated parties would behave in comparable situations, rather than on certain accounting or legal definitions or those for general tax purposes. Indeed, the Discussion Draft does not differentiate between ‘trade vs. marketing’, ‘soft vs. hard’ and ‘routine vs. non-routine intangibles’. Instead, it presents the view that intangibles are intended to address ‘something which is capable of being owned or controlled for use in commercial activities’. A key break-through in this Discussion Draft is the distinction between intangibles and market conditions or other circumstances that are ‘not capable of being owned, controlled or transferred by a single enterprise’ – such as features of local markets, level of disposable income, size or relative competitiveness of the market and group synergies. Moreover, the Discussion Draft argues that goodwill and going concern value (with certain exceptions) should not be considered separately as intangibles for transfer pricing purposes, but rather taken into account as part of other business assets. Nevertheless, the OECD considers that these factors may affect the determination of prices and should be considered in the comparability analysis or adjustments.

The Discussion Draft goes on to clarify that, indeed, not all intangibles are valuable and certainly not all deserve a separate compensation or give rise to premium returns in all circumstances (e.g. non-unique or easily accessible know how). Contractual agreements and legal registrations continue to be seen as a valid and necessary starting point for assessing ownership concepts. However, the actual conduct of the parties and substance of the transactions involved remains the key test in allocating entitlement to intangibles-related returns. Here, the Discussion Draft takes guidance from Chapter IX of the Guidelines to stress the importance of notions such as ‘control over functions (and risks)’. In other words, ownership of intangibles needs to stem from the performance (including having the requisite capability or capacity) and control (and when outsourced to affiliates or third parties, the oversight and management responsibility) of the important functions related to the ‘development, enhancement, maintenance and protection’ of the intangible (and bearing the necessary costs and risks thereof). Conversely, where a party passively bears costs related to the IP but does not control the risks or critical functions related thereto, ownership of the intangibles (and the related returns) should not be attributable to such party. Any determination should be supported by a rigorous comparability analysis as such activity could equally have been outsourced to a third party (that as a matter of principle would not create intangible ownership). As part of such assessment, the Discussion Draft also integrated a form of a ‘bright line test’ where a taxpayer should evaluate whether or not a party has borne costs and risks or performed functions disproportionately as compared to independent parties.

The Discussion Draft provides guidance on factors to consider in the characterisation of intra-group intangible transfers. It distinguishes between two broad classes of transactions involving the use of intangibles. In the first type of transaction, intangibles

The work of the OECD

are used by one or both parties to the controlled transaction in connection sales of goods or services but there is no transfer of intangibles. The second type of transaction involves situations in which the rights to intangibles are transferred as part of the controlled transaction. Attention is also drawn to ‘combinations of intangibles’, the (artificial segmentation) thereof and the link with the choice of transfer pricing methodology and tested party. In certain situations, bundled transactions are sufficiently unique that it may not be possible to identify comparable transactions. In some cases, it may be necessary to ‘segregate the various parts of the package of services and intangibles for separate transfer pricing consideration’. In other cases, one or more intangibles and/or services are ‘so closely intertwined that it is difficult to separate the transactions for purposes of a transfer pricing analysis’. Nuances have been highlighted through the use of examples in the consumer products, pharmaceutical and information technology industries.

One specific example provided in the Discussion Draft includes the transfer of the business rights including the transfer of both tangible and intangible assets including patents, trademarks and other brand intangibles held by the parent company and developed in a local country, B, to a newly formed subsidiary, Company S. The example emphasises that in determining the amount to be paid ‘for the tangible assets transferred with the licensed right to use the intangibles in country B, the goodwill and going concern value of the business transferred to Company S should be taken into account’.

The Discussion Draft confirms the principle that associated enterprises do not necessarily ‘organise their affairs’ in a similar manner to independent parties. Considerable attention has been given to comparability analysis and the two-sided approach, where the Chapter IX ‘Business Restructurings’ test reoccurs – in the form of the notion of ‘options realistically available’. Taking into account the more stringent standards on comparability in the context of transactional comparables, the Discussion Draft then addresses the selection of transfer pricing methodologies (including the use of the transactional profit split method) to evaluate different transactions as well as situations with and without comparables to some detail. However, the OECD cautions against the adoption of a transfer pricing methodology that ‘too readily assumes that all residual profit from transactions after routine returns’ should necessarily accrue to the owner of the intangibles or the party entitled to the returns on the intangibles. Instead, the Discussion Draft calls for, among other things, a thorough understanding of the group’s value chain, business process and the interaction of the two with the intangibles. A clear message to taxpayers from the Discussion Draft is to devote proper time and effort to the functional analysis as part of the comparability assessment.

Financial valuation methods continue to be a discussion point. While such valuation methods continue to be available to taxpayers, the OECD noted that certain accounting principles under financial valuation methods may be inconsistent with transfer pricing principles. In particular, ‘valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing analyses’. It further emphasises that the selection of valuation methods will need to be based on robust and consistent underlying assumptions (such as purpose, financial projections and other indices). Industry ‘rules of thumb’ are discouraged. Consistently, the Discussion Draft takes a dim view of cost-based approaches to measure the value of partially or fully developed intangibles as unreliable.

Considerable discussion is also devoted to the application of valuation methods that use discounted cash flows. The Discussion Draft expresses concern about the use of financial projections which extend past the point where a business enterprise can realistically forecast income and expense and questions the accuracy of constant growth assumptions that fail to account for business cycles and other relevant fluctuations to the business of the company or the industry as a whole. Discount rates used in valuation analyses must be tailored to reflect the risks associated with the discounted cash flows and the use of the company's weighted average cost of capital as the default discount rate is discouraged. Where small changes in discount rates produce significant variations in results, taxpayers are instructed to develop ranges of values based on reasonable variations such as discount rate assumptions.

The Discussion Draft clearly recognises that, in most cases, intangible assets have finite lives. It cautions that the lives assumed for purposes of the transfer pricing analysis must also be consistent with lives used for other business purposes. Certain intangibles will contribute to creation of non-routine profits by future intangibles and the valuation analysis of such intangibles must take this into consideration. Importantly, while some intangibles may have indeterminate lives, it does not mean that they are expected to produce non-routine returns indefinitely.

Reconciliation of pre- and post-tax cash flows appears to be a point of struggle for the OECD. The Discussion Draft emphasises that 'prices for transfer pricing purposes must typically be determined on a pre-tax basis'. However, explicit acknowledgment is also made that the 'specific tax situations of the transferor and transferee' are relevant to the analysis and that 'it is important to take into account the perspectives of the parties to the transaction in this regard and to consider how unrelated parties might account for the relative tax advantages or disadvantages faced by the transferee following the transfer' in determining the arm's-length price. Moreover, in the subsequent example provided involving the use of an application of the discounted cash flow approach, the analysis is done on an after-tax basis from the perspective of both the transferor (at a tax rate of 30%) and the transferee (at a tax rate of 10%) yielding a range of possible results.

As suggested by the business commentators, the OECD has included over 20 examples to provide practical guidance on the appropriate application of the principles contained in the Discussion Draft. The comment period following the release of the Discussion Draft ended 14 September 2012. The OECD has signalled that transfer pricing is a high priority and more follow up to the Discussion Draft is likely in the near term.

The OECD and the new United Nations transfer pricing manual

On 2 October 2012, the United Nations released its *Practical Manual on Transfer Pricing for Developing Countries* (UN Manual). While largely similar to the OECD Guidelines, the UN Manual is specifically tailored to address the needs and concerns of developing countries, most of whom are not OECD members. Prior to the UN Manual's release, at the OECD International Tax Conference sponsored by The United States Council for International Business held in Washington, D.C. in June 2012, some audience members expressed scepticism about the practical guidance regarding transfer pricing being given to developing countries by the UN. Specifically, there was concern that the work of the UN might fuel theories on transfer pricing among developing countries that are at odds with the conventional interpretation of the arm's-length standard. Speaking for

The work of the OECD

the OECD, Pascal Saint-Amans, the new Director of the OECD's Centre for Tax Policy and Administration (CTPA), stated that he did not see the UN Manual as a competing set of standards from the OECD Guidelines. Given the newness of the UN Manual, it is premature to speculate as to the impact or acceptance it will have as compared with the prevalence of the OECD Guidelines.

4.

Establishing a transfer pricing policy – practical considerations

Arm's-length pricing – market prices

By definition, use of the arm's-length standard to determine inter-company prices demands an examination of the market conditions surrounding both the inter-company and unrelated party transactions.

Market prices are driven by the characteristics of the particular transaction. For instance, a product that is sold with a well-known and highly valuable trademark sells at a premium compared with a product that is identical in every respect, except that it is sold with an unknown trademark. In this case, additional profit accrues to the owner/developer of the valuable trademark. The premium for the market leader may well decline over time, provided that the unknown brands can establish reputations for quality and value for money.

An example to consider in this area is the way in which prices for personal computers, branded by leading manufacturers such as IBM, Dell and others, have been driven down as the reliability of inexpensive clones has improved. By way of a further example, a distributor that provides marketing and technical support to its customers should be able to earn a higher profit margin than a distributor that does not provide these services.

These two examples illustrate the basic principle that prices in third-party situations are determined by the facts and circumstances present in any given situation. Similar factors apply in an inter-company situation. In the latter case, a functional analysis must be performed to identify which party is responsible for manufacturing, research and development (R&D), materials purchasing, logistics, sales, distribution, marketing, after-sales service, etc. Once these facts are known, the entities can be characterised as manufacturing-type companies, sales/distribution-type companies, contract R&D companies, service providers, etc. as appropriate. From the characterisations, the analyst may look to comparable companies operating independently in the open market. The next step is to determine the method to be used for transfer pricing within the group. It is interesting to consider how prices are set in comparable unrelated party situations as, in many jurisdictions, it pays dividends to mimic the mechanism used as far as possible. However, it is not easy to identify how independent companies set their trading prices. Instead, the data usually available concerns the results of these transactions. In such cases, the inter-company transfer price will be based on the most appropriate method in all the circumstances and will try to emulate as clearly as possible financial results observed from the independent trading situation.

Obviously, if the facts change, the characterisation of the entities involved in the inter-company transactions will change accordingly and the prices used in the inter-company transactions must be adjusted. Consequently, the first step in establishing a transfer pricing policy must be to gather all the relevant facts and circumstances surrounding

Establishing a transfer pricing policy

a particular inter-company transaction. These facts can be summarised in three categories: functions (*see Functions, below*), risks (*see Risks, below*), and intangible and tangible assets (*see Intangibles, below*).

Functional analysis

Functional analysis is a method of finding and organising facts about a business in terms of its functions, risks and intangibles in order to identify how these are allocated between the companies involved in the transactions under review.

To obtain a comprehensive understanding of the facts surrounding the inter-company transactions, it is necessary to gather information from numerous sources. Firstly, operating employees within the multinational must be interviewed to obtain in-depth information regarding functions, risks and intangibles of each legal entity. These interviews identify further areas for review, including relevant contracts and financial data. Secondly, industry experts and publications about the industry must be consulted to understand standard operating practices within the industry as well as the relative values of the intangibles involved in the transaction.

Interviews

The analyst obtains much information about the criteria under review through interviews. She/he should draw up a list of key employees who are able to state clearly what functions, risks and intangibles are relevant to the operations for which they are responsible. Personnel from each entity involved in the inter-company transactions should be interviewed. It is important to hear all sides recount the facts. Frequently, human perspectives are different, particularly when the individuals involved are working at corporate headquarters or at a subsidiary. Hearing all sides allows the analyst maximum opportunity to determine the truth of the inter-company relationship and hence the most appropriate transfer pricing policy to fit the circumstances.

On-site interviewing is preferable to questionnaires or telephone conferences. Questionnaires are subject to many interpretations, are usually inadequately completed and make it impossible to determine the tone of the response (i.e. the nuances of the relationship). Furthermore, questionnaires make follow-up questions difficult.

Another non-tax reason for interviewing all affected parties is that the implementation of new transfer pricing policies can be highly controversial within a company. When all parties feel that they have played a role in the proper determination of a transfer pricing policy, it is usually easier to deal effectively with the political problems, which inevitably arise.

As the functional analysis progresses, certain persons may be added to, or deleted from, this list of intended interviewees, as appropriate. Appendix 1 provides a list of questions that may be used as a starting point to design the interviewing process. These questions should not be viewed as covering every area of importance. During the interview process, various questions are discarded and many more added so that a thorough understanding of the facts is obtained.

The interviews typically cover the following topics, as they apply to each entity involved in the manufacture and distribution of products as well as performance of inter-company services:

- Manufacturing functions: production scheduling, production process, materials purchasing, supplier approval, personnel education and training, quality control procedures, quality control implementation, reporting relationships, process technology and improvement.
- Marketing functions: strategic marketing plans, advertising, trade shows, sales force, the relative autonomy of various entities in marketing the company's products, forecasts, selling techniques, key marketing personnel, new market penetration, reporting relationships, training.
- Distribution functions: warehousing and distribution, inventory, warranty administration, third-party distributor relationships.
- Administrative, management or other inter-company services performed on behalf of other related parties and/or third parties.

Other information or documents required

In addition to carrying out interviews, analysts should examine documents and other information from the entities. This information includes: organisation charts; existing inter-company pricing policy statements; inter-company agreements such as licences and agreements covering distribution, R&D, cost-sharing, management services, etc.; and product and marketing information. Examples of product and marketing information include product brochures and literature, stock analyst reports, trade press articles, in-house news publications, reports on competitors, advertising literature and information regarding customers. This information aids in understanding the information gathered at interview and the economics of the markets in question.

Note that the company itself is not the only source of information to the person conducting the functional analysis. The analyst should also gather information on trade associations, competitors, academics, etc., to learn as much as possible about the company, its industry, its products and the markets it serves. These days, it is also likely that information of relevance is publicly available on the internet (as the internet is accessible worldwide, tax authorities are also making use of the available data in the conduct of their transfer pricing investigations).

Functions

Functions are defined as the activities that each of the entities engaged in a particular transaction performs as a normal part of its operations. Table 4.1 provides a list of some typical business functions. In general, the more functions that a particular entity performs, the higher the remuneration it should earn, and its prices should reflect this.

It is not enough simply to determine which entity has responsibility for a particular function, risk or intangible. The proper development of a transfer pricing policy requires that the transfer pricing analyst also determines the relative importance of each function in that transaction, industry and market. For instance, it is common in many industries for a foreign distribution subsidiary to be responsible for marketing and advertising, as well as distributing the parent's product. However, marketing and advertising activities may be far more important in the consumer goods market, where products may be differentiated by image and brand name recognition, than in the chemical industry, where the company's name may be of limited importance compared with the specific chemical properties of the product.

Several functions are particularly important in the context of a manufacturing company. The first is the materials purchasing function. For instance, does the parent

Establishing a transfer pricing policy

corporation purchase raw materials on behalf of its manufacturing subsidiary and then consign those materials to its subsidiary, or does the subsidiary purchase its own raw materials? The selection of materials will naturally have a significant impact on the price and quality of the finished goods, the reliability of supply and other areas of the business process.

Another major function in manufacturing is production scheduling. Does the parent corporation tell its manufacturing subsidiary what to produce, how much to produce and when to produce it, or does the subsidiary plan its own production schedule?

Quality control is also an important area. The analyst must determine which legal entity is responsible for establishing quality control policies, the implementation of those policies and the monitoring of their differences. Does the manufacturing subsidiary have limited control over the policies that it uses, or does it develop and implement its own quality control procedures?

Table 4.1 Typical business functions

Product research, design and development	Electronic data processing
Purchasing materials, supplies and equipment	Public relations
Controlling stocks of raw materials and finished goods	Production planning and scheduling
Developing and administering budgets	Industrial engineering
Quality control	Management and supervision of offshore operations
Production of finished goods	Manufacturing site selection
Packaging and labelling of products	Administrative services
Sales	Government affairs
Marketing	Finance and control
Shipping of products to customer	Accounting services
Facilities engineering	Arranging product liability insurance
Personnel	Establishing and controlling pricing policy
Manufacturing engineering	Technical service
Maintenance: building, grounds and equipment	

Risks

A significant portion of the rate of return (ROR) earned by any company reflects the fact that the business is bearing risks of various kinds. Table 4.2 provides a list of some potential business risks.

Market risk relates to the potential loss that may be associated with selling in an uncertain marketplace. If a parent company has made arrangements to protect its manufacturing subsidiary so that it does not incur operating losses if it encounters adverse market conditions, then the subsidiary should sell to affiliates at considerably lower prices (and earn lower levels of profit) than if it bears the full risk of market fluctuations. In such a case, the plan will probably have been for the marketing subsidiary to carry the risk of the market. It is particularly important to document this fully and to ensure that the marketing company has sufficient capital resources to support the risk it is taking. This should assist in fending off a tax authority attack on losses contained in the marketing company (tax authorities often tend to assume

that such companies do not carry the risk of the market and therefore seek to disallow losses accruing in this way).

Table 4.2 Typical business risks

- Market risk
- Inventory risks: raw materials, work in progress and finished goods
- Defective products and warranty
- Credit risk
- Product liability risk
- Foreign exchange risk
- Environmental risk

There are various ways to judge whether market risk exists. One way is to determine the time in the product development cycle at which manufacturing responsibility for the product was transferred to the subsidiary by the parent company. For example, if the product is first manufactured by the subsidiary immediately after it leaves the group's pilot manufacturing plant, then the manufacturing subsidiary has considerably more market risk than if the product had been manufactured first by the parent and was firmly established in the marketplace at that time.

The extent of market risk depends also on the degree of competition and economic structure in the market. For instance, where the parent has limited competition in a particular industry, the manufacturing subsidiary may face considerably less market risk than if it faced stiff competition from several companies that produce close substitutes for its product.

The existence of limited competition within a particular industry or product sector can arise from a number of factors. Barriers to entry by new firms, such as government regulation or the need for an extremely large initial investment (the development and commercialisation of new drugs in the ethical pharmaceutical market is a good example). Even if there is more than one firm in the industry in question, a company can establish a competitive advantage by developing a patent or proprietary know-how that essentially bars or inhibits competition in a particular product or market. If such barriers exist, they can have a material impact on the degree of market risk faced by a particular firm.

Market risk can also vary with the sensitivity of the industry to general economic conditions. The performance of some industries, such as the automotive industry, varies dramatically over the business cycle. When the economy is in recession, these industries are in recession, and when the economy is booming, so too are they. Other industries, such as pharmaceutical and medical supplies, may be more immune to the impact of fluctuations in the national or world economy. People fall ill and suffer injury during good and bad times alike. As a consequence, the protection that a parent may provide for its subsidiary against market risk can be significantly more valuable in some industries than in others. It depends on the market structure and the underlying demand profile for the product.

Inventory risk is another factor that should be investigated in every transfer pricing study. Both raw materials and finished products inventory risk are particularly important, but work in progress may also be material (for instance, the value of work in

Establishing a transfer pricing policy

progress for a whisky distiller, which needs to age the stock for many years before it can be sold as premium aged Scotch).

If a company wishes to maximise profits in a manufacturing subsidiary, it must be prepared to take all write-offs associated with inventory in that subsidiary. This responsibility reduces profits in the year of the write-off; however, that experience can be used to demonstrate to a tax authority that inventory risk lies within the subsidiary. Some manufacturers rarely own any raw materials or finished goods; their inventory risk is minimal or nonexistent. On the other hand, some manufacturers do face inventory risk since they typically purchase raw materials, schedule production and hold a stock of finished goods. In short, inventory risk is a critical component of the risk assumed by parties engaged in an inter-company manufacturing transaction.

Other important risks include defective product, warranty and environmental risks. If a product is returned as defective by the final customer, for instance, who bears the cost of that return? Is it the company that distributed the product or the foreign manufacturer? Who bears the warranty costs? If an environmental accident occurred at the manufacturing subsidiary, which party would bear the cost of the clean-up? With increased attention being paid worldwide to environmental problems in virtually every industry, it is becoming increasingly important to develop a clear understanding of which party assumes this risk and how these risks vary across countries.

It is also important to consider how contract law might be used to deal with the location of risk in this area. For instance, it might be that a manufacturing operation is obliged by local law to be responsible for all environmental risks associated with its activities. However, its parent company might be able to establish indemnity arrangements to cover this risk, effectively shifting the local, legally imposed risk to another jurisdiction.

It is important to recognise that risks can vary markedly across industries and geographic markets. In some businesses, there is no credit risk because customers are required to pay before delivery is made. The retail trade is often operated in this way. By comparison, in other industries it is standard practice to request payment within three to nine months of delivery. Differences in judicial systems across countries can mean that, within a given industry, underlying product liability risk is a much more significant factor in one geographic market than another.

Intangibles

Table 4.3 provides a list of typical intangible assets.

Table 4.3 Typical intangible assets	
• Patents	• Copyrights
• Unpatented technical know-how	• Technical data
• Formulae	• Ability to provide after-sales service
• Trademarks and brand names	• Customer list
• Trade names	• High-calibre personnel, such as a strong sales force
• Licences	

Intangibles are ordinarily divided into two categories: manufacturing and marketing. Manufacturing intangibles are characterised as one of two types – patents or nonpatented technical know-how – and arise out of either R&D activity or the production engineering activities of the manufacturing plant.

Marketing intangibles include trademarks, corporate reputation, the distribution network and the ability to provide services to customers before and/or after the sale. This category of intangibles is very broad indeed, and regard must be had to the question of ownership of such assets as well as to their maintenance and development.

It is not necessary that the asset appears on the balance sheet for it to have significant value for transfer pricing purposes. The accounting practices that apply to particular categories of asset vary enormously from one country to another and any apparent balance-sheet value may therefore be of little relevance. For instance, goodwill arising on the acquisition of a highly successful business might be written off immediately or carried forward and depreciated over 40 years, depending on the accounting practice adopted in the acquiring country. In both cases, the goodwill might, in reality, be an appreciating asset.

It must be determined which intangible assets play a role in the transaction under consideration, as well as their relative values. Specifically, the transfer pricing analyst must determine which type of intangible – manufacturing, marketing, or both – accounts for the success of a particular product. Does the product's design explain its success? Or is it the company's ability to deliver the product when promised? Or is it the company's trade name? In this connection it must be borne in mind that all marketing intangibles are not created equal. A trade name that is well-known and thus valuable in one market may be completely unknown and of no initial value in another market.

The return earned by the various entities should vary directly with the importance of the functions performed, the degree of risks undertaken and the value of intangibles provided. Looking at the production intangibles, is it a proprietary manufacturing process that enables the company to produce goods at 20% below the cost of its nearest competitor? Or is it a combination of this and other intangible assets?

Companies that have developed valuable proprietary manufacturing know-how may decide not to patent the technology for fear of making the process known to competitors. This know-how can range from design changes made on a standard machine to a more efficient plant layout, to an innovative production process. A particularly pertinent question to ask when visiting a plant is whether there is anything in the plant that the company would not show to a competitor. If the answer is yes, the analyst may have found a valuable manufacturing intangible, though further investigation would be necessary to establish who developed the know-how, its value to the company, etc.

Characterisation of businesses

Characterisation of the related parties is an important component to a transfer pricing analysis and is typically used as the foundation in developing the economic analysis. Characterisation of businesses means making comparisons of the functions and risks of the related entities under review and comparing those to uncontrolled entities that

Establishing a transfer pricing policy

exist in the same or similar industry. Such characterisation involves using information from the functional analysis and information about the industry.

Contract manufacturers and fully fledged manufacturers

There are two general characterisations of manufacturing businesses: the contract manufacturer and the fully fledged manufacturer. (A subtype of contract manufacturing is toll manufacturing, whereby the contract manufacturer does not take legal title to the raw material or products manufactured.) Both contract and fully fledged manufacturers are found in almost all industries, an important point because the ROR received by contract manufacturers is generally significantly lower than the ROR received by fully fledged manufacturers (see Table 4.4).

Contract manufacturers provide manufacturing services to fully fledged manufacturers. They do not develop their own product lines but offer expertise in performing certain manufacturing functions only. They may or may not perform such functions as materials purchasing and production scheduling or own the inventory (raw materials, work in progress and finished goods). Over the course of a contract, they do not face direct market risk because they have a guaranteed revenue stream from the customer with which they are under contract. They may be remunerated on a fee basis (cost-plus), or on a pre-established price per unit (which will probably have been determined on a cost-plus basis). The contract manufacturer's intangibles are limited and typically consist of know-how pertaining to the manufacturing processes.

Fully fledged manufacturers develop their own product lines and may have substantial R&D budgets or may obtain the technology they require through licences. They perform all manufacturing functions, such as vendor qualification, materials purchasing, production scheduling and quality control procedures. Also, they are typically extensively involved in marketing to the ultimate customers (or end-users) of the product. They bear several types of risk, including inventory risk and market risk.

Table 4.4 below summarises the critical features that distinguish contract manufacturers from fully fledged manufacturers. As a general rule, manufacturing companies within a multinational group do not fall precisely into one or other category; rather they gravitate towards one end or the other. Identification of the differences between the model and the multinational's circumstances provides information that can be used in adjusting potential comparables to create a justifiable inter-company price. (Of course, it is possible to determine the risks incurred by a contract manufacturer within a multinational and also to determine the functions it performs. This offers the group considerable flexibility of structure and hence tax-planning opportunities.)

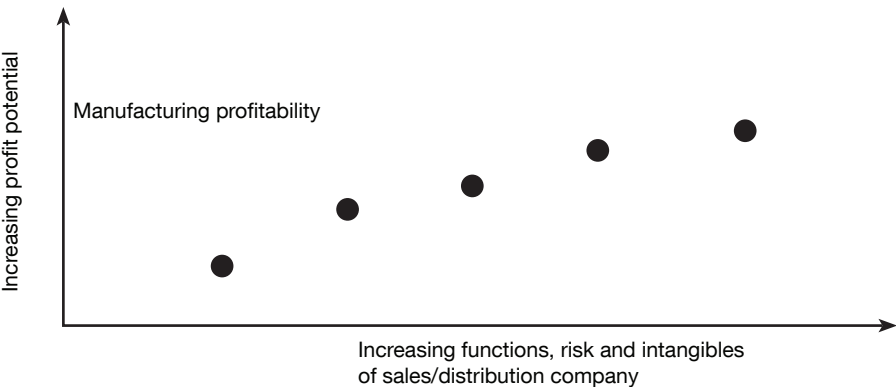
Table 4.4 Characterisation of manufacturing entities

Contract manufacturer	Fully fledged manufacturer
Does not own technology	Owens technology
Little risk	Full of risk
	Purchasing
Little discretion in production scheduling	Production scheduling
Does not totally control equipment	Select own equipment scheduling
Scheduling	
Quality control usually dictated	Direct control over quality by customer

Table 4.4 Characterisation of manufacturing entities

Usually manufacturing high-volume,
mature products

Manufacturing products at all high-volume,
mature products stages of product life cycle



Note that, as shown in the diagram above, greater functions/risks may not only have greater profit potential but may also have greater loss potential.

Characterisation of distribution/selling companies

The four general characterisations of distribution/selling companies are, in order of increasing functions, manufacturer’s representative (or commission agent), limited distributor, distributor and marketer/distributor. This characterisation is important because the prices paid/profits earned vary, sometimes considerably, between these various types of selling entities, with the manufacturer’s representative earning the least profit of all.

A manufacturer’s representative does not take title to the merchandise it sells. It bears neither credit risk nor inventory risk. It does not have any marketing responsibilities and is typically paid a commission based on the sales revenue it generates for the company it represents.

A limited distributor takes title to the merchandise. It has limited inventory risk and credit risk. It has limited marketing responsibilities but typically does not bear foreign-exchange risk on purchases from its suppliers.

A distributor takes title to the merchandise, bears credit risk and inventory risk. It has limited marketing responsibilities, and may or may not have foreign-exchange risk.

A marketer/distributor takes title to the merchandise, has credit risk, inventory risk and may have foreign-exchange risk. It has total marketing responsibility for its product lines, including, generally, the determination of marketing strategy for its market. This typically occurs in inter-company situations where the subsidiary is mature or where it is located in a different time zone from the parent company or where, for cultural reasons, the parent is unable to compete effectively in the foreign marketplace.

Establishing a transfer pricing policy

Table 4.5 summarises the salient characteristics of each type of sales entity and indicates their relative profitability.

Goals of the multinational corporation

A company's financial goals are important considerations in developing a transfer pricing policy because it is often possible to achieve them through transfer pricing.

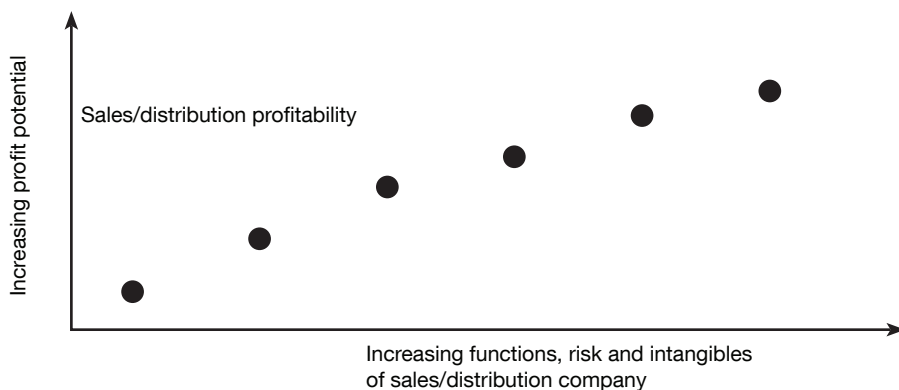
Financial goals include managing cash flows, supporting R&D, funding capital expansion, paying interest on debt, meeting tax liabilities in accordance with overall group tax strategies and funding dividend payments to shareholders. Satisfying each requires placing income in the legal entity where the funds are ultimately required and transfer pricing can be used to move funds as required, so long as the substance of the relationship between the related entities supports the policy adopted. It may be possible to achieve this result by altering the previous arrangement of functions, risks and intangibles within the group.

A company may have overriding business reasons for wanting to place functions, risks and intangibles in certain locations. For example, the goal may be to rationalise global production, or centralise management, financial and marketing functions to improve efficiency and reduce costs, or it may be necessary for a variety of reasons to manufacture the product within the market in which it will be sold. These reasons may include transportation costs, legal requirements that a product be manufactured where it is sold, customs and indirect tax reasons, etc. The realisation of these goals has implications for the transfer pricing policy adopted by the group.

A key goal of most multinationals is to minimise the global tax charge. Corporate income tax rates vary across countries and form an important consideration in establishing a transfer pricing policy. Because the arm's-length standard for transfer pricing requires that pricing, and so profit, be based on the substance of a transaction, corporate restructuring, which places important functions, risks and intangibles in jurisdictions that have lower tax rates, results in a lower overall tax rate for the group, maximising earnings per share. Some examples of these possible restructuring techniques are set out in sections 412–419.

Table 4.5 Characterisation of distribution/selling companies sales/distribution profitability

Manufacturer's representative	Limited distributor	Distributor	Marketer/Distributor
Does not take title	Takes title	Takes title	Takes title
No credit risk minimal/parent controls policy	Credit risk	Credit risk	Credit risk
No inventory risk	Inventory risk minimal Inventory risk	Inventory risk	Inventory risk
No marketing responsibilities limited	Marketing responsibilities	Marketing responsibilities limited	Total marketing responsibilities
No FX risk	No FX risk	May or may not have FX risk	May or may not have FX risk



Note that, as shown in the diagram above, greater functions/risks may not only have greater profit potential but may also have greater loss potential.

Manufacturing opportunities

It is self-evident that the more income that can be placed in subsidiaries located in low-tax jurisdictions, the lower will be the multinational corporation's effective tax rate. In recent years, the effective use of tax havens has become increasingly difficult as tax authorities have found ways of attacking taxpayers' planning schemes. However, in many instances the use of tax havens continues to be beneficial, if carefully planned. The key to success is to be certain that the low-taxed affiliate is compensated properly in respect of the functions, risks and intangibles for which it is responsible. In this way, offshore profits that are not taxed directly by anti-avoidance laws (such as the US subpart F or the UK controlled foreign companies legislation) may remain offshore, tax-free.

Manufacturing in tax havens is desirable only when it makes commercial sense. For example, if a company can serve a certain geographical region from a single manufacturing location (for example, a plant located in Ireland to serve the European market) and the tax haven has the infrastructure, the labour force, etc. needed to support the manufacturing activity, then manufacturing in the tax haven is plausible.

To place as much profit opportunity in the tax haven as possible, the manufacturer should be a fully fledged rather than a contract manufacturer (although there is normally a risk of loss as well, depending on the economics of the business). This can be contrasted with the situation where, if manufacturing in a high-tax jurisdiction is necessary for commercial reasons, it may be possible to structure the activity as a contract manufacturer (if established this way at the outset), thereby minimising the income that must be reported in that jurisdiction.

Centralised support activities

Many multinationals, responding to the globalisation of business, have centralised certain support services in an attempt to minimise costs. In various situations, support activities can be placed in low-tax jurisdictions to reduce the total income subject to tax in higher tax jurisdictions. For example, trading companies can be used to centralise foreign-exchange risk and/or worldwide inventory control. Trading companies can be placed in any country where the requisite substance can be established.

Establishing a transfer pricing policy

Support activities, such as accounting and marketing, can be centralised in a low-tax jurisdiction and affiliates can be charged for the services rendered. Typically, these entities are limited to charging their costs plus a markup. Nevertheless, this is a means of reducing income in higher tax jurisdictions, provided that the service entities do have the substance needed to support the charges made. In practice, the absence of good communications and an appropriately qualified workforce is often a real barrier to shifting important support functions to pure tax havens. Opportunities exist, however, in using low-tax vehicles located in more mainstream countries, such as the Belgian Coordination Centre. However, both in the context of Ecofin Code of Conduct and EU state aid developments, it was decided that the regime will be safeguarded until 2010 and that, in any event, no refund of tax savings would be required. As an alternative regime, many groups are contemplating the use of the Belgian notional interest deduction related to equity funding of Belgian enterprises. This incentive consists of granting business relief for the risk-free component of equity and is available to all Belgian enterprises, so as to avoid any challenges on the deemed selective nature of the measure.

Selling companies

As a general rule, selling companies are located close to their customers, often in high-tax jurisdictions. If the multinational is actively seeking to minimise its worldwide tax rate, it may be possible to reduce the level of income that must be earned by a given selling entity. For example, if the reseller operates as a marketer/distributor, possibly the marketing function could be moved to a central location and thereby remove marketing income and related intangibles from the high-tax jurisdictions. Alternatively, it may be possible, in certain limited circumstances, to set up the marketing activity as 'contract' marketing (if done at the outset) so that the marketer is paid on a cost-plus basis for the marketing activity performed. An important consideration is that this arrangement is established before any marketing intangible is generated to ensure that the contract service provider is economically limited to the remuneration that it receives for performing such contract services. In other words, there is no pre-existing marketing intangible that it may have created before entering into a contract service.

Contract service providers

In addition to contract manufacturers (*see Contract manufacturers and fully fledged manufacturers, earlier in this chapter*), there are other types of contract service companies – these include contract R&D and contract marketing. Such entities are typically established for commercial reasons and can be structured as service providers to minimise tax or to place ownership of valuable intangibles created by the R&D or marketing activity in a central location.

Contract research and development

Contract R&D firms provide facilities and personnel to assist their customers (typically a fully fledged manufacturer or a parent company's R&D activity) in developing intangibles. As long as they honour the terms of the contract, they do not bear the risk that their R&D may not lead to a commercially successful product or application, nor are they entitled to the profits of exploiting viable new ideas or products developed under the contract. (This technique was found to be acceptable in a US tax case – *Westreco, Inc. v Comr.*, 64 TCM (CCH) 849 (1992).)

This construction is useful in the inter-company pricing context when the parent wishes to conduct R&D in several countries, but wishes to retain legal ownership of the

intangibles (and therefore the profit created by the R&D) in a single country. Contract R&D places the risk in the country that will ultimately own the technology.

Example

Militia Inc. is a US corporation that develops, manufactures and markets industrial applications for use in the defence, aerospace and automotive industries in the US and internationally. The company recently established Militia Canada Company, a wholly owned Canadian subsidiary to develop and manufacture certain raw materials that are needed to manufacture Militia Inc.'s products. The original manufacturing process and know-how for these raw materials was developed in the US and was transferred to the Canadian subsidiary. Currently, all of the intellectual property resides in the US regarding the development and manufacture of these raw materials. However, as Militia Canada Company begins operations, the company believes it will be most efficient to have its Canadian subsidiary conduct all the research and development activities for these raw materials.

The management of Militia Inc., however, also believes that maintaining legal ownership of all intellectual property in the parent company maximises the company's ability to protect and defend this property from predators. The decision has therefore been taken to place all economic and legal ownership of intangibles in the parent company. In addition, the parent's vice president in charge of R&D will be assigned to coordinate and manage the R&D activities of Militia Canada Company.

In this situation, a contract R&D arrangement would allow the group to maintain economic ownership of intangibles in the parent company. Militia Inc. will effectively employ Militia Canada Company to perform certain R&D functions under its guidance, paying them on a cost-plus basis and reserving all rights to the intangibles developed under the contract. By ensuring that an executive employed by Militia Inc. is overseeing the R&D operations of Militia Canada Company, the substance needed to defend the use of this technique (i.e. centralised decision-making from the parent) appears to exist. Documentation of this arrangement is critical.

Other reasons for establishing contract research and development

Contract R&D is a useful technique to employ when a subsidiary has special expertise available to it, which the parent wishes to exploit but where the subsidiary does not have funds available to cover the costs. By setting up a contract R&D arrangement, the parent company can finance the R&D activity that is conducted by the subsidiary. Similar to a contract marketing service provider, an important consideration is that this arrangement is established before any R&D intangible is generated to ensure that the contract service provider is economically limited to the remuneration that it receives for performing such contract services. In other words, there is no pre-existing R&D intangible that it may have created before entering into a contract service.

Example

Semi-Chips Inc. (a US company) has been manufacturing and selling custom-designed semiconductor equipment for semiconductor original equipment manufacturers (OEMs) in the US for ten years. It recognises that a vast majority of semiconductor OEMs (its direct customers) have moved operations to Asia. As such, the company has determined to establish a subsidiary in Taiwan to be closer to its customers. At the same time, the company has noticed that because of the large amount of

Establishing a transfer pricing policy

semiconductor manufacturing activities in Asia, there exists a great deal of technical expertise in Taiwan. Due to this fact, the company determines that it is more efficient for the Taiwanese subsidiary to also conduct R&D activities for products on its behalf.

The new Taiwanese subsidiary is capitalised by Semi-Chips Inc. with 1 million United States dollars (USD) and sets about hiring Taiwanese scientists to conduct the R&D. The subsidiary does not have the cash to pay these scientists; therefore, the parent establishes a contract R&D arrangement and pays the Taiwanese subsidiary its costs plus an arm's-length markup for its services.

Contract maintenance

Contract maintenance firms provide a labour force with the skills, instruments and tools needed to maintain or service equipment. These companies typically use special expertise, which is developed by the manufacturer of the product and provided free of charge to the contract maintenance company for use in servicing the manufacturer's customers. They are usually compensated on a cost-plus basis.

The application of this concept in an inter-company pricing context offers one method that may assist in controlling the profitability of a subsidiary responsible for selling products and providing an after-sales service to customers. The sales activities may be characterised as those of a basic distributor, while the service activity is treated as a contract activity and remunerated only on a cost-plus basis. The transfer of 'expertise' or the 'method of providing service' need not be compensated because the owner of the technology receives the entire service fee except for the return on labour, which is paid to the contract service provider. Great care must be taken in structuring these arrangements, and this technique may not be appropriate where the service activity is a crucial part of the overall sales activity, rather than a routine after-sales obligation.

Contract marketing

Contract marketers perform marketing activities on a contract basis. This technique is used in inter-company pricing situations to prevent the development of marketing intangibles in the affiliate that conducts the marketing activity. If the arrangement is established at the time marketing activities commence, the affiliate does not bear either the cost or the risk of marketing intangible development and therefore is entitled to none of the marketing intangible income earned in the future.

Example

Forever Young Inc. (FY), a US company, manufactures and sells cosmetics, body and skincare products and nutritional supplements. The company operates in the direct selling industry, using independent distribution networks to sell their products to end-consumers. After experiencing a tremendous success in the US market, the company decided to enter the international market. The company expects to repeat its success setting up subsidiaries in Germany and France. The company expects to derive a significant amount of revenue in the future from those markets, but would not like to place more income than is necessary in Germany or France for their sales support activities. Under a contract sales support and marketing arrangement, the subsidiaries in Germany and France would implement the marketing strategy, source all marketing materials from the parent and promote the business model in their local countries. All activities would be approved and supervised by the management of the parent company. The service providers would be compensated on a cost-plus basis for their

sales support and marketing activities. As a result, the parent company would arguably retain the economic ownership of the marketing intangibles in the local markets.

The evaluation of pricing options

This chapter has examined the way in which functional analysis can be used to characterise a business and has looked at some examples of particular ways in which operations might be structured. When evaluating the options available in particular circumstances, the facts may lead directly to a clear choice of pricing method. If this is not tax-efficient, changes need to be made to the functions, risks or intangibles in order to justify an alternative pricing structure. As the decision is being made, it is also necessary to determine how the local tax authority is likely to react so that any exposure can be quantified before opting for a particular structure. In order to do this it is vital to seek local advice to be certain that the structure will not lead to tax problems in any locations. This is especially true for companies that may be deemed to have intangible property.

The search for comparables

Once a pricing structure is chosen, arm's-length prices need to be computed. To do this it is necessary to conduct a comparables search, as it is only through comparable transactions that a business can objectively establish a clear basis on which to defend its transfer prices. Chapter 3 discussed the methods of determining transfer prices that are consistent with the OECD Guidelines. The following example illustrates how the process of selecting and evaluating comparables might work.

Example

Fishy Fish KK (Fishy Fish) is a Japanese company that manufactures, develops and distributes fishing rods, reels and tackle in Japan and internationally. Fishy Fish distributes its products within the US through its US subsidiary, Fishy Corp. (Fishy US).

Fishy Fish has to determine whether the transfer price for which it sells its products manufactured in Japan to Fishy US to distribute within the US market is at arm's length. After a thorough functional analysis has been carried out, it has been determined that Fishy US is a distributor that conducts limited additional marketing activity, similar to what an independent distributor would conduct. Fishy US is also determined to take on certain limited business risks, such as product liability risk, market risk and credit risk, but Fishy Fish is assessed to be the primary entrepreneur of the group, and therefore the primary risk-taker of the operation.

Further, it is determined that the fishing products are successful in the US market primarily because of the design and quality of the fishing equipment. Both of these attributes are the responsibility of Fishy Fish, the parent.

Fishy Fish now wishes to identify comparables that can be used to determine and support transfer prices between the manufacturing activity in Japan and the distribution activity in the US by Fishy US.

The preferred method of determining the price for this transaction is the comparable uncontrolled price (CUP) method. There are three methods of identifying a CUP for this transaction:

Establishing a transfer pricing policy

- The Japanese parent may have sold the same fishing equipment to an unrelated distributor in the US.
- The US subsidiary may have purchased the same fishing equipment from an unrelated manufacturer.
- An entirely separate operation, Company A, may have manufactured identical fishing equipment and sold it to Company B (unrelated to Company A), which serves as its distributor in the US.

Rarely do transactions such as these exist due to the stringent product comparability requirements. However, if it is possible to identify such transactions, it would be necessary to determine whether they could be applied directly or whether adjustments must be made to the CUP to account for elements of the CUP that differ from the related party transactions (*see Chapter 3, Resale price method*).

In the event that a CUP cannot be found, the most likely method that would be used in this example is the resale price method. To apply this method, it is necessary to identify distributors of fishing equipment (or, if these cannot be found, other sporting goods) in the US. These distributors must purchase their sporting goods from unrelated manufacturers. If these types of transactions are identified, income statements for the distributors need to be obtained and the gross margin (sales less cost of sales) for the distributors calculated. Adjustments must be made to the gross margin if there are substantial differences between Fishy Fish's relationship with its subsidiary and the relationship between the unrelated parties involved in the comparable transaction.

It should be recognised that Fishy Fish may sell fishing equipment to unrelated distributors within the US. In this event, it may be possible to use these relationships to determine an arm's-length discount to apply the resale price method. (While the CUP method would not apply because of differences in market prices across the US, distributor margins are frequently very similar across the US.)

In this example, the resale price method would be the next option to be sought. However, there may be difficulties in using what may appear to be an obvious solution. These include the following:

- There may be no published accounts for comparable distributors.
- If accounts are available, they may not disclose the gross margin.
- If gross margin is disclosed in the accounts, it cannot be analysed with sufficient certainty to enable reliable comparisons to be made with Fishy US's gross margin.

When these obstacles to using the resale price method cannot be overcome, as is often the case, the transactional net margin method (TNMM) under the OECD Guidelines or the comparable profits method (CPM) in the US transfer pricing regulations, discussed in Chapter 3, would most likely be applied. When using the CPM/TNMM, the degree of functional comparability between the tested party and the uncontrolled distributors is less than that required under the resale price method to obtain a reliable result. To search for comparables under the CPM/TNMM, a search for external comparable independent distributors with broadly similar functions as the tested party (i.e. Fishy US) using information obtained from the functional analysis, is conducted. Once this set of comparable companies is established, the profitability results of the distribution business of Fishy US are benchmarked against the profitability results of the uncontrolled distributors. If Fishy US profitability results fall within the range

of profitability results established by independent distributors, Fishy Fish should be treated as having reasonably concluded that its transactions with Fishy US were at arm's length.

Identifying appropriate comparables

It is crucial to bear in mind the underlying aim in searching for comparative information. A comparable can be used to support the validity of the terms of a transaction if, in commercial terms, it can be shown that third parties at arm's length have agreed terms similar to those set between the affiliates. A comparables search may be undertaken to identify CUPs, gross profit margins for use in applying the resale price method, cost markups for use in applying the cost-plus method or other information required to apply or support other pricing methods.

Comparables may be sought from a variety of sources and, broadly, fall into two categories: those that may be identified internally within the group and those identified from external sources, which reflect transactions not carried out by group companies.

Internal comparables

It is advisable to perform a thorough analysis of group transactions to ascertain whether any comparable transactions with third parties exist. Internal comparables may be preferable to external comparables for a number of reasons, including:

- They are more likely to 'fit' the affiliated transaction as they occur within the context of the group's business.
- More information about the comparable situation should be readily available.
- One internal comparable may be sufficient to support a defence of the transaction under review, whereas a wider base of support may be required if external comparables are used.

A broad perspective is required in reviewing the group's business for comparative transactions, as their existence may not be immediately obvious, as illustrated in the following example.

Example

Healthy Life Inc. (HLUS), a US manufacturer of medical devices, must determine transfer prices with its subsidiary in Ireland. The Ireland subsidiary (HLI) is a manufacturer that employs certain specific technologies from its parent company to manufacture its medical devices.

HLUS would like to identify comparable agreements that can be used to determine an appropriate royalty rate for the licence of its intangible property to Ireland. After discussions with HLUS management, it was discovered that HLUS licensed similar intangible property (under diverse agreements with third parties) compared to the intangible property used by Ireland in their manufacturing process.

The preferred method of determining the price for this transaction is the comparable uncontrolled price (CUP method using internal comparable licensing agreements. As a result, it is possible to construct a range of royalty rates using the internal licensing agreements for similar intangible property.

Establishing a transfer pricing policy

Identification of internal comparables may be made through:

- discussions with management of all the entities involved in the transaction, and
- review of the management accounts of the entities.

External comparables

Detailed information regarding transactions carried out by independent entities may not be easy to obtain, and the extent to which useful information is available varies from country to country.

The main sources of information regarding third-party comparables are as follows:

- Government (e.g. statutory public filing requirements and government trade department publications).
- Commercial databases.
- Industry associations.
- Knowledge of employees.

Of the many sources of information for conducting a search for comparable transactions, the most important source may be the operating personnel who know their industry and the characteristics of competitors. These individuals can frequently provide valuable sources of information about competitors and potential comparables.

Trade associations are also important because they publish trade journals or other helpful documents. In addition, many trade associations have conducted studies of the market and/or employ experienced industry experts who may provide a wealth of valuable information.

Online databases are useful for identifying potential comparables and obtaining financial information about them. Other business research resources may also be consulted, as necessary. Appendix 2 contains a list of some of the currently available resources.

To establish whether a comparable transaction is, in fact, appropriate, it may be useful to approach the third-party comparable to ask for help in comparing the relevant aspects of the transaction. Although, when approached for this purpose, third parties may be unwilling to discuss their business, in some instances, very useful information can be obtained.

The search for comparables, as well as adjustments that are made to those comparables, is an art rather than a science, for the information collected is rarely wholly complete or perfect; judgements must be made at many points during the process of analysis. For this reason, it is important to test the reasonableness of the results before finally determining appropriate transfer prices.

The test of reasonableness should be based on a financial analysis of the projected results on applying the comparative information (*see Financial analysis, below*).

Functional analysis and comparable information – an overview

While the process of completing a functional analysis of a business and identifying useful information on comparables should be detailed, it is imperative always to bear in mind the importance of the basic arm's-length principle that underlies the pricing review. For instance, it is easy to become so engrossed in the analysis of functions that this tool of information provision becomes confused with the methods of computing a transfer price. Functional analysis is not an alternative to searching for comparables; it is a way to establish what sort of comparables need to be sought.

Example

Never Fail Motor Co. (NFM) is a US-based manufacturer of electric motors used in a variety of applications, including the medical, aerospace and military industry. Customers of NFM are manufacturers that purchase NFM products to incorporate in their equipment and systems.

As part of its strategic business expansion, NFM acquires shareholding interest in Never Fail Computer Co. (NFC), a manufacturer of computer products, which could use NFM motors to create a new highly reliable computer product. Subsequent to the acquisition, NFM sells its motors to NFC to incorporate in NFC's new product. NFM charges NFC for the motor at a price comparable to the price of motors sold to its unrelated customers under similar contractual arrangements.

The functional analysis establishes that both NFM and NFC are manufacturers that develop and own significant non-routine intangibles and assumes entrepreneurial risks in their operations. The analysis further indicates NFC does not purchase similar products from unrelated parties. As a result, the sale price of products sold by NFM to its unrelated customers should be used as a comparable transaction. However, this transfer pricing policy results in a significantly lower profit on products sold to NFC.

While internal comparable transaction seems to exist based on the functional interview, the contradicting operating results is an indication that there are differences in the functions performed by NFM in its uncontrolled and controlled transactions. Further analysis shows that NFM performs additional custom design services for the motors sold to NFC. Such services are not required for products sold to unrelated parties. Therefore, the price of products sold to NFC should reflect these additional design services functions performed by NFM.

Documentation

Contemporaneous documentation is crucial in order to prove to the tax authorities that a transfer pricing policy is arm's length. In other words, if a company can show what its policy was, how it interpreted that policy and why the prices chosen satisfy the arm's-length standard, then the tax authority has little choice but to accept the policy. Companies that have not properly documented their policies are likely to face severe problems in the context of an intensive transfer pricing audit.

How to document a policy

In the past, little guidance was available on the appropriate level of documentation needed to support a transfer pricing policy. In many countries, the fact that the burden of proof lay largely with the tax authority gave little incentive for work in this area. However, the US provided a lead at the start of the 1990s, culminating in regulations

Establishing a transfer pricing policy

that impose heavy penalties for transfer pricing adjustments unless the taxpayer holds contemporaneous documentary evidence that it was reasonable to believe that the policy was in fact arm's length. As more tax authorities began to take transfer pricing matters seriously, it was recognised that documentation standards were important and new regulations have now emerged in many countries. The OECD also devoted attention to the matter in Chapter V of the Guidelines, which was part of the work published in 1995. As a general guide, however, a defensible transfer pricing policy requires documentation covering the following areas in order to demonstrate how the policy complies with the arm's-length principle:

- A description of the transfer pricing methodology used to test the arm's-length nature of the inter-company transactions.
- Guidelines interpreting the choice of the methodology.
- Inter-company legal agreements.
- Functional analysis of the entities involved.
- Comparables supporting the policy.
- Financial analyses of the comparables as well as the tested party.
- Industry evidence required to substantiate the decisions made.

Financial analyses

Thorough financial analyses and financial segmentations are crucial to the documentation of a transfer pricing decision, because they act as compelling evidence that the prices were set on a reasonable basis. The purpose of this exercise is to produce an income statement that reflects what the company's results would be if a particular business line were its only business.

Construction of transfer pricing financial statements (profit and loss (P&L) accounts and balance sheets) requires certain judgements to be made with respect to allocations and other issues. First, business lines have to be grouped and the statements constructed according to those groupings. Criteria that should be considered in grouping business lines are:

- Existing groupings (established based on industry practices, division or department, or for management purposes).
- Profitability (business lines that are 'big winners' should be analysed separately, as should business lines that are losing money or that are earning significantly lower income than other products).
- Materiality (do not form a separate business line grouping if the income/cost profile of the group is immaterial).

Once business line groupings have been formed, allocations of sales, general and administrative expenses must be made to each P&L account. This should include an allocation of R&D expenditure if, and to the extent that, such expenditure relates to the given product grouping. The allocations should be based on a reasonable methodology. Such a method will often be in current use, although in different contexts: for example allocations used for financial reporting, tax or management purposes.

To the extent possible, the chosen allocation method should first make direct allocations where particular expenses can be definitely and accurately matched to a specific business line. Then, indirect allocations of other expenses may be made on a

reasonable basis. (Examples of allocation bases for this purpose include sales, gross profit, volume and headcount ratios.)

The aim of this exercise is to produce an income statement that reflects what the company's results would be if a particular business line grouping were its only business. (One of the reasons for constructing such a statement is that when comparables are found, the results of one line of business may be compared with the results of independent companies that operate only that line of business.)

Similarly, balance-sheet assets should be allocated to correspond to the relevant lines of business.

Example

Continuing with the example in *The search for comparables* section, above, income statements for Fishy US are constructed. In 2007, sales to Fishy US are 80. Assume that Fishy US's sales to its customers during this period are 100. The following income statement reflects these transactions:

	Fishy Fish	Fishy US	Consolidated
Net Sales	\$80	\$100	\$100
Cost of sales	56	80	56
Gross income	\$24	\$20	\$44
Gross margin %	30.0%	20.0%	44.0%
Selling, general and administrative Expenses	21	18	39
Operating income (loss)	\$3	\$2	\$5
Operating margin	3.8%	2.0%	5.0%

Evaluation of financial analyses

There are many ways to check the reasonableness of a transfer pricing policy, all of which compare certain financial ratios for the related party transaction with their counterparts in the industry in which the multinational trades. This analysis must be tempered by knowledge of the unique characteristics of the inter-company transaction at issue and should never become mechanical.

Financial ratios that are selected are determined by the availability of reliable data as well as the particular facts of the transaction under review. For example, in some situations, a review of gross margins, operating margins and profit splits would be sufficient. In other situations, a review of return on assets (ROA) and operating margins may be appropriate. The decision regarding which ratios to examine must be made on a case-by-case basis, taking into consideration all the relevant facts.

Example

For Fishy US, it is determined that the appropriate financial ratios for evaluation purposes are gross margin and operating income/sales.

The gross margin for the manufacturer is 30% and the gross margin for the distributor is 20%. As previously mentioned, Fishy US is the tested party in our transaction since it is the less complex party and does not possess valuable intangible assets. Comparable

Establishing a transfer pricing policy

manufacturing margins are much harder to judge, primarily because of the return on intangible assets that they reflect.

Fishy US's gross margin is 20% and other comparable distributors of similar products in the US are found to have gross margins that range between 20% and 25%. Based on this data, it is likely that the determination will be made that the gross margin for Fishy US on the purchase of finished products to Fishy Fish is not unreasonable.

The operating margin for Fishy US is 2%. This ratio may be compared with the operating margin for comparable distributors of similar products.

Transfer pricing policy

A transfer pricing policy is a statement that the company is committed to the arm's-length standard for transfer pricing and should be included in the financial policies of the parent company. The statement need not be detailed, but should set out the philosophy upon which the company bases its pricing decisions.

Transfer pricing guidelines

Transfer pricing guidelines are detailed descriptions of the various inter-company transactions that exist within the group, together with the methods by which transfer prices will be determined for each of those transactions. Generally, guidelines do not include numbers for markups, discounts or royalty rates. Instead, they say the comparables (or whatever other means of computing the prices used) will be identified and prices will be determined annually (or semi-annually, or within whatever time frame is appropriate). The guidelines, therefore, constitute the 'formulae' by which transfer prices will be determined, based on the nature of the company's inter-company transactions.

Inter-company agreements

Inter-company legal agreements are a method of formalising the relationship between affiliated companies and might include distribution agreements, licence agreements, contract R&D agreements, etc. Each inter-company relationship that gives rise to a transfer price should be documented through a legal agreement.

In certain circumstances, these agreements can be disregarded by the tax authorities in certain countries (e.g. the US). In other countries (e.g. Germany), they are inviolable. The agreements enable a company to state, for the record, what it intends the inter-company relationship (characterisation of the entities) to be, and it is difficult in any country for the tax authority to disregard totally such agreements, especially if the functional analysis supports the form that is documented.

Documentation of the functional analysis

The functional analysis, together with the characterisation of the entities, should be documented so that it can be provided at the time of a tax audit. In addition, memoranda that set out the functional analysis are extremely valuable to a company that is preparing for an audit (to remind the relevant personnel of the facts) or re-evaluating its policy.

Documenting the comparables

All information gathered about the comparables (e.g. financial statements and functional analyses) should be retained in a useful form so that it can be referred to in presenting explanations to the tax authorities. Updates of financial statements from those comparables should be collected annually to be sure that the prices applied continue to reflect the arm's-length standard. It is also important to update the search for comparables on a regular basis (as independent companies enter or leave the market) to ensure that the sample used for analysis remains as complete as possible.

Income statements

The income statements prepared as part of the analysis should be retained and updated at least annually to show the reasonableness of the policy.

Industry evidence

This category is a potpourri of items that support conclusions reached, adjustments made, etc. Whatever information is needed to be able to explain to the tax authority what was done, why it was done and why it produces an arm's-length result should be retained and updated periodically.

Implementing a transfer pricing policy

Implementation is perhaps the hardest part of the determination and defence of a transfer pricing policy. Calculating transfer prices and establishing the controls necessary to be certain that the prices are not changed without prior notification can be time-consuming.

The implementation process itself depends upon the nature of the business and the pricing structure. But, in all cases, implementation is more likely to be successfully achieved if employee politics and sensitivities are fully considered. In particular, relocation of functions and adjustments to employee pay or bonus schemes (*see Chapter 6, Impact on management/employee bonus schemes*) require careful handling.

Monitoring the application of the policy

The arm's-length standard requires that inter-company pricing must reflect the substance of transactions. As a business grows, evolves and possibly restructures, the substance of transactions changes. Transfer prices may also have to change to remain arm's length. Monitoring the application of the policy is important so that the taxpayer knows when facts have changed and no longer support the existing pricing structure.

Even in the absence of changes in the substance of the relationship, business cycles can mean that prices change (going up during periods of high inflation and down during recession). Regular re-evaluation of the facts and the prices to determine that they are, and remain, arm's length, is advisable. Documentation should be prepared to reflect that this process is carried out and that appropriate conclusions are reached and acted upon.

The policy should be examined quarterly until it is clear that it is working. After that, semi-annual examinations are usually sufficient, unless the industry is inordinately volatile. The evaluation should include an examination of the financial results realised under the policy. That is, financial ratios and profit splits should be calculated and

Establishing a transfer pricing policy

examined to ensure the policy is producing the anticipated results. If it is not, the reasons for this should be determined and appropriate adjustments made.

In addition, the facts should be checked. Has there been a change in the substance of any transactions? Is one entity now performing a function that another entity originally performed? Have risks changed or shifted? Has there been a change or innovation in the industry that affects prices?

Finally, the implementation of the policy should be checked. Have the inter-company agreements been put in place? Do appropriate personnel in the various entities understand the policy? Are the inter-company charges reflecting the appropriate pricing?

Compensation of management

Transfer pricing to achieve tax or financial goals may result in levels of income in the various legal entities that are inconsistent with the way in which management should be compensated on the basis of performance-related pay or bonus schemes.

Typically, multinationals establish a separate transfer pricing scheme for management-reporting purposes (not necessarily based on the arm's-length standard), so that management is encouraged to behave in a particular way in running the business and is properly compensated when it obtains the desired results.

5.

Specific issues in transfer pricing

Management Services

Management fees – introduction

The term ‘management fee’ is often used to describe any of a variety of inter-company services charges. In this chapter, the term is used to describe charges paid for general administrative, technical services, or payments for commercial services that are provided intragroup from one or more providers to one or more recipients. Chapter 2 considered the types of services that might be provided between related companies. This chapter focuses on specific challenges related to the methods of determining arm’s-length charges for the services and the documentation needed to support the arrangements.

The importance of management fees

Multinationals have a long-standing practice of providing certain services from a central point to one or more affiliates; in many cases it is appropriate for a charge to be made by the renderer. While the parent company is often the centralised service provider in recent years for the model of one affiliate providing services on a central basis to several other affiliates has become popular. Examples include regional HQs located in Europe to provide centralised marketing, management and accounting assistance to all European entities in a non-European group. In these situations, cost-contribution (or shared-service) arrangements can be constructed to charge the costs of the service providers to the affiliates that benefit from the services they provide.

As the unique bundle of services provided may vary significantly between taxpayers, it may be difficult to find a comparable price for such services or to evaluate the benefit received. Because of this difficulty, rightly or wrongly, many tax authorities regard the area of management fees as particularly prone to potential abuse and are therefore devoting increasing resources to auditing such transactions. Tax authorities consider these management fees to be ‘low-hanging fruit’ and perceive that taxpayers’ documentation and support for them is often lax. At the same time, the increasingly competitive global marketplace is demanding greater efficiency from multinational businesses. They must take every opportunity to minimise costs, so there is an ever-greater need to arrange for the centralisation of business functions where possible.

It is important to understand that centralisation does not necessarily mean that the functions are all grouped together in one location. It may be the case that specialised departments are spread throughout the group in what are commonly called ‘Centres of Excellence’, depending on the particular needs of the group and the location of its resources. If the group wishes to avoid serious double taxation problems, it is of paramount importance that it operates a tightly controlled management-fee programme, aiming at the funding of central resources and allocating expenses to the correct companies, ensuring that tax deductions are obtained for these costs.

Specific issues in transfer pricing

The tax treatment of management fees – an overview

The world can be divided broadly into two camps regarding the tax treatment of management fees. Many developed nations have adopted laws and regulations dealing with inter-company services, which accept the deductibility of inter-company charges as long as they comply with the general requirements of the national tax code and with the arm's-length principle. The rest of the world typically does not recognise these types of inter-company charges and refuses deductibility for tax purposes. Included in this latter category are authorities (e.g. some South American jurisdictions) that offer limited deductions but place restrictions on remittances of funds through foreign-exchange controls and withholding taxes. These limitations often create an effective barrier to establishing service arrangements.

Management fees in the developed world

Before any meaningful structure can be devised for a management-fee arrangement, it is vital to establish the following:

- The exact nature of the services that are to be performed.
- Which entities are to render the services.
- Which entities are to receive the services.
- What costs are involved in providing the services.

Once these facts are known, consideration can be given to selecting the basis for charging the recipient group companies. The fee structure and the general circumstances of the arrangement should be recorded in documentation evidencing the arrangements between provider and recipient. Often this documentation takes the form of a bilateral or multilateral service arrangement. Such documentation should include, in addition to a written agreement, sufficient evidence of costs involved and services actually rendered. The documentary evidence required by tax authorities varies from territory to territory, and it may be necessary to provide timesheets, detailed invoices and/or other detailed worksheets or evidence of costs incurred. Recently, multinational groups are finding that even having the aforementioned documentation may not be sufficient to ward off a potential adjustment or disallowance of a deduction in the recipient jurisdiction. Often, the recipients are required to prove that benefit is derived from the services received and that such benefits are of a more than just remote or indirect benefit. As a result, depending on the facts and circumstances, it may be imperative for the multinational group to maintain more than just the documentation referenced above, but also documentation of the facts and circumstances of the service arrangement and the benefits received.

Dealing with shareholder costs

Central services include services provided to:

- One or more specific companies (perhaps including the parent company) for the specific purposes of their trading activities (e.g. marketing advice).
- A range of companies (perhaps including the parent) for the general benefit of their businesses (e.g. accounting services).
- The parent company in its capacity as shareholder of one or more subsidiaries.

The costs in this last category are generally known as shareholder costs. They are the responsibility of the ultimate parent company and should not be borne by other group members. If incurred by the parent, the cost should remain with the parent. If incurred elsewhere, the expense should be recharged to the parent, possibly with a markup.

Once costs for shareholder functions have been addressed, it is necessary to consider charging for other services. Recent developments in the US (i.e. the Final Service Regulations issued on 31 July 2009) have put a renewed emphasis on the evaluation of inter-company service transactions dealing with myriad issues in this area. Of the many services considered, these new regulations have redefined or narrowed the definition of ‘shareholder activities’ to those expenses that solely benefit the ultimate shareholder. The focus of the new US regulations were to be more consistent with the OECD Guidelines; however, the new definition in the context of shareholder expenses may prove problematic because of its restrictiveness. This narrowed definition creates a new aspect that multinationals (particularly US-based companies) must consider, as the potential for challenges of deductibility for non-shareholder costs may be initiated by the provider country (*see US chapter*).

Analysing the services

The correct allocation of shareholder costs should be the first step in determining inter-company service fees. The next step is to identify the specific additional services that are provided. This process is most easily accomplished through a functional analysis described in Chapter 4.

Through interviews with operating personnel, it will be possible to identify specific services that are provided to related parties as well as the companies that provide those services. At the same time, care must be taken to identify the nature of the benefits received by the recipient. Where a direct relationship exists between the rendering of a service and the receipt of benefit, it should normally be possible to charge a fee for the service and obtain a deduction in the paying company.

Example

EasternMed (EM), a US company, operates a worldwide network of distribution companies that sell alternative nutritional supplements. The nutritional supplements are manufactured in the US by EM (or by vendors for EM) and sold to each non-US location for further resale to the local customer base. EM has operations throughout the Western European countries, Canada, the Australia–Asia region and Bermuda. EM has engaged external advisers to assist in determining inter-company charges for services rendered by the parent company to its subsidiaries. The study on inter-company charges was jointly commissioned by the parent company and the subsidiary to provide assurances regarding appropriate inter-company service fees, which would be deductible to each of the subsidiaries and acceptable from EM’s viewpoint in the US. As a result of the functional analysis performed, the following services were identified:

- Accounting assistance to the subsidiaries by the parent with respect to maintaining local accounts.
- Management of the group’s internal IT system, which the group members use to track customer accounts.
- Marketing assistance in the form of recommendations for advertisements and promotional campaigns.
- Provision of marketing assistance in the form of sales brochures that have been localised to the local customer base and used by the foreign affiliates in their distribution operations.

Specific issues in transfer pricing

After discussions with each of the subsidiaries, it was determined that:

- Bermuda is a tax haven, and the Bermudan government does not care how much the parent extracts from the Bermudan subsidiary in the form of management fees; in contrast, the tax authorities dealing with other EM subsidiaries require satisfaction that any service charges are computed on an arm's-length basis
- all subsidiaries agreed that the accounting assistance was extremely helpful in establishing an accounting framework for their businesses. The cost of the accounting assistance can therefore be charged to all affiliates
- no subsidiary located outside the US uses any aspect of the advertising and promotion information provided by EM because it applies only to the US market, which is significantly different from the markets in the rest of the world. None of the costs of the advertising and promotion information can therefore be charged
- the costs associated with the sales brochures are actually used by each subsidiary in its sales efforts and therefore a charge is appropriate for these costs, and
- the cost of the transfer pricing study can be spread between the affiliates as part of the cost base of the services covered by the management fee.

The remaining matters to be considered are whether a markup can be applied and whether it makes sense to make a charge to Bermuda, given that no effective tax relief will be obtained.

The preferred method for the determination of inter-company charges is generally the CUP method. In other words, if the provider of the service is in the business of providing similar services to unrelated parties, or if the service is also obtained from third parties, then the arm's-length charge is that which the third party would pay/charge. Typically, a CUP is not available in respect of management services because of the unique nature of the services provided within a group.

The reports of the OECD (*see Chapter 3*) state that there may be circumstances in which comparable data may be available, for example where a multinational establishes its own banking, insurance, legal or financial services operations. Even here, however, great care is needed in comparing group activity with third-party businesses. Third parties face the challenge of the real market, whereas group companies are often forced to buy the internal services when available. A group insurance company deals with the risks of one business only, rather than a multitude of different customers. These examples merely illustrate that comparables are hard to find for group service activities, even where similar services appear to be offered by third parties.

The cost base for service charges

Where services are rendered for which no fee can be established under the CUP method, the cost-plus method is typically applied to arrive at an arm's-length service fee. This method requires an analysis of the costs incurred in providing the services.

Since the services are rendered to several companies in the group, the costs involved must be charged to the various beneficiaries on a pro rata basis. Therefore, the aggregate amount of costs that the service unit incurs in providing the services must be allocated to the recipient companies in accordance with an acceptable allocation key. Costs of a central personnel department may be allocated, for example, by the time spent on assisting each subsidiary. When the central services are more general in nature, allocation by reference to a relative headcount of each company may be appropriate. One of most frequent reasons that management fees are challenged by

tax authorities is on the basis that the allocation methodology was insufficient to establish that the entity receiving the charge was the true beneficiary of the underlying costs incurred.

Allocation keys need to be responsive to the nature of the costs to be divided; other keys that may be appropriate are relative capital employed, turnover and number of users (in the context of IT systems).

The cost-accounting method

The costs actually incurred in providing the services are ascertained by using an acceptable cost-accounting system. National tax laws and regulations do not generally prescribe a particular cost-accounting method, but leave it to the individual group of companies to determine which cost-accounting method is most suitable for them in the specific circumstances, provided that the chosen cost-accounting method is generally acceptable and consistently applied.

The computation on a full-cost basis

Since the charge determined under the cost-plus method ought to reflect all relevant costs, the aggregate amount of service costs must include direct and indirect costs. It is not acceptable, under generally accepted practice, for costs to be computed on the basis of incremental cost only.

Direct costs to be considered are those identifiable with the particular service, including for example, costs attributable to employees directly engaged in performing such services and expenses for material and supplies directly consumed in rendering such services. Indirect costs are defined as those that cannot be identified as incurred in relation to a particular activity but which, nevertheless, are related to the direct costs. As a result, indirect costs include expenses incurred to provide heating, lighting, telephones, etc. to defray the expenses of occupancy and those of supervisory and clerical activities as well as other overhead burdens of the department incurring the direct costs.

Although it may often be difficult in practice to determine the indirect costs actually related to a particular service, the supplier of the service is normally expected to charge the full cost. Therefore, an apportionment of the total indirect costs of the supplier on some reasonable basis would be accepted in most countries.

The US Temporary and Proposed Service Regulations effective for tax years commencing after 31 December 2006 and the subsequent Final Regulations applicable for tax years beginning after 31 July 2009, require the inclusion of stock-based compensation in the costs associated with a particular service. This change has proven controversial, as third-party dealings typically do not include such costs in their service cost base nor does stock-based compensation ever enter into consideration in third-party negotiations. Nevertheless, the inclusion of stock-based compensation is part of the new regulations and hence companies should consider the impact of these regulations on their inter-company service transactions. There will undoubtedly be controversy related to this issue in the recipient jurisdictions as US multinationals are forced to comply with these new rules, especially in those jurisdictions where stock-based compensation is nondeductible, or if deductible, subject to stringent policies in non-US jurisdictions (*see US chapter*).

Specific issues in transfer pricing

When should a profit margin be added to cost?

The question arises as to whether a profit markup should be added to the costs in calculating a service charge. Nearly all tax authorities expect a group service company to render charges to affiliated enterprises in accordance with the cost-plus method and therefore to add a profit markup to the allocable cost. On the other hand, double taxation is avoided only if the tax authorities of the country in which the recipient company is resident allow a deduction, and not all countries accept the markup element of the charge as deductible.

In an arm's-length situation, an independent enterprise would normally charge for its services to third parties in such a way as to recover not only its costs but also an element of profit. Consequently, any enterprise that is engaged solely in the business of providing such services should seek to make a profit. This scenario is particularly true in the following three situations:

1. Where the service company's only business activity is rendering services.
2. Where service costs are a material element in the cost structure of the service provider.
3. Where the service costs represent a material part of the cost structure of the service recipient.

Most tax authorities in developed countries accept these conditions as relevant in reviewing the application of a markup to service costs. However, a more formalised approach is taken in certain instances, particularly in the US. As noted in the US chapter, the revised US regulations on services require the addition of profit margin to the intragroup charge for services rendered where the services provided are not considered low-margin services or the median arm's-length markup for such services exceeds 7%.

A further issue directly addressed in the new US regulations relates to 'pass through' costs. The underlying principle is that only those costs regarded as value added costs incurred by the service provider in conducting its own business should be included in the pool of costs to be marked up. For example, if the service provider incurs third-party expense (for instance arranging for advertising space to be made available for its client), then it may well be correct to evaluate the advertising costs as an expense reimbursement (covering disbursements, financing and handling charges). It will invoice for the service of arranging it (labour, phone, office costs, etc.) on a cost-plus basis. The total costs recharged would be the same, but the profit recognised in the service provider would differ significantly.

When it is appropriate to include a profit element on service charges, arm's-length markups are determined by reference to comparables where possible. Once the service is identified, the cost of providing the service is determined and comparables are sought to determine the arm's-length markup for those costs. In practice, many tax authorities expect to see certain levels of profit margin as the norm, typically between 5% and 10% of costs for most support services. However, as global competition gears up, companies should take care to ensure that the higher historical norms are not allowed to prevail in inappropriate circumstances, or the internal service provider may prove to be a cost-creating mechanism rather than a vehicle to enhance efficiency.

The determination of an arm's-length service charge

The following example sets out how an arm's-length service charge might be determined.

Example

Continuing the example above, it has been determined that three services have been provided for, which it is appropriate to make inter-company charges:

- Assistance with the determination of arm's-length service fees.
- Provision of marketing assistance in the form of sales brochures.
- Accounting assistance.

The next step is to determine the fully loaded cost of providing those services. The costs of providing transfer pricing assistance consist of the external adviser's fee plus the costs of the company's tax department personnel involved in the study. The cost of providing tax personnel and the accounting assistance can be determined by reference to the amount of time the relevant individuals have spent in providing the services and the departmental costs in terms of salaries and overhead expenses. Once the time devoted to the pricing study has been identified, this amount can be expressed as a percentage of the total resources used by the relevant department during the year. Looking at the accounting support, for example, suppose one person was involved and spent 50% of the year on the project. There are three people in the accounting department. Therefore, the cost of providing the service is one-half of the affected person's salary and benefits plus one-sixth of the overhead expenses of the accounting department. If we assume that a markup is deductible in each of the countries to which charges should be made, comparables must be identified for tax consulting (for the service fee project) and for accounting assistance. An obvious comparable is the markup the external adviser earned on the project. However, this information may not be publicly available, so other benchmarks must be used. Likewise, for accounting assistance, companies that provide accounting services and for which publicly available financial information exists may be identified. Once this markup is known, the inter-company charge can be determined. In practice this process may not be necessary, as many tax authorities accept that a margin of 5% to 10% on cost is *prima facie* acceptable. Nevertheless, a properly recorded and documented margin always offers a stronger position. For charges relating to the creation and printing of the sales brochures, one could allocate the departmental costs involved in the developing the brochures as well as any external printing costs. The charges could be allocated on the relative basis of brochures shipped or other allocation keys deemed more appropriate.

Documentation

Documentation in the area of management fees is every bit as important as in the case of the sale of inventory or the transfer of intangibles. At a minimum, it is necessary to provide documentation regarding the services that are provided, the costs of rendering those services and support for the appropriateness of any markup. It is imperative to have an inter-company agreement that sets out the circumstances under which services will be provided as well as the charges that will be made.

The support that might be needed to document each of these types of items could include the following:

Specific issues in transfer pricing

- A written description of the different services provided, summarising the type (specialist skills, seniority, etc.) and number of employees involved, any reports or other end products of the services, and a statement of the aims of the services (to save costs, increase sales, etc.).
- A full analysis of the cost base, including explanations of allocation formulae, how they apply and why they are appropriate; a detailed list of the expenses to be allocated (salaries, overhead expenses, etc.); and invoices from other entities where they substantiate expenses suffered.
- A detailed computation of the amount of each invoice submitted to the recipient entities – it should be possible for a computer to produce this calculation relatively easily once the cost base and allocation formulae have been established.
- A justification of the markup applied referring to comparables or market practice. In a Canadian case, the court gave detailed consideration to the subject of documentation of management fees and concluded that the following items of evidence would be of key significance:
 - Evidence of bargaining between the parties in respect of the amount to refute any inference that the taxpayer ‘passively acquiesced’ to the charge.
 - Working papers supporting the expenses charged.
 - Details explaining how the charges were calculated, including support for the apportionment of employee work performed or other expenses such as allocations of rental costs.
 - A written agreement for the management charge.
 - Evidence that the expenses relate to the period of charge rather than a prior period.

The above comments are based on a 1991 case that predates the detailed OECD Guidelines chapter on Intra-Group Services. Today, most tax authorities’ expectations are likely to mirror the OECD Guidelines.

Contract services and shared service centres

Multinationals are increasingly looking for ways to improve their competitive position in the global marketplace through increased efficiency of operations. The traditional model for expansion, whereby the parent sets up one or more new companies for each new country of operation, has been successful in a number of ways. However, it has also encouraged bureaucratic and territorial approaches to business, which carries with it significant hidden costs. For instance, does each company really need its own personnel director, marketing director, finance department, inventory warehouse and buffer stocks, etc. or can these functions be fulfilled from a central point? With respect to strategic approaches to the market, the parent will want to encourage a global market view, while the old ‘country company’ model tends to narrow horizons to a very local level. All these pressures and others are driving the creation of shared service centres which fulfil a wide variety of support functions for companies in many countries.

Another way in which multinationals are seeking to improve is through building on best-in-class techniques. If one of their operations appears to be particularly skilful in performing an activity, perhaps this entity should provide this service to others, rather than allow the latter to continue to operate at less than optimal standards.

Finally, the search for access to the best resources for a task at the lowest price is leading to the creation of contract research and development (R&D) centres and contract manufacturing activities. The idea here is that the multinational can tap into

what it requires without impacting its strategy for managing intellectual property or manufacturing, while tightly controlling the costs. The best-known example of contract R&D comes from the US case, Westreco, in which the Swiss group Nestlé was involved. Nestlé wanted to conduct research into the US market in order to design successful products for that market. If this research had been financed by its US operation, any intangibles created would have belonged in the US and subsequent profits derived would have been taxable there. Instead, Nestlé established a contract research operation that sold its services to the Swiss operation, which thereby owned the resultant intangibles. Subsequent exploitation by way of licence was therefore possible.

The key to the establishment of a successful contract R&D activity (or contract manufacturing operation, which is a similar concept) is to draw up a service agreement that sets out clearly the activities required to be performed, service quality standard, timelines, etc. The service provider's remuneration should be set by reference to appropriate comparables and is typically a cost-plus approach. Capital risk is a particularly important area to monitor, however. If the service provider needs to make significant investment in order to fulfil the contract, will the purchaser cover the financing costs and risk of disposal at this end of the contract? This question can be answered in many ways, but the answer will materially affect the profit, which it will be appropriate for the service provider to earn. As usual, risk should be compensated by the prospect of future reward.

Transfer of intangible property

Transfer of intangibles – introduction

Generally, intangible assets can be transferred between related parties in three ways: contribution to capital, sale or licence. In addition, the parties may have agreed to share the costs and risks of the development of an intangible through a cost-sharing arrangement or otherwise referred to in the OECD Guidelines as a cost-contribution arrangement.

Sale for consideration

When intangibles are sold, tax laws in most countries require that the developer/owner receive the fair market value of the intangible at the time of transfer. The geographic rights to the property that is sold can be broad or narrow. For example, the developer may sell the North American rights to the property. Alternatively, the developer may sell the worldwide rights for uses other than for the use that it wishes to keep for itself. For example, in the pharmaceutical industry, the developer may keep the rights for human use while selling the rights for animal use.

Once the sale has taken place, the party that purchased the intangible is the legal owner of the property and is entitled to receive any third-party or related-party royalties that accrue to the property. The owner also has the right to sublicense or dispose of the property.

Licence

The typical method of transferring intangible rights between related parties is through the use of an exclusive or a non-exclusive licence agreement. When a licence is used, the developer continues to own the property and can dispose of it as she/he see fit. The rights given to the licensee may vary. In general, the licence is evidenced by a document specifying the terms of the licence. The key terms of a licence are likely to include the following:

Specific issues in transfer pricing

- The geographic rights the licensee is granted.
- The length of time for which the licensee may use the property.
- The uses to which the licensee may put the property.
- The exclusivity of the licence (i.e. exclusive or non-exclusive and the basis of exclusivity).
- The amount and type of technical assistance that the licensee may receive from the licensor (together with fees for assistance above that which is provided as part of the licence).
- The royalty rate, method of computing the royalties and the timing of payments.
- Whether the licensee has sublicensing rights.

It is important that licence arrangements be committed to writing. It should also be noted that several of the points listed above play a significant role in the determination of the royalty rate. For example, an exclusive licence typically carries a royalty rate significantly higher than a non-exclusive licence. Broader geographic rights may result in a higher royalty rate, although this result is not always the case.

Determination of arm's-length royalty rates

Determining the proper compensation due to the developer/owner of intangible property can be difficult. In setting an arm's-length royalty rate it is important to distinguish, as precisely as possible, what property is to be licensed. Once the property is identified, the rights granted to the licensee and their relative value is determined. The property may be an ordinary intangible in that it provides some, though not complete, protection from competitors (this type of intangible is sometimes referred to as a typical or a routine intangible). Alternatively, it may constitute a super-intangible, which effectively gives the licensee a monopoly or near-monopoly over the market in question. However, there is no difference in the approach to setting an arm's-length royalty. The concept of super-intangibles is mentioned here for completeness only. It arose following the 1986 Tax Reform Act in the US. One of the key issues included was a requirement that the licence income to be enjoyed by a licensor in the US from an overseas affiliate should be 'commensurate with the income' associated with the intangible. There was concern that insufficient royalty income was being derived from US intangibles that proved to be valuable after being licensed overseas. There was considerable concern outside the US that excessive use has to be made of hindsight in this area.

The optimal method for determining an arm's-length royalty is to refer to licences between unrelated parties under which identical property has been transferred. Such licences can be identified where the developer has licensed a third party to use the technology under terms identical or similar to those granted to the related party, or where the inter-company licensor has received the technology from a third party. If such a licence agreement is identified, adjustments can be made for differences in terms in order to determine an inter-company, arm's-length royalty rate.

Example

Abbra Cadabbra AG (ACAG), a German company, has developed a method of removing grass stains from clothing, which does not also remove the colour from the cloth. It has obtained a patent on its invention and is manufacturing the product for sale in the German market. It has recently decided to establish a manufacturing affiliate in Ireland, where it will benefit from a favourable low-tax regime for the earnings of the Irish subsidiary.

The Irish subsidiary will manufacture the product for resale throughout Europe. ACAG wishes to maximise the income that it places in Ireland. Therefore, it is taking all steps necessary to ensure that the Irish subsidiary is a full-fledged manufacturer. To this end, it has decided to licence the patent and related technical know-how to the Irish subsidiary.

ACAG will grant the Irish subsidiary an exclusive licence to make, use and sell the product in all European markets. A written agreement is drawn up containing all the relevant terms. The remaining issue is to determine an arm's-length royalty.

Assume that ACAG licensed ZapAway Inc., an independent US company, to make, use and sell the product in North America. The technology provided to ZapAway is identical to the technology licensed to ACAG's Irish subsidiary. Both licences are granted for the life of the patent and both provide for 20 workdays of technical assistance in implementing the technology. The only significant difference between the two licence agreements is that the third-party licence gives the licensee the rights within North America and the related-party licence grants the licensee the rights to European markets.

The question that must be addressed is whether the North American and European markets are economically similar so that the royalty rate applied to the North American licence would be expected to be the same as the royalty rate for the European licence. The economics of the two markets must be examined in order to answer this question. In general, if the differences are small, then the third-party licence should form the basis for the related-party royalty rate. If significant differences exist, adjustments can be made to account for them so long as they can be valued. The underlying question here, of course, is whether both licensor and licensee, at arm's length, give thought to the profit potential of the intangible when arguing a royalty rate. If markets are different from one another, potential investment returns will also differ and hence the acceptable royalty rate.

Determining an arm's-length royalty rate in the absence of perfect comparables

If a perfect comparable does not exist (a common occurrence), then licence agreements between unrelated parties for economically similar technology may be used to determine the appropriate inter-company royalty rate. Typically, this determination is made by reference to third-party licences within the industry.

Example

Assume that the ZapAway agreement (*see Determination of arm's length royalty, above*) does not exist (i.e. ACAG does not licence the property to any third party). However, another competitor licences a similar product (another grass stain remover) to a third party. This licence agreement is subjected to the same analysis discussed above in the *Determination of arm's length royalty section*. If the differences do not affect the royalty rate or can be valued, then this third-party licence arrangement can be used as a basis for the determination of the arm's-length royalty between ACAG and its Irish subsidiary.

In a situation where no comparables exist, it is possible to impute a royalty rate by reference to the factors that unrelated parties would consider in negotiating royalty rates. For example:

Specific issues in transfer pricing

- The expected profits attributable to the technology.
- The cost of developing the technology.
- The degree of protection provided under the terms of the licence as well as the length of time the protection is expected to exist.
- The terms of the transfer, including limitations on geographic area covered.
- The uniqueness of the property.

Super-intangibles

Super-intangibles are those that give the owner a monopoly or a near-monopoly in its product class for a significant period of time. It is unlikely that, due to their nature, close comparables exist for these intangibles. However, occasionally a developer may not wish to market the product resulting from an invention (or does not have the capital required to exploit the invention) and chooses to licence it to a third party. Even in the case of super-intangibles, a comparables search should be completed to ascertain whether comparables exist.

Valuation of royalty rates for super-intangibles

In the absence of comparables, the determination of arm's-length royalty rates is extremely difficult. Chapter VI of the OECD report reviews the important issues on intangibles, but recognises the great difficulty in determining arm's-length pricing for an intangible transaction when the valuation is very uncertain, as is usually the case at the outset of a business venture. The OECD urges companies and tax authorities to give careful attention to what might have happened at arm's length, all the other circumstances being the same. Consequently, parties might opt for relatively short-term licence arrangements or variable licence rates depending on success, where future benefits cannot be determined at the start. This commentary is essentially highlighting the dilemma shared by companies and tax authorities in this area; neither can foresee the future. Companies wish to take a decision and move forward, while tax authorities usually must consider, in arrears, whether such decisions represent arm's-length arrangements. Tax authorities should not use hindsight. Equally, it is often difficult for companies to demonstrate that they devoted as much effort in trying to look forward when setting the royalty rate, as they might have done at arm's length. Where particularly valuable intangibles are involved, or tax havens are in the structure, a residual income approach may be adopted by the tax auditor in the absence of other evidence. This approach avoids a direct valuation of the royalty but determines the value of the other elements of a transaction (e.g. the manufacturing of the product) and calculates a royalty based on the total income accruing as a result of the transaction less the cost of these other elements, so that the residue of income falls to be remitted as a royalty.

Example

Clipco Inc. (CI), a US company, is a manufacturer of shaving equipment. It has recently developed a new razor that is guaranteed never to cut, nick or scrape the skin of its users. Its success is tied to a microprocessor, contained in the blade, which signals the blade to cut or not cut, depending on whether the substance it senses is hair or skin. Clipco has been granted a patent on this device and is currently marketing the razor in the US where it has obtained a 90% market share.

Clipco has established an Irish subsidiary to manufacture the razors for the European market. Clipco (Ireland) (CIre) will manufacture the razors and sell to third-party distributors, which the parent company is currently supplying.

The issue is the proper royalty rate to be set for the use of the patented technology and related technical know-how that the parent company provides to CIre. The functional analysis is summarised in Table 5.1.

Table 5.1 Functional analysis

US PARENT

Functions	Risks	Intangibles
Research and development	Foreign exchange (on royalty)	Patent
Marketing (on royalty)	Trademark	Unpatented know-how
Technical assistance		

IRISH SUBSIDIARY

Functions	Risks	Intangibles
Manufacturing	Warranty	None
	Obsolete products	

In this simplified example, the Irish subsidiary is a manufacturer, nothing more (perhaps a contract manufacturer, although the risk pattern is inconsistent with that conclusion). The US method of determining the royalty rate in these circumstances may be to find comparables for the value of the manufacturing activity (usually on a cost-plus basis). All remaining income, after compensating the Irish subsidiary for its manufacturing activity, is as a royalty for the use of the technology.

This method usually overstates the return on the base technology by including all intangible income except for the intangible income that is specifically allowed to the manufacturing company. Hence, this valuation method is one that the typical company will seek to avoid when its manufacturing operations are located in a low-tax jurisdiction. However, it may be useful when manufacturing in high-tax jurisdictions.

Cost-sharing

Cost-sharing – introduction

In 1979, the OECD published a paper on transfer pricing and multinational enterprises. This document included a discussion of the experience of multinational enterprises in establishing and operating cost-contribution arrangements for R&D expenditure. The OECD summarised its knowledge of these arrangements and the experiences multinational companies have undergone in handling cost-sharing arrangements (which are referred to as cost-contribution arrangements (CCAs)) with tax authorities around the world. The OECD commentary has been widely regarded as best practice by many tax authorities and the comments in that paper, to a large extent, remain valid today. However, there are differences beginning to develop in practice, particularly in the US, as tax authorities obtain more experience of the operation of cost-sharing arrangements and become more sophisticated in dealing with multinational corporations. For its part, the OECD issued Chapter VIII of its Transfer Pricing Guidelines, which governs the tax treatment and other transfer pricing issues related to CCAs entered into by controlled taxpayers. The guidelines set out in Chapter VIII are essentially the same as draft guidelines the OECD originally proposed in 1994. The primary principle surrounding the OECD's determination of whether a cost allocation under a CCA is consistent with the arm's-length principle is whether the allocation of

Specific issues in transfer pricing

costs among the CCA participants is consistent with the parties' proportionate share of the overall expected benefits to be received under the CCA.

Cost-sharing is based on the idea that a group of companies may gather together and share the expenditure involved in researching and developing new technologies or know-how. By sharing the costs, each participant in the arrangement obtains rights to all the R&D, although it funds only a small part of the expense. As soon as a viable commercial opportunity arises from the R&D, all contributors to the cost-sharing arrangement are free to exploit it as they see fit, subject to any constraints laid down by the agreement (*see Cost-sharing arrangements and Cost-sharing agreements, below*). Such constraints typically include territorial restrictions on each participant regarding sales to customers.

Cost-sharing is an inherently simple concept, enabling R&D expenditure to be funded on an equitable basis by a range of participants. However, there are many complex issues, both in accounting and tax terms, which arise in practice from the establishment of a cost-sharing arrangement between companies under common control.

Advantages of cost-sharing

Cost-sharing may offer several advantages to the licensing of intangible property. First, it may obviate the need to determine an arm's-length royalty rate. If the parties have participated in the development of an intangible, they own it for the purpose of earning the income generated by it, and no royalties need be paid if the intangible is exploited under the terms of the CCA. Such cost-sharing arrangements eliminate the necessity of a royalty payment for the use of intangible property that would otherwise be owned by another party.

Second, cost-sharing is a means of financing the R&D effort of a corporation. For example, assume that the R&D activity has historically been carried out by the parent company and it is anticipated that this scenario will continue. Further, assume that the parent company is losing money in its home market but the group is profitable in other locations. This fact pattern implies that the parent may find it difficult to fund the R&D activity solely from the cash generated by its own business. Cost-sharing is a means of using the subsidiaries' funds to finance the R&D activity. The corollary of this theory is that ownership of intangibles will be shared with the subsidiaries rather than the parent company alone.

Cost-sharing arrangements

A valid cost-sharing arrangement between members of a group of companies involves a mutual written agreement, signed in advance of the commencement of the research in question, to share the costs and the risks of R&D to be undertaken under mutual direction and for mutual benefit. Each participant bears an agreed share of the costs and risks and is entitled, in return, to an appropriate share of any resulting future benefits.

Cost-sharing arrangements of this nature are not unknown between companies that are not related, and in many respects resemble joint venture activities or partnerships. As a result, there is a *prima facie* indication that they are likely to be acceptable in principle to the majority of tax authorities.

All participants in a cost-sharing arrangement must be involved in the decision-making process regarding the levels of expenditure to be incurred in R&D, the nature of the R&D to be conducted and the action to be taken in the event that proves abortive. Members also need to be involved in determining the action to be taken to exploit successful R&D. Their prima facie right to benefit from the R&D activity can be exploited through their own commercialisation of products or through selling or licensing the R&D results to third parties within their specified rights (typically territories) under the terms of the CCA. Typically, any income received from third-party arrangements would be deducted from the R&D costs before allocation of the net R&D costs among the signatories to the cost-sharing agreements.

Cost-sharing agreements

Because cost-sharing is a method of sharing the costs and risks of the development of intangibles, the key to cost-sharing is that the agreement exists prior to the development of the intangibles so that all parties share the risk of development (i.e. cost-sharing is a method of funding the development process). Each participant in the cost-sharing arrangement must bear its share of the costs and risks, and in return will own whatever results from the arrangement. For a description of cost-sharing after the development of the intangible has already begun, (see *Establishing cost-sharing arrangements in mid-stream, below*).

Allocation of costs among participants

The strongest theoretical basis for allocating R&D expense among members of a cost-sharing arrangement is by reference to the actual benefits they derive from that arrangement. However, not all R&D expenditure gives rise to successful products for exploitation, and there must be a mechanism to deal with abortive expenditure as well as successful expenditure. Because of this fact, arrangements usually try to allocate expenditure by reference to the expected benefits to be derived from the R&D. Such a method of allocation is necessarily complicated to devise and, in practice, considerable regard is given to the relative sales of each participant. Hybrid arrangements are also used from time to time, whereby current sales or other relevant business ratios are used for determining the expense allocation and hindsight adjustments are made where the original allocation proves to be inequitable.

Whenever R&D gives rise to intangible property that can be patented, all members of the cost-sharing arrangements have rights to it. The fact that it may be registered with one member of the cost-sharing arrangement does not give any priority to that member in the exploitation of the intellectual property. In effect, the registered holder is acting in a trustee capacity for the benefit of the cost-sharers as a group.

Although most tax authorities prefer to follow the general tests previously propounded by the OECD and now embodied in Chapter VIII of the OECD Guidelines, some tax authorities have special rules for dealing with cost-sharing arrangements. The National Peoples Congress of China recently passed the Corporate Income Tax (CIT) Law which will become effective 1 January 2008, and under Article 41 includes legal framework supporting CCAs and provides clarification for a number of issues. In March 2006, Japan for the first time released guidelines on CCAs that provide a definition and guidance on the administration of CCAs, the treatment of pre-existing intangibles and appropriate documentation. Also, Australia issued Taxation Ruling 2004/1, which accepts and builds upon the views in Chapter VIII of the OECD Guidelines in the context of the relevant provisions of the Australian income tax law.

Specific issues in transfer pricing

The most notable exception from following the OECD Guidelines is the US. The US issued final cost-sharing regulations in 1995 (the 1995 US final cost-sharing regulations), proposed regulations in 2005 (the 2005 US proposed cost-sharing regulations), and most recently in 2008 (the 2008 US temporary cost-sharing regulations). Where authorities do have rules, such as the US rules on cost-sharing arrangements, there is a growing tendency for the rules to be complex and restrictive. Furthermore, prior to the issue of Chapter VIII of the OECD Guidelines, there was some variation between different taxing authorities as to whether profit margins are acceptable within cost-sharing arrangements. As noted above, Chapter VIII of the Guidelines now focuses upon whether the allocation of costs among the participants reflects the relative benefits inuring to the parties. This point can be illustrated by considering a cost-sharing arrangement.

Example

A, B and C decide to work together and spend up to an agreed amount in trying to design the world's greatest mousetrap. If successful, A will have rights to the intangibles in the Americas, B in Europe and C in the rest of the world. In practice, C is prepared to do most of the work involved, charging A and B their allocations of the amounts to be cost-shared.

In this situation, there is no joint sharing of cost, risk and benefit, and therefore no cost-sharing arrangement (or, technically, a CCA) under Chapter VIII of the Guidelines. Rather, C will incur most of the costs and risks, and hence, the benefits. Under Chapter VIII of the Guidelines, in order to satisfy the arm's-length standard, the allocation of costs to A and B would have to be consistent with their interests in the arrangement (i.e. their expected benefits) and the results of the activity. Under these facts, the arrangement with C for the provision of services would be evaluated for transfer pricing purposes from the standpoint that C will incur most of the costs, risk and benefits. Additionally, C would be the developer for purposes of the intangible property provisions of the Guidelines.

Deductibility of cost-sharing payments

As noted in the *Cost sharing arrangements* section above, cost-sharing arrangements may be entered into by third parties, and it follows, therefore, that similar arrangements should be regarded as, *prima facie* arm's length where entered into by related companies. However, a key issue as far as each taxation authority is concerned, is whether the net costs borne by the entity under their jurisdiction are deductible for tax purposes on a revenue basis. To determine the deductibility of these costs, there will need to be reference to the tax treatment of specific types of expenditure under local law and practice. As a result, it will be decided whether the costs incurred qualify as a revenue deduction or whether they should, for example, be treated as capital (in whole or part) and therefore subject to different rules.

The more fundamental question, however, is whether the proportion of cost allocated to the company under review is reasonable. This scenario necessarily requires a review of the total cost-sharing arrangement. It is not uncommon for a tax authority to require a detailed examination of the cost-sharing arrangement at group level and not just at the level of the company they are looking at. Consequently, they will need to see the cost-sharing agreement in writing and be convinced that it was entered into in advance and that the basis on which costs are allocated is reasonable. They will require convincing that the costs being accumulated are in accordance with the agreement and do not include costs not covered by the agreement. They will wish to see that the

company they are auditing has a reasonable expectation that proportionate benefits will accrue from the cost-sharing payments.

It is clear, therefore, that a multinational enterprise must expect to make a considerable level of disclosure on a wide geographical basis if it proposes to enter into and successfully defend a cost-sharing arrangement. Hence, it is of crucial importance that any cost-sharing policy be fully documented and its implementation and operation carefully managed and controlled.

The greatest problems with tax authorities are experience, in practice, where R&D is relatively long-term in nature or where there are significant levels of abortive expenditure. The tax authorities always have the benefit of working with hindsight and long development times, or abortive expenditure makes it more difficult to demonstrate the expectation of benefits at the time the contributions to the cost-sharing arrangement were made.

Examining the nature of costs to be included and allocated under a cost-sharing arrangement, the OECD argues that indirect costs of R&D should be shared by the participating companies in addition to the direct costs. Indirect costs would be those that were not directly involved with R&D, but which nevertheless are intrinsically related to the direct cost elements and, typically, would include all the general overhead expenses of running a research business. Since such an allocation will necessarily involve approximations, the tax authorities are likely to scrutinise it closely.

Local country laws vary as to whether any particular item of expenditure is deductible. If the amount being charged under the cost-sharing arrangement is the proportionate share of assets of a capital nature, such as machines, buildings, etc., questions may arise as to whether the cost will be treated as revenue or capital for accounting purposes and tax purposes.

For instance, it may be necessary to look through the total allocated expense and analyse it into its constituent parts, consisting of, for example, R&D expenditure or depreciation on buildings. To the extent that national practices on the tax relief given for capital expenditure vary considerably, timing and absolute differences may emerge.

Any kind of subsidy received for R&D purposes (whether through government grants, third-party royalty income earned from exploiting technology derived from the cost-sharing facility, etc.) should be deducted before determining the net amount of costs to be allocated under the terms of the cost-sharing arrangement.

Particular care must be taken to demonstrate that the companies involved in the cost-sharing arrangement are not paying twice for the costs of the same R&D. For instance, no part of the R&D expenses dealt with under cost-sharing should be reflected in the transfer price of goods to be acquired by a cost-sharer.

Looking at the question of whether a profit margin should be added to the pool of costs allocated among the sharers, an earlier report of the OECD concluded that it would normally be appropriate for some kind of profit element to be included, but that it should relate only to the organisation and management of R&D and not the general investment risk of undertaking it, as that risk is being borne by the participants. As noted above, however, Chapter VIII of the OECD Guidelines now focuses upon whether the allocation of costs among the participants reflects the relative benefits inuring to

Specific issues in transfer pricing

the parties. A profit element is thus no longer to be allocated among the participants in the cost-sharing arrangements.

Payments under cost-sharing schemes are not generally regarded as royalties for tax purposes and therefore are typically not subject to withholding taxes.

Cost-sharing adjustments

By their nature, most cost-sharing arrangements are long-term. The allocation of costs to participants by reference to their relative anticipated benefits is also an inexact science and can be tested for reasonableness only over an extended period. Chapter VIII of the OECD Guidelines recognises these difficulties and provides that adjustments should not therefore be proposed in respect of just one fiscal year's apparent imbalance between cost-sharers. It also provides that tax authorities should challenge an allocation of costs under a cost-sharing arrangement when the tax authority determines that the projection of anticipated benefits would not have been used by unrelated parties in comparable circumstances, taking into account all developments that were reasonably foreseeable by the parties at the time the projections were established and without the use of hindsight. Consequently, the tax authority would have to conclude that the cost-sharing arrangement was not entered into in good faith and was not properly documented when implemented. If a tax authority does successfully contend that a correction is required, the position can become complex. In essence, an imputed charge to the other cost-sharers will be imposed. This charge imposes considerable difficulties with respect to obtaining relief for the additional costs in the other cost-sharers. In the absence of multilateral tax agreements, the group will need to begin simultaneous requests for relief under a number of separate double tax agreements, which is likely to prove a lengthy task.

Cost-sharing and risk

Cost-sharing arrangements can be implemented only prospectively. Becoming a cost-sharer represents a change in the nature of business for the paying company. By implication, it becomes involved in the high-risk activity of R&D and agrees to carry the business risk of significant future expenditure. While the offsetting income that it hopes to generate in the future is of value, this income may not accrue for quite some time. Overall, risk is therefore increased and the participants expect eventually to see a corresponding increase in general levels of profitability.

However, before the future income stream starts to arise, it is likely that overall expenses will increase in the contributing companies. Therefore, during this transitional phase, there may be a dramatic reduction in profitability taking place at the same time as an increase in business risk. This result will increase the chance of a review of inter-company transactions by the local tax authorities. Lost or delayed income tax deductions and possible limitations on the deduction of start-up losses might also arise during the transitional phase. These items might magnify unprofitable operations and increase business risk.

Cost-sharing arrangements also attract the authorities' attention because they typically appear as a new category of expense in company accounts and tax returns where, historically, cost-sharing has not been practised. Change is always an occasion when tax authorities might identify an area as worthwhile for investigation.

Once implemented, the cost-sharing arrangement must be actively monitored by all involved parties. Care should be taken to ensure that the legal form of the cost-

sharing agreement reflects its substance. In addition, the documentation of the active involvement of the members in policy setting, monitoring and controlling the cost-sharing agreement on a current basis is indispensable.

The participants

Cost-sharing is generally performed among manufacturing, distribution or standalone R&D companies. While cost-sharing arrangements have traditionally been most popular between manufacturing companies, distribution and standalone R&D companies are increasingly becoming participants. This change is in part due to the increasing use of third-party contract manufacturers. In a cost-sharing arrangement among manufacturing companies, the manufacturers produce goods that are sold at a price that reflects the R&D costs incurred. Any associated distribution companies are remunerated only for their distribution functions and risks.

A cost-sharing arrangement involving a distribution company may fundamentally change the functions and risks typically performed by each participant and greatly increase the complexity of the group's transactions. The distribution company effectively assumes the functions and risks of a research company and distributes goods that are sold at a price that reflects the R&D costs incurred. In this type of cost-sharing arrangement, the manufacturing company assumes the functions and risks of a contract manufacturer that produces goods sold to the distributor (that owns the intellectual property) for a price that reflects the contract manufacturing costs incurred.

To the extent that most of the R&D is concentrated in one company in physical terms, cost-sharing at the distribution company level represents a purely fiscal decision, since the substantive activities of the distribution company do not directly utilise the fruits of the R&D expenditure. While cost-sharing may be achieved in legal and financial terms through the use of contracts, it remains true that arrangements that are purely fiscal in nature are coming under increasing attack by tax authorities around the world.

Establishing cost-sharing arrangements in mid-stream

If a company has historically conducted and funded R&D in one legal entity and wishes to establish a cost-sharing arrangement in the future, the company must carefully consider two issues:

1. Buy-in payments.
2. The business issue regarding the location of ownership of intangible property (i.e. which entities are characterised as the developer of the intangible – under the OECD Guidelines, the developer is the entity that acquires legal and economic ownership of the intangible property).

Buy-in arrangements

When a group decides to form a cost-sharing arrangement to fund the development phase, as opposed to the research phase of R&D, an important issue arises: whether a payment should be made by a company entering into a cost-sharing arrangement with the owner of existing technology. This concept, known as 'buy-in', has been under debate for some time but came under widespread review following the publication of a white paper by the IRS in the US in 1988. This white paper interpreted the transfer pricing proposals contained in the Tax Reform Act of 1986 in the US, which obtained widespread publicity. Most tax authorities are now aware of the concept of buy-in and are in the process of considering the issues raised by this concept.

Specific issues in transfer pricing

The concept of buy-in is based on the view that when a new member joins a cost-sharing arrangement, the benefits emerging from research typically not only build on current R&D costs but also capitalise on past experience, know-how and the prior investment of those involved in the earlier cost-sharing arrangement. Consequently, the new member receives benefits from the historical expenditure of the earlier participants, although it did not contribute to those costs. In the international context, the US has made the point very strongly that it is inappropriate for a new member to receive these benefits free of charge.

While the need for a buy-in payment is well-established, the required computation may be controversial. The IRS has advocated that a valuation be carried out to determine an amount that would be appropriate to be paid to the original cost-sharers by the new member, reflecting the fact that the latter has obtained access to know-how and other valuable intangible property, which it will not be paying for through its proportionate share of future R&D expenditure.

The 1988 white paper indicated that the buy-in valuation should encompass all pre-existing, partially developed intangibles, which would become subject to the new cost-sharing arrangements, all basic R&D not directly associated with any existing product, and the going-concern value of the R&D department, the costs of which are to be shared.

The 1995 US final cost-sharing regulations provide that buy-in payment is the arm's-length consideration that would be paid if the transfer of the intangible was to, or from, an unrelated party. The arm's-length charge is determined under the pertinent part of the US regulations, multiplied by the controlled participant's share of reasonable anticipated benefits.

The 2008 US temporary cost-sharing regulations refer to buy-in payments as platform contribution transactions (PCTs) and expand the definition of intangible property subject to a PCT payment as any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost-shared intangibles. Under this new definition, the contribution of an experienced research team in place would require adequate consideration in the PCT payment. Such a team would represent a PCT for which a payment is required over and above the team's costs included in the cost-sharing pool.

The 2008 US temporary cost-sharing regulations also make an important change to the requirements under which reasonably anticipated benefit ratios are calculated for PCTs and cost-sharing arrangements. There is now an explicit requirement that reasonably anticipated benefit ratios be computed using the entire period of exploitation of the cost-shared intangibles.

Furthermore, the 2008 US temporary cost-sharing regulations reiterate that the rights required to be transferred in order to eliminate a perceived abuse where the transfer of limited rights could result in lower PCT payments. Therefore, under these 2008 US temporary cost-sharing regulations, the PCT payment must account for the transfer of exclusive, non-overlapping, perpetual and territorial rights to the intangible property. The 2008 US temporary cost-sharing regulations also consider other divisional bases in addition to territorial basis, including field of use.

Similar to the 2005 US proposed cost-sharing regulations, the 2008 US temporary cost-sharing regulations do not allow a reduction in the PCT for the transfer of existing 'make or sell' rights by any participant that has already paid for these rights.

Another significant change in the 2008 US temporary cost-sharing regulations is the so-called 'periodic adjustment' rule, which allows the IRS (but not the taxpayer) to adjust the payment for the PCT, based on actual results. Unlike the 'commensurate with income' rules, the temporary regulations provide a cap on the licensee's profits (calculated before cost-sharing or PCT payments) equal to 1.5 times its 'investment'. (For this purpose, both the profits and 'investment' are calculated on a present value basis.) Notably, this periodic adjustment is waived if the taxpayer concludes an APA with the IRS on the PCT payment. There is also an exception for 'grandfathered' CSAs, whereby the periodic adjustment rule is applied only to PCTs occurring on or after the date of a 'material change' in scope of the intangible development area. The 2008 US temporary regulations also provide exceptions to the periodic adjustment rule in cases where the PCT is valued under a CUT method involving the same intangible and in situations where results exceed the periodic adjustment cap due to extraordinary events beyond control of the parties.

In addition, the 2005 US proposed cost-sharing regulations introduced the 'investor model' approach, which provides that the amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participants' aggregate net investment in developing cost-shared intangibles pursuant to a CCA, attributable to external contributions and cost contributions, is reasonably anticipated to earn a rate of return, equal to the appropriate discount rate. The 2008 US temporary cost-sharing regulations significantly change the application of the investor model. This model indicates that the present value of the income attributable to the CSA for both the licensor and licensee must not exceed the present value of income associated with the best realistic alternative to the CSA. In the case of a CSA, the 2008 US temporary cost-sharing regulations indicate that such an alternative is likely to be a licensing arrangement with appropriate adjustments for the different levels of risk assumed in such arrangements. The 2008 US temporary cost-sharing regulations also recognise that discount rates used in the present value calculation of PCTs can vary among different types of transactions and forms of payment. These new proposed rules are discussed in more detail in the US chapter. Furthermore, the requirements under the Temporary Regulations for application of the Residual Profit Split Method will likely restrict the use of this method to certain cases where the licensee brings pre-existing intangibles to the CSA. In cases where the licensee does not possess pre-existing intangibles, the Income Method, Market Capitalisation Method and Acquisition Price Method are likely to predominate.

Chapter VIII of the OECD Guidelines supports the use of buy-in payments as the incoming entity becomes entitled to a beneficial interest in intangibles (regardless of whether fully developed), which it had no rights in before. As such, the buy-in would represent the purchase of a bundle of intangibles and would need to be valued in that way (i.e. by applying the provisions of the Guidelines for determining an arm's-length consideration for the transfers of intangible property).

Note that the terminology employed in Chapter VIII of the Guidelines, the 1995 US final cost-sharing regulations and the 2008 US temporary cost-sharing regulations with respect to this concept is somewhat different. Under Chapter VIII, a buy-in is limited to a payment made by a new entrant to an existing cost-sharing arrangement for

Specific issues in transfer pricing

acquiring an interest in the results of prior activities of the cost-sharing arrangement. Similarly, a buyout refers only to a payment made to a departing member of an existing cost-sharing arrangement. Chapter VIII refers to any payment that does not qualify as a buy-in or a buyout payment (e.g. a payment made to adjust participants' proportionate shares of contributions in an existing cost-sharing arrangement) as a 'balancing payment'. In contrast, the 1995 US final cost-sharing regulations use the terms more broadly. Buy-in and buyout payments refer to payments made in the context of new as well as existing cost-sharing arrangements under these regulations. There is no such thing as a balancing payment in the 1995 US final cost-sharing regulations. In further contrast, the 2008 US temporary cost-sharing regulations refer to buy-in payments as PCTs for which the controlled participants compensate one another for their external contributions to the CCA. In addition, post-formation acquisitions (PFAs) occur after the formation of a CCA and include external contributions representing resources or capabilities acquired by a controlled participant in an uncontrolled transaction.

If payments are to be made to another participant in the cost-sharing arrangement (regardless of whether the payment is characterised a buy-in, a buyout or a balancing payment), consideration must be given to the tax deductibility of such payments made by the paying entity and their accounting treatment. Unless there is symmetry between their treatment as income in the recipient country and deductible expenditure in paying countries, a related group might well face significant double taxation as a result of the buy-in payment. The buy-in payment issue must be addressed on each occasion a new company becomes involved in the cost-sharing arrangement.

Ownership of intangibles

Since cost-sharers own the technology developed through the cost-sharing arrangements, when technology is partially developed prior to the commencement of the arrangement and then modified or further developed as part of the arrangement, an issue arises concerning the ownership of the resulting technology. This area is murky and may lead to significant business problems if defence of the property rights becomes necessary.

Example

Bozos Unlimited (BU), a US company, manufactures toy clowns sold to children worldwide through wholly owned subsidiaries located in Canada, Germany, France and the UK. Its manufacturing activities are conducted in the US and in a wholly owned subsidiary in Ireland. Currently, the Irish subsidiary pays a 3% royalty to the parent for the technology that it uses and all R&D has, to date, been conducted in the US and paid for by BU.

To meet child safety requirements throughout the world, as well as to reduce manufacturing costs so that its product remains competitive, BU has decided to embark on a major R&D effort. The cost will be significant, and BU realises that it will need the financial resources of the Irish subsidiary to help fund this project. It has decided that neither dividends nor an inter-company loan are desirable, and a cost-sharing arrangement is therefore selected.

To implement the cost-sharing arrangement, BU must address the following issues:

- The need for a buy-in payment.
- The amount of the cost-sharing payment to be made by the Irish subsidiary.
- The rights which will be given to the Irish subsidiary.

Because the Irish subsidiary has been paying for the pre-existing technology through the licence agreement, it is determined that this arm's-length royalty rate is sufficient under Chapter VIII of the OECD Guidelines to compensate BU for the existing technology. However, under the 1995 US final cost-sharing regulations, the buy-in payment is required to be the arm's-length charge for the use of the intangible under the pertinent provisions of the US transfer pricing regulations, multiplied by the Irish subsidiary's anticipated share of reasonably anticipated benefits. The prior royalty payments will likely be insufficient, and the Irish subsidiary will have to pay a buy-in payment to the parent to the extent that the royalty payments made are less than the required buy-in payment amount. In further contrast, under the 2008 US temporary cost-sharing regulations, the prior royalty payments would be considered 'make or sell' rights, which cannot reduce the amount of the buy-in for the existing technology.

Under Chapter VIII of the OECD Guidelines, the cost of the R&D is calculated by aggregating the direct and indirect costs of the R&D activities; this expense is divided between BU and its Irish subsidiary, based on the relative sales of both entities. Under the 1995 US final cost-sharing regulations and 2008 US temporary cost-sharing regulations, the cost of the R&D is calculated by aggregating certain operating expenses other than depreciation or amortisation charges (i.e. expenses other than cost of goods sold, such as advertising, promotion, sales administration), charges for the use of any tangible property (to the extent such charges are not already included in operating expenses) plus charges for use of tangible property made available by a controlled party. Costs do not include consideration for the use of any intangible property made available to the cost-sharing arrangement. Under the 1995 US final cost-sharing regulations, 2008 US temporary cost-sharing regulations and Chapter VIII of the OECD Guidelines, these costs are allocated between BU and its Irish subsidiary in proportion to their shares of reasonable anticipated benefits from the developed R&D. However, the 2008 US temporary cost-sharing regulations specify the reasonable anticipated benefits shares be computed using the entire period of exploitation of the cost-shared intangibles.

The rights that will be granted to the Irish subsidiary under the agreement are the use of the technology in respect of sales outside North America. Under the 2008 US temporary cost-sharing regulations, the rights granted to the Irish subsidiary must be the exclusive and perpetual use of the technology in respect of sales outside North America.

Other types of cost-sharing agreements

Costs other than those involving R&D can also be shared through a cost-sharing arrangement. For example, common costs such as accounting, management and marketing can be the subject of a cost-sharing agreement among the affiliates that benefit from the services offered. (*See Management Services section, above for further discussion of this type of cost-sharing arrangement.*)

Specific issues in transfer pricing

Foreign exchange and finance

Foreign exchange risk – introduction

Unexpected foreign exchange-rate fluctuations pose one of the most difficult commercial challenges to an effective inter-company pricing policy. On several occasions over the past 20 years, the value of currencies such as the US dollar and UK pound sterling have moved by up to 40% over a relatively short time, only to rebound by a similar amount. Exchange-rate fluctuations affect the competitiveness of a multinational firm's various worldwide operations. A depreciating US dollar, for instance, tends to improve the export competitiveness of US-based manufacturers. If a multinational firm's transfer prices do not respond to changing competitive pressures, the composition of the firm's worldwide profit profile will be distorted. These distortions can disrupt a multinational firm's production, financial and tax planning.

The arm's-length standard

The arm's-length standard requires related parties to set their inter-company pricing policies as if they were unrelated parties dealing with one another in the open market. It follows that this principle requires a multinational firm's transfer pricing policy to include an exchange-rate adjustment mechanism similar to that which would be employed by unrelated parties in similar circumstances.

Unfortunately, firms across different industries, and even within the same industry, respond to exchange-rate changes differently. Sometimes, the manufacturer bears the exchange risk, sometimes the distributor bears it, and sometimes the two share it. The choice of which party will bear the exchange risk depends on the multinational firm's unique set of facts and circumstances. If, for instance, the manufacturing arm of the firm sells to many different related distributors in many countries, it may make most sense for it to centralise foreign-exchange risk. The profits of the company bearing the exchange risk will fluctuate with the relevant exchange rates. When these fluctuations are unusually large, they are likely to draw the attention of the domestic or foreign tax authorities.

Types of exchange-rate exposure

The exchange-rate exposures of a multinational enterprise can be categorised as translation (*see Translation exposure, below*), transaction (*see Transaction exposure, below*) and economic (*see Economic exposure, below*) exposure.

Translation exposure

Translation exposure, often referred to as accounting exposure, relates to the multinational firm's need to translate foreign currency denominated balance sheets into its domestic currency, so that the multinational firm can create a consolidated balance sheet. It measures the change in the consolidated net worth of the entity, which reflects changes in the relevant exchange rate.

Transaction exposure

Transaction exposure concerns the impact of unexpected exchange-rate changes on cash flows over a short time, such as the length of existing contracts or the current financial planning period. It measures the gains or losses arising from the settlement of financial obligations, the terms of which are stated in a foreign currency. If the currency of denomination of a transaction is the domestic currency – for instance, if the invoices are stated in terms of the domestic currency – the domestic firm could still bear transaction exposure if the domestic currency price varies with the exchange rate.

For example, assume that a contract between a Japanese manufacturer and a Belgian distributor states the price of goods in Euros. It would appear that the Belgian company bears no exchange risk. However, if the euro price is adjusted to keep the Japanese company's yen revenues constant when the yen/euro exchange rate changes, then the Belgian company is exposed to exchange risk. Consequently, transaction exposure depends not on the currency of denomination of a contract or transaction but on the currency that ultimately determines the value of that transaction.

Economic exposure

Economic exposure measures the change in the value of the business resulting from changes in future operating cash flows caused by unexpected exchange-rate fluctuations. The ultimate change in the firm's value depends on the effect of the exchange-rate movement on future volumes, prices and costs. Economic exposure consequently looks at the effects once the market has fully adjusted to the exchange-rate change. Factors that determine the degree of economic exposure include the following:

- Market structure.
- Nature of competition.
- General business conditions.
- Government policies.

Example

USM, a US-based manufacturer of auto parts, exports its product to UKD, its UK-based distribution subsidiary. UKD sells parts to unrelated retailers throughout the UK. USM denominates the transfer price in pounds and converts its pound receipts into dollars. USM has adopted a resale price approach to set its transfer price for goods sold to UKD. The resale price method calculates the transfer price by deducting an arm's-length markup percentage for UKD's distribution activities from the resale price.

Given this pricing method, USM bears all the foreign-exchange transaction exposure. When the value of the dollar appreciates, USM reaps unexpected exchange-rate gains on its dollar receipts; when the value of the dollar depreciates, USM incurs unexpected exchange-rate losses.

Planning opportunities

The presence of foreign exchange risk in inter-company transactions provides some potentially valuable planning opportunities to multinational firms. These opportunities relate to the strategic placement of foreign-exchange risk. The more risk that a particular entity bears, the higher the compensation it should earn, and a multinational can place foreign-exchange risk in one entity or another by the way that it sets its transfer prices.

Example

A large automotive company manufactures auto parts in many countries, operates final assembly plants in several other countries, and then sells products in virtually every country around the world. This firm's inter-company transactions generate enormous exchange-rate exposures. For example, each assembly plant purchases parts from its affiliates located in as many as 15 countries and then sells finished automobiles in over 50 countries. The firm has a number of choices to make concerning the management of its foreign exchange risk.

Specific issues in transfer pricing

Each of the plants incurs expenses denominated in local currency, such as wages, rent, interest and taxes. In an effort to help smooth out the cash flow of these local companies so they can pay local expenses with a minimum of concern about exchange rate fluctuations, corporate management may wish to insulate them from exchange rate exposure. The company could, for instance, establish a trading company that would buy and sell raw materials, parts and finished products from and to each of the local operating companies in the company's local currency. The trading company would, in these circumstances, bear all of the firm's foreign exchange risk.

Because all goods sold inter-company would pass through the trading company, this company could also centralise and coordinate the purchasing of supplies for the firm's worldwide operations. By acting as the central agent, the trading company could ensure that supplies were always procured from the suppliers offering the lowest prices, and could capitalise on volume discounts where available.

Clearly, in order to be tax effective, the creation of the trading company would need to be supported by a well-established business plan that significantly altered the operations of existing entities and placed real business functions and risks in the trading company. Furthermore, the trading company's employees must have a level of expertise and be sufficient in number to conduct its business. For instance, if it reinvoices and manages foreign-exchange risk, it needs accountants to handle the invoicing and the collection activity plus foreign-exchange managers to deal with hedging.

As with all inter-company transactions, it is necessary to apply an arm's-length pricing policy between the trading company and its affiliates. The more functions and risks transferred to the trading company, the higher the return that the trading company should earn.

Instead of centralising foreign-exchange risk in a trading company, the automotive firm could decide to place all foreign-exchange risk in the local operating companies. In this way, it would force the local managers to control and minimise all of the risks generated by their operations. The return earned by each of the operating companies would then have to be adjusted upwards by enough to compensate them for the additional foreign-exchange exposure.

Loans and advances

The financial structure is important when considering a range of planning moves with a multinational group, such as:

- starting a business in another country
- financing expansion
- underwriting losses of troubled subsidiaries, and
- determining or establishing a trading account between two affiliates.

The use of debt frequently aids in the movement of earnings from one country to another in a tax-efficient manner. The financial structure may also be important in establishing commercial viability in another country. Various types of credit may be involved, including:

- Demand loans.
- Term loans.
- Temporary advances.
- Open trading accounts.
- Cross-border guarantees or other collateralisation of an affiliate's outstanding debt.

Characterisation of loans

For tax purposes, the issue of the characterisation of funds placed with a subsidiary as debt or equity was considered in *Financing transactions* in Chapter 2. In summary, many countries have specific rules or practices that restrict the permissible level of related-party debt, and it is crucial to review these before adopting any amendments to the group's international financial structure.

Interest on loans

The arm's-length principle is applicable to the rate of interest paid on inter-company debt. Developed countries have rules that embody the arm's-length principle. However, application of the principle by the tax authorities in each country and by each country's courts varies significantly.

The basic principle is that the interest rate to be charged between related parties is the market rate of interest that would be charged at the time the indebtedness arose between unrelated parties, assuming similar facts and circumstances. The facts and circumstances that should be taken into consideration include:

- Repayment terms (i.e. demand, short-term, long-term).
- Covenants.
- Collateralisation.
- Guarantees.
- Informal and temporary advances.
- Open lines of credit.
- Leasing arrangements that are not bona fide leases.
- Trading accounts.
- Credit risk of the debtor (i.e. debt-to-equity ratio).
- Volatility of the business.
- Reliance on R&D or other high-risk investments such as oil and gas exploration.
- Track record of affiliate.
- Location of exchange risk.
- The market – differences may exist among the markets of various countries, the regional market such as the European market or the Eurodollar market.

This general principle is used in most countries, but some provide a 'safe harbour'. Consequently, although a provision is made for arm's-length interest rates, if an interest rate falls within a specified range, other factors of comparability will be ignored. For instance, in Switzerland, the tax authorities have issued required minimum and maximum rates based on the Swiss market. However, deviations from the rate may be made when the debt is in foreign currency or the difference is modest and the rationale is reasonable. The US also has an extensive system of safe harbours.

Specific issues in transfer pricing

Loan guarantees

Generally, the tax authorities are silent on the treatment of guarantees of indebtedness provided by related parties. Presumably, such guarantees should require an arm's-length fee for the guarantee. The fee would be determined by the fee that would be charged for such a guarantee between two unrelated taxpayers under similar circumstances. Since such guarantees are infrequent, the arm's-length principle may be difficult to apply. However, when the interest rate between the borrower and the lender is reduced by virtue of the guarantee, the interest rate reduction can be used as a measure of the value of the guarantee. This concept has recently attracted significant attention from the OECD in its working papers on global dealings as well as in the US. As such, one can expect to see more activities in the examination of these types of arrangements in the near future.

Bona fide leases

Leasing as a form of loan financing is discussed in Section 221. The use of a bona fide lease as a means of securing the use of tangible property without bearing the risk of ownership is another type of financing. In this context the transfer pricing rules relating to interest rates are not appropriate. However, rules prescribed by the tax authorities on arm's-length rental rates are minimal. The OECD does not provide guidelines, and most countries do not address the subject, even in a general manner. It is thought that cross-border leasing of equipment (using bona fide leases) is not common practice (being focused mainly on individual, high-value transactions requiring individual treatment), probably because cross-border leasing is commercially complex and raises myriad business and tax issues. For instance, owning equipment located in some countries may create a permanent establishment problem for the foreign-based lessor. In addition, there may be withholding taxes on rentals payable under certain jurisdictions.

Establishing an arm's-length rental rate

Most countries accept proof of an arm's-length rental rate based on one of the following methods:

- A comparable uncontrolled price.
- Pricing based on economic depreciation of the leased asset.
- Pricing based on interest and a profit markup for risk.
- Pricing based on any other method for establishing a reasonable rent.

E-business

Introduction

There are no transfer pricing rules specific to e-business and none are currently being proposed. However, this situation has not prevented a great deal of discussion taking place about the impact of e-business and new business models on the application of traditional transfer pricing concepts.

Instantaneous transactions across international boundaries – which are quicker, more frequent, often highly automated and involve the greater integration of functions within a multinational group – potentially make it harder to perform a traditional analysis of functions, assets and risks. What is it that creates value, for instance, where huge costs may be taken out of the supply chain by the use of a software platform that links the entire chain from raw materials supplier to ultimate customer? Can one readily ascertain which party performs which specific function, and where? Given that

current tax regimes work within international boundaries, and transfer pricing rules require one to attribute value to location, has it become even more difficult to establish where profit is made? And if one can successfully identify the transaction and its essential attributes, is there a readily available comparable transaction given the unique factual circumstances which, for now, may relate to certain e-business activities?

Transfer pricing issues for the business community

If one looks at the new business models emerging, one begins to realise that there are opportunities to reduce the tax burden. Let us start with electronic marketplaces. These are the online exchanges and networked business communities, usually involving established businesses, which allow these businesses to buy and sell products and services. These exchanges are often multi-member joint ventures with geographically diverse investors and newly hired management and staff. They are lean operations with high potential value and no loyalty to any particular geographical or business location. Despite the deflation of the dot.com bubble, interest in such business models continues, with some caution over the measure of benefits expected.

The playing field is by no means level and the right choice of location can have a great positive impact on the rates of return for investors. Tax is a significant factor in choosing where to set up a new business and, despite what some may say, competition in this area is alive and well.

There is also the issue of how established businesses are starting to transform themselves. The new technology has allowed new businesses finally to integrate changes that took place in the 1990s – in particular, restructuring and business process standardisation and a focus on core skills. These changes have brought the emergence of brand owners, or entrepreneurs, who outsource non-core physical activities across the supply and demand chains. They may even move out of manufacturing entirely and simply have finished products shipped from external suppliers.

Bring tax and transfer pricing into this process and the who, what and where of what a business does has a crucial impact on the earnings that a business generates. Whether a website or server has a taxable presence in another country into which the business is selling pales in importance beside the priority of ensuring that the value in this streamlined and more mobile business is created in the most friendly tax jurisdiction. The change in business model has afforded the established business an ideal opportunity to revisit the tax efficiency of how and from where they operate.

Issues for tax authorities

Tax authorities have been concerned about the perceived difficulty of identifying, tracing, quantifying and valuing web-enabled cross-border transactions. A number of countries including Australia, Canada, Ireland, New Zealand, the UK and the US, issued reports on the tax implications of e-business, which included discussions about the impact of e-business on existing transfer pricing rules and practices. However, there has been a general recognition that the response, if needed, has to be international and has to be coordinated. Consequently, tax authorities within and outside the OECD have used the OECD as the forum to address the issues and produce appropriate international guidance.

Specific issues in transfer pricing

This debate at the OECD has produced some conclusions which have been incorporated in the latest version of the OECD Model Tax Convention on income and on capital, which was released in January 2003. For instance, it has been concluded by most OECD countries that a website by itself does not constitute a permanent establishment, as it is not tangible property and so cannot be a fixed place of business. However, if the enterprise that carries on business through the website also owns or leases the server on which the website is located, then the enterprise could have a permanent establishment in the place where the server is located, depending on the nature and extent of the activities carried on through the server and the website.

Other issues, such as the attribution of profit to a server permanent establishment remain to be resolved and the work of the OECD on the taxation of e-commerce continues.

6.

Managing changes to a transfer pricing policy

Introduction

From time to time, it will become necessary to change a group's transfer pricing policy, and these amendments themselves can give rise to a considerable range of problems. In addition to deciding exactly what changes to make, the group must address the challenges involved in communicating the changes to all those involved, ensuring that the new procedures are implemented smoothly, and monitoring the effects of the changes on the profitability of the legal entities involved.

Additionally, several strategic questions must be dealt with concerning, in particular, the timing of the changes and the evaluation of their possible effect on the perception of the group's operations, both by the users of the group's accounts and the tax authorities that deal with the affairs of the group in various countries.

The purpose of this chapter is to guide the reader through these difficult areas and to highlight the critical points that require attention.

Transfer pricing committee

To guarantee the smooth operation of a transfer pricing policy, all aspects of the transfer pricing process need to be carefully monitored on an ongoing basis. The functional analysis must be kept up to date, as must information on industry-standard operating practices, comparables and the financial performance of each legal entity within the group. In particular, it is necessary to consider alterations to the transfer pricing policy, which may be required to allow for changes in the business, such as acquisitions, major new product lines, new geographic markets and competitors. For any group with significant inter-company transactions, this can be a mammoth undertaking.

A helpful approach is to establish a committee to assist in the management of pricing policy. The committee should consist of individuals with a clear understanding of each of the major commercial departments within the company, including R&D, manufacturing, marketing and distribution, logistics, and after-sales service. The interests of each division or business unit should be represented so that the transfer pricing policy clearly reflects business reality and meets the needs of the group as a whole. On the financial side, the committee should include representatives from accounting, finance, tax and treasury.

The responsibility of the committee is to advise on whether the arm's-length transfer pricing policy that the group has adopted is properly and efficiently implemented and continues to work effectively. It must recommend that appropriate transfer pricing policies are implemented for new products, new geographic markets, etc. The committee's brief will be to monitor changes in the business, whether they be major

Managing changes to a transfer pricing policy

restructurings made for operational reasons, intended acquisitions, new product lines or changes in operations, and to determine whether the policy is effective or recommend changes that need to be made to correct any deficiencies.

The transfer pricing committee will therefore have a wide brief to look at the group's operations as a whole and review how the pricing policy operates. Its members must be prepared to take a broad view of the business, and the committee must be given authority to obtain the information they need and to make recommendations from an independent viewpoint.

The chairperson of the committee should therefore be chosen with care as he or she will, from time to time, have to make recommendations for change, which will invariably be unpopular somewhere in the organisation. The final choice of a chairperson will naturally depend on the individuals available within the group, but it would be preferable for someone with the broadest overview of the group to take this role. In general, the chairperson should not be a tax person for the pragmatic reason that this would give the wrong message to the group's personnel as well as to the tax authorities as to the nature of the committee's activities. The choice of chairperson might be more or less controversial in different jurisdictions (for instance, in the US a tax person as chairperson would certainly be inappropriate), but it must be borne in mind that the committee is not a tax-planning device but a key tool in the effective financial management of the company. It would be inappropriate for other executives or the tax authorities to reach the conclusion that the committee exists purely for tax purposes.

The transfer pricing committee is responsible for policy but may delegate various detailed activities to finance personnel, sales managers and plant managers. The committee should meet when major operating changes are envisaged, but otherwise a regular quarterly meeting is advisable.

Setting the group's initial pricing policy

The first occasion on which a group begins to carry on part of its business on a cross-border basis is the point at which it must establish a defensible transfer pricing policy. Needless to say, this is often seen as the least important consideration for those involved (if they consider it at all), who will be far more interested in operational business issues and ensuring that the new operation is a commercial success. At this initial stage, the sums involved may be small and people may be unwilling to invest the necessary effort in establishing the policy. However, whether a company is expanding overseas for the first time or an existing group is adding a new line of business to its multinational operations, 'getting it right first time' must be the objective of those who are responsible for the group's pricing policies. Any more limited objective will inevitably give rise to difficulties in resolving the group's tax liabilities in the countries concerned and, in the medium- to long-term, necessitate making changes to the policy that could have associated tax costs and adverse fiscal implications.

Active planning of the global tax charge

It is not unusual for a group to begin its international operations with a transfer pricing policy that is not efficient from an effective tax rate perspective. Apart from the difficulty in devoting sufficient resources to pricing and planning when developing new markets, it is difficult to predict accurately how the overseas operations will progress in terms of sales and expenses. If the pricing policy is still less than optimal when these

transactions become a material portion of the total business of the group, there will be correspondingly serious tax problems to be addressed.

The group should undertake a review to consider the possible courses of action that may be pursued to rectify the policy. This analysis may conclude that only fine-tuning is needed to achieve an arm's-length result.

The substance of the operations of a given legal entity determines the amount of profit that should accrue to that entity. Therefore, the only effective way of managing the worldwide tax rate, when the existing policy is arm's length, is to change the manner in which the group conducts its operations. As a result, the group will make substantive changes in its operations to reduce income in high-tax jurisdictions and increase income in low-tax jurisdictions.

However, the impact of a major change in operations of a group should not be underestimated. What appears attractive from a tax management perspective may have adverse commercial results. It is also not for the short-term – tax rates may change rapidly, but it is not easy or cheap to decommission a factory. Having said that, it may be easier to “move” some of the business risks around the group rather than the functions. For example, exchange risk can be moved by changing the currency in which transactions are denominated, and risks of delivery and usage could be transferred by a subcontracting arrangement. One must also consider the tax consequences of transferring substantial functions and risk from a particular jurisdiction. Tax jurisdictions are well aware of these functional and risk moves and are legislating, or clarifying, their existing statutes to address the deemed notion of transfers of business or goodwill upon restructure of the operations, which potentially may attract significant tax consequences.

Change in the operating structure of the company

If the group does decide to alter its operations through rationalisation of manufacturing plants, centralisation of certain support services, etc., pricing policy changes can often be handled fairly easily. It is generally the case that a new transfer pricing mechanism will be necessary to achieve an arm's-length result.

If it can be demonstrated that both the present and previous transfer pricing policy adhered to arm's-length standards, then the only issue should be to ensure careful contemporaneous documentation of the changes in the business which necessitated the change in policy. The change in policy should be implemented at the same time as the change in the business (or as soon thereafter as possible).

Parent company pressure

Transfer pricing policy amendments are sometimes made solely to meet the needs of particular problems within the group not directly related to tax law or commercial law and not necessarily in accordance with arm's-length rules. For instance, a parent company seeking to pay significant dividends to its shareholders requires not only profits available for distribution but also cash. Where profits and cash are locked up in subsidiaries outside the home country, there will always be a choice between paying dividends to the parent or effecting remittances to the parent in some other form, for example through the mechanism of a management fee, payment of royalty or technology transfer fees, interest on borrowings from the parent, or perhaps through increasing transfer prices for goods sold from the parent to the subsidiary for onward

Managing changes to a transfer pricing policy

distribution. One should navigate cautiously when executing these strategies because, in addition to the income-tax implications, if these policies are deemed inconsistent with the arm's-length principle by a taxing authority, indirect tax issues may crop up.

The problem created by policies of this sort is the risk of tax audit when the policy is clearly not arm's length. It is a fact of life that such problems crop up, but a successfully managed group will resist submitting to such pressures unless the changes proposed can be accommodated within a fully arm's-length pricing policy.

Tax audit settlements

When resolving disputes with a tax authority, it is good practice, where possible, to ensure that the methodology agreed between the company and the authority for settling the current year's tax position is also determined as acceptable for some period into the future. This may necessitate an amendment to the existing transfer pricing policy. It is important to consider both sides of the transaction. In settling a tax audit, a competent authority claim (*see Chapter 10*) may be necessary to involve the authorities of the other state. In going through this claim with these authorities, it is important to address proposals for the future at the same time, if possible. If both countries agree on the approach to be adopted, a change to the transfer pricing policy should be uncontroversial. However, where different positions are adopted, great care will need to be exercised. In circumstances such as these, the company may wish to consider alternate measures to address the forward-looking issues by means of an advance pricing agreement (*see Chapter 10*).

When assessing the full cost of any settlement, it is important to take account of any late payment interest or penalty charges that may apply. Such charges are, in some jurisdictions, themselves not deductible for tax purposes. These liabilities may sometimes be open to negotiation.

For further discussion of tax audits, *see Chapter 7*.

Problems with current policy

A group may often find that an existing inter-company pricing policy no longer provides the results it requires. This is usually caused by one or more of the following factors:

- Changes in business conditions (e.g. recession or inflation) which cause changes in prices or volumes of third-party sales.
- Market-penetration activities that are designed to increase market share by reductions in market prices or by substantially increased marketing and promotional expenses. This could also be brought about due to breakthrough technology advances that force companies to re-engineer their pricing.
- Market-maintenance activities that are designed to protect market share in the face of intense competition. This can be accomplished through pricing policies or through marketing/promotion expenses.
- Where a group acquires a business with a different transfer pricing policy from that used elsewhere, the policy for the new expanded group should be reviewed. Even if, initially, there will be little cross-trading, over time it is inevitable that there will be transactions between the two groups. If pricing policies are not in line, there may be problems with local tax authorities, which will see similar intragroup transactions taking place in a single company.

- Where there are regulatory changes that affect pricing, which typically takes place in the pharmaceutical industry due to drugs going off-patent or due to the prices of drugs being agreed upon with the regulators.

Making corrections through fine-tuning

In this paragraph, it is assumed that the change needed to rectify the situation is fairly limited and represents fine-tuning. The situation where the current transfer pricing policy must be changed in a material way is dealt with in the next section (see *Massive change: alteration to business reality*).

Transfer pricing policies should be reviewed frequently. If the policy is monitored periodically (e.g. quarterly), it will be immediately apparent if it is not working properly. In this case, changes to transfer prices can be made for the subsequent quarter and the error in the result of the transfer pricing policy at the end of the year will generally be fairly small and, over a long period of time, the results of each company within the group will reflect the correct operation of the policy. There may be cut-off errors between one period and another, but they will even out over time, and dealing with corrections on a prospective basis is a more defensible position than retroactive changes, which third parties rarely make except where serious disputes are involved.

It is important to be aware of pressures in some countries to bring transfer prices up to date on as regular a basis as possible. For instance, while minor cut-off errors are likely to be fitted into the acceptable arm's-length range of transfer prices for US purposes, errors that mean that US profits cease to meet the arm's-length test will require adjustment for that year.

Transfer pricing policies should be managed within a range rather than on the basis of an exact formula, as it is impossible to maintain a precise transfer pricing result. An arm's-length range of acceptable results should be determined, with management within that range as the group's objective. So long as prices (and profitability) remain within the range, no changes should be necessary. Once prices move outside the range (or are predicted to move outside it), adjustments should be made. If the policy is monitored regularly, changes can be made prospectively without the need to be overly concerned about past mistakes or aberrations.

Massive change: alteration to business reality

A transfer pricing policy must address significant changes in the business environment. If a manufacturing company sells finished goods to a related distribution company using a resale price method, then changes in the market price of the product automatically vary the transfer price. These 'flow-through' price changes merely keep the arm's-length policy in place. If a reduction occurs in prices in this market and the discount that is used to apply the resale price method has to be increased from, say, 25% to 26% in order for the distributor to trade profitably, then this should be viewed as 'fine-tuning' and should not create significant problems if it is properly documented. However, assume that a massive recession occurs so that the market price of the goods and the volume sold declines precipitously. In addition, the discount earned by independent distributors declines from the previous norm of 25%–15%. Without a change in the transfer pricing policy, these factors could easily produce losses in the distribution company (because volume has significantly decreased without a corresponding change in overheads) or in the manufacturing company (same reason).

Managing changes to a transfer pricing policy

Such a situation is not unusual in some industries and provides a very difficult problem for transfer pricing as well as for the business generally.

It is important in these situations to realise that transfer pricing changes cannot solve the business problem (i.e. the market has collapsed and losses arise on a consolidated basis). All that a transfer pricing policy can do is to allocate the losses to the appropriate legal entities on an arm's-length basis.

Changes in law

If a group has established an arm's-length transfer pricing policy that is working well in all the countries in which it operates, how should it deal with the situation when a new law in one of its territories means that existing policies are no longer acceptable in that particular country? All cross-border transactions have an impact on the accounts of at least two separate legal entities, and if a policy is changed to meet the requirements of one country's laws, will the new policy be acceptable to the country affected on the other side of the transaction? While the arm's-length principle is widely recognised, individual countries have different views of exactly what this means. There is, therefore, always a risk of asymmetric treatment of transactions for tax purposes in different jurisdictions, resulting in double taxation.

A group's reaction to the different legal requirements, country by country, will necessarily be driven by its evaluation of the tax risks involved. If it seems inevitable that one particular country will apply its laws aggressively, resulting in double taxation if the group's policy for that country is not altered, then it may be necessary to amend the policy to produce the lowest tax result for the group as a whole. In these cases, monitoring the position in other countries will be of crucial importance.

Example

Cool EC (Cool) is a group of companies engaged in the manufacture of refrigerators operating entirely within the European Union (EU). Cool's engineering department is located in the UK company (Cool UK) and has for many years provided technical assistance to the group's sales companies throughout the EU. The services have been provided under the terms of a formal agreement, and charges are made for the engineers' time and expense in exactly the same way as charges are invoiced to third-party customers for the same services. This arrangement has been accepted by all the EU tax authorities, with the result that the service income is taxed only in the UK and tax deductions for the same amount are taken in the paying companies.

Cool has recently secured a large order for its machines from the biggest distributor of domestic electrical goods on the African continent. New subsidiaries will be established to service this market and to deal with customer services. However, as with the EU operations, Cool UK's engineers will also be required to provide their services from time to time. Unfortunately, Cool UK has found that it is likely to suffer extensive taxes if it seeks to charge for the engineers' services in the same way as in the EU countries.

The position varies in detail from country to country, but the range of problems include the difficulties in arranging foreign exchange clearances to obtain currency, withholding taxes, local sales taxes and, in certain cases, direct local taxation of the full service charge on the basis that the services represent a permanent establishment of Cool. Cool UK has calculated that the effective tax rate on the service fees could exceed 80% in certain circumstances, in addition to causing cash-flow problems.

How then, should Cool UK react to this significant problem? There are three main options:

- The group could pursue a policy consistent with the present arrangements in Europe, which would be supported by the third-party comparables.
- The group could decide that no charge be made, on the basis that the tax rate effectively wipes out any benefit.
- The group could find an entirely new way of dealing with the problem.

The first option is unacceptable due to the resulting high tax rate.

The second option will probably give rise to transfer pricing questions in the UK. The Inland Revenue will not accept that free services should be provided over an extended period to overseas affiliates and are likely to assess a deemed amount of income to UK tax. There is also the possibility that the other EU authorities could challenge the charges made to them if Cool's UK operation sought to increase the inter-company service charges to its European affiliates to offset the loss-making African service.

After lengthy negotiations, Cool UK finds that the African authorities are prepared to give full foreign-exchange clearances for payments for the refrigerators, and no other African withholding taxes would be applied to these payments. If the transfer price of the refrigerators can be increased to cover the expected cost of service by the UK engineers, then the UK authorities are unlikely to complain. Careful documentation will be needed to support the pricing. In particular, it will be helpful to monitor what the normal charge for the engineers' time on African affairs would have been and how this compares with the recovery made through the transfer price. It will also be relevant to consider if the increased transfer price would cover the estimated cost of maintenance services over the warranty period alone or would also cover after-sales service, which may be normally paid for by the end-customers. Consideration must also be given to the cost of spares, which would have to be imported for the service. One possibility is to increase the price of spares to cover the service component. Finally, it must be borne in mind that increasing the transfer price will increase the base on which African customs duties will be calculated. This hidden tax must also be evaluated in making the final decision on how to proceed.

Input from Cool's transfer pricing committee will be helpful in smoothing over management difficulties, which might otherwise arise. In particular, in this example, the head of the engineering department had been concerned that one result of recovering the value of engineering services through the transfer price of products would be that the apparent profitability of his division would decrease while the sales department's income would go up by a corresponding amount. As both managers receive bonuses calculated on divisional profits, there is an apparent conflict between their personal interests and those of the business. One solution may be for the bonus scheme to make adjustments for the African business. Alternatively, the engineering department could render an internal invoice to the sales department.

Dealing with major changes

Occasionally, a transfer pricing policy will not be arm's length and will require major changes. For example, it is not unusual for a parent company to establish transfer prices from its own manufacturing plant to related parties in high-tax jurisdictions using a cost-plus approach. Often, the cost base is standard manufacturing cost. The

Managing changes to a transfer pricing policy

'plus' is frequently quite low (e.g. 5% or 10%). If the result of a policy such as this is to produce recurring losses in the manufacturing entity, after deducting overheads and general and administrative expenses, while the sales affiliate is making large profits, it is clear that the transfer pricing policy is not arm's length; no independent manufacturer would tolerate manufacturing at a loss in this way. If such a policy has been in operation for a number of years and has not created problems with the tax authorities in the manufacturer's country, changing the policy is problematic – particularly because the need for change usually emerges as a result of a crisis. For example, a manufacturing company may experience recurring losses and consequent cash-flow problems. When this happens, the result is a critical need to change the policy to rectify the problem. The issue that must then be addressed is the reaction of the tax authorities involved.

When large changes are made to existing transfer pricing policies, the reaction of the tax authority in the country in which higher taxes will be paid is likely to be to investigate the reasons why the change was not made in prior years; it may be that opportunities exist to assess further taxes for years before the change came into effect. In contrast, the reaction in the country that loses revenue is likely to be exactly the opposite. Sometimes the group must simply accept this risk because the crisis requires the immediate imposition of the new policy. However, it may be possible to make changes in the substance of the business (e.g. shift risks between countries) to provide a basis for an argument that the business has been restructured and the new pricing policy reflects these changes.

Before the imposition of a new policy, it is necessary to evaluate the need for the change, relative to the tax audit exposure caused by the change. The attitude of the tax authorities involved must be considered along with the extent to which other matters may need to be negotiated with them. In some countries (e.g. the US) it is possible to protect subsequent years by arguing that the policy was wrong in the past. Careful management of prior years' audits will mitigate the risk in these situations.

Year-end adjustment

Towards the end of the fiscal year, a group usually examines the forecasted final income statements of the various legal entities within the group. For companies that have failed to plan their transfer pricing policies carefully, the results of this examination may not be acceptable. The reaction in these groups is often to process a lump-sum payment at the end of the year to 'make things right'. Determining the amount to put on these invoices is generally not difficult. It is deciding what to call the payment and how to justify it that is problematic. If it is described as a retroactive price change, it has the implications discussed in next section (see *Retroactive price changes*). If it is termed a royalty, it is necessary to show what intangible property has been provided to the licensee and why this was not recognised and formalised in a licence agreement at the beginning of the year. If it is called a management fee, the problem is how to demonstrate what services were provided, their cost and why the services were not formalised in a management service agreement at the beginning of the year.

In short, end-of-year adjustments are difficult to defend because there is no easy way to explain what the payment is for. Furthermore, it is usually impossible to find third-party comparables supporting major changes to the pricing of 'done deals'. This, and other points made in this chapter, point to the need to plan transfer pricing policies in advance so that these problems do not occur. If such changes are unavoidable, their

risks must be recognised and such documentation as can be assembled should be produced to defend the position taken.

Retroactive price changes

At the end of the fiscal year, companies sometimes discover that their transfer pricing policies have not produced the desired result. The temptation is to change transfer prices retroactively to correct the error. This behaviour is particularly likely if one of the related entities faces urgent cash or profitability needs. These types of changes should be resisted at all costs, if they affect years for which financial statements have been audited and published and tax returns have been filed. It is difficult to conceive of third-party situations where such a change would be justifiable, except perhaps on very long-term contracts. Furthermore, it is hardly likely to be in the group's best interests to withdraw their accounts and tax returns. Concern from banks, shareholders and tax authorities regarding the implications of such a move is bound to be highly unwelcome.

When the change affects only the current fiscal year, the picture is somewhat murkier. While the income-tax authority audits the result of a transfer pricing policy, rather than the method used, there is a 'smoking gun' aura surrounding retroactive price changes that undermines the credibility of the taxpayer's claim that an arm's-length transfer pricing policy is in place. Having said this, the direct tax authorities tend to review accounts rather than invoices, and if the overall effect is to produce a fair result they may not be able to identify the late timing of events.

Companies should not be complacent, however, even where it is unlikely that the direct tax authorities will be able to identify a year-end adjustment. The interest of indirect tax authorities must also be considered, as there will probably be duty and value-added/consumption tax implications of a retroactive price change.

The best approach must be to refrain from retroactive price changes unless the business situation is so desperate that the inherent tax risks are overwhelmed by commercial necessity.

Defensible late adjustments

The question of whether a charge can be made retroactively without creating significant tax problems can usually be answered by considering comparable transactions between parties at arm's length. For instance, in most forms of professional advice that companies seek, it is normal for the consultant to charge his client in arrears for work they undertake at their request. However, such an arrangement will have been agreed in advance between the consultant and the client. It will typically be evidenced in a contract between them describing the basis upon which they will work together. Consequently, the rendering of an invoice some time after the work has been done (and possibly indeed in a different financial year) will not affect the reasonableness or validity of the charge. However, an invoice rendered for work carried out without prior authorisation of that work by the client will often result in a dispute and possibly non-payment for the consultant.

To take the example even further, a consultant who gratuitously provides a company with information that could be of value to that company might do so as a speculative activity, hoping to win the company as a client. However, it seems unlikely that the consultant would be in a position to demand payment for such advice, even if successful in winning the business. The initial work is an investment for the future.

Managing changes to a transfer pricing policy

If we take these examples in the context of a group of companies where the parent company is taking a decision to charge all the subsidiaries a management fee, it will usually be evident from the facts whether a charge made on the last day of the year to cover the whole of the previous 365 days will be acceptable. The questions to be asked are whether the subsidiary requested the service and whether the subsidiary benefited from the service. It is not good enough merely for the parent to have incurred expenses in carrying out work that might or might not have been for the benefit of, or at the request of, the subsidiaries.

Typically, the purchase and sale of goods is a fairly simple process. Two parties enter into a contract for the supply of a product. The contract provides that the purchaser takes title to the goods subject to certain conditions (perhaps, for instance, full payment of the invoice) and the purchaser usually takes the goods under some kind of warranty from the seller as to their general condition and their fitness for their intended purpose. The contract also specifies the price at which the sale is to take place. As a result, most sales between parties at arm's length happen once and once only, and any subsequent transactions relating to the same goods concern warranty costs where the purchaser has found a difficulty with the items purchased.

It would be most unusual in a third-party situation for the seller of a product to demand more payment for what has already been sold, sometime after the original transaction has taken place. Despite this, many groups seek to do just this when they realise at year-end that the profits of the group have not arisen in the different subsidiaries quite as expected.

In certain industries, such as electronic components and semiconductors, distributors are typically afforded price protection by the manufacturer. In these situations, the distributor may receive credit notes by means of a retroactive discount on goods that it cannot move, due to market conditions or discounts on future purchases to affect the credit. However, these circumstances are limited to particular industry practices and should not be blindly applied. A group should tread cautiously in applying these adjustments and have documentation of third-party arrangements to support its positions.

If the change is necessary to bring the group's position into line with an arm's-length standard, then the timing is not as important as the need to make the change itself. Failure to make the change at that time will merely perpetuate a situation that is known to be incorrect and is therefore inadvisable. A technique that may assist in reducing these tensions is to include limited rights to vary certain transactions as part of the overall policy applying between the group companies (i.e. create a situation where invoices are issued on an interim basis and may be adjusted for certain predetermined and mutually agreed factors). Such contracts are not unknown between third parties, as they can offer a mechanism to share risks, such as foreign exchange, particularly on long-term contracts, but care must be taken to ensure that indirect taxes and customs duties are handled appropriately.

Timing of changes

The timing of a change in transfer pricing policy, particularly if it corrects an error in a prior policy, is crucial. If an income-tax audit is ongoing at the time the policy change is made, the tax authority might become aware of the change, and it could be alleged that the prior policy was incorrect. This type of evidence is not helpful in

settling the audit favourably. It is, therefore, imperative to plan carefully the timing of the implementation of a policy change to minimise the impact on the tax liability for previous years. This involves weighing the risks for prior years against the potential cost to the company of inaction, in the form of possibly higher tax rates in the future or possible penalties. This analysis is detailed and must be done on a case-by-case basis to arrive at a defensible answer.

‘Big bang’ or gradual

Where a change in an existing transfer pricing policy is to be made for the future, the decision must be made to phase in the change gradually or to make the change in one ‘big bang’. Assume, for example, that the change desired is to double transfer prices. This may be implemented through a doubling of the prices on 1 January of the next year (the big bang) or by phasing the price change in through incremental changes over the next three years (the gradual approach). Which of these options should be selected is largely determined by the reaction of the local tax authority of the country that is to pay the higher prices and vice versa in the source country of the price increases. In some countries, the big bang works so long as it can be clearly demonstrated that the new prices are arm’s length and the risk of audit on prior, open years is controlled. In other countries (e.g. Italy), phase-in is the only way to deal with the potential objections of the tax authority. Knowledge of the size of the change and the reaction of the tax authority that will lose revenue on the transaction is essential to this decision.

Communicating the changes to the tax authorities

For certain changes in transfer pricing policies, it may be important to obtain local government approval. In some countries (e.g. Korea and China), for instance, royalty payments must be approved by foreign-exchange control authorities. This is especially true when dealing with the developing countries in general and countries that are heavy importers of technology of all kinds. Tax authority clearances may also be required to avoid withholding taxes or to benefit from the lower rates offered by a double tax treaty. In other situations, it may be useful to approach the authority concerned for a ruling on the policy under review. Such an advance pricing agreement offers certainty to the multinational, albeit at the price of higher levels of disclosure than might otherwise be the case (see *Chapter 7, Advance rulings*). Sometimes, in the course of a previous year’s transfer pricing audit, the tax authorities may also seek the financial statements of the succeeding years. A change in transfer pricing policy would then come to light earlier than expected and hence the taxpayer should be prepared to explain the rationale for the variance in advance.

Tax return disclosure

Unless the change in policy has been agreed in advance with the relevant tax authority, the mode of its reflection in the tax return should be carefully considered. It is generally important (to avoid penalties for fraudulent or negligent non-disclosure) to ensure that reasonable disclosure is made, while avoiding drawing unnecessary attention to the change of policy. For example, it would generally not be sufficient to include a significant new management fee under a profit and loss account category such as ‘miscellaneous expenses’, but it might be described as ‘technical fees’ if it mainly related to technical support provided to the company.

Managing changes to a transfer pricing policy

Accounting disclosure

In some countries, the extent and form of accounting disclosure of a change in certain transfer pricing policies may be prescribed by statute or accepted best practice. However, there is generally some discretion as to the wording in the accounts, which should be considered carefully because the accounts are likely to be reviewed, certainly by the domestic tax authorities, and possibly by foreign revenue authorities.

Impact on banks and other users of the financial statements

Legal entities within a corporate group may publish separate company financial statements that are provided to third parties, most frequently banks. In addition, groups are continually changing through acquisition, merger or perhaps by spinning off a subsidiary into a public company. When this is the case, the transfer pricing policy takes on special importance and it is essential that the policy is arm's length so that the financial statements are fairly presented. In these situations, when the group wishes to change its transfer pricing policy, the risks of such a change are magnified. All the problems and cautions referred to in this chapter apply; the burden of explaining the change is critically important for the successful implementation of the new policy. As a practical matter, it may be impossible to make the changes in this situation.

There may also be other, more subtle, points to consider. For instance, the subsidiary company may have entered into arrangements with its banks that require it to meet certain profitability levels in order for them to maintain certain levels of overdraft facilities. Would the reduced profitability of the company concerned (as a result of pricing policy changes) give rise to problems in its relationship with the banks (e.g. trigger a default of a debt covenant)? Will new guarantee arrangements be needed from the parent company in order to give the banks the level of comfort they require for the banking facilities needed by the subsidiary? These and other matters require careful handling as part of the pricing policy changes.

Communicating the changes to employees

Changes to the transfer pricing policy of a multinational will have an impact on numerous people and organisations. There will be an immediate effect on the employees involved in the transactions, for there may be completely new procedures for them to follow and they need to be directed exactly how to proceed. The reasons underlying the change and the technical justification for it need to be recorded as part of the group's overall documentation of its transfer pricing policy. It may be useful, however, to communicate the key reasons for the change to employees and to explain what has happened and why. This will help make employees more supportive of the change and may well be of value in future years when those same employees may be questioned by tax authorities on the reasons why changes were made.

For example, in the area of management services rendered by a parent company to its subsidiaries, the parent company executives may be quite clear about the nature of the services they carry out for subsidiaries and will also have ideas about the value to the subsidiary of their work. However, executives at the subsidiary company may feel overawed by the parent company or, alternatively, feel that the parent company does not understand their position. Their view of the benefit of the services they receive will therefore be a different one, and in such circumstances it would be enormously helpful for both sides to be clear about what is being provided and why and how the services will be priced. The work involved in documenting these points would follow the course of an ordinary negotiation between parties at arm's length and, if followed,

should produce a result that will be fully justifiable and properly understood by all those involved. At the same time, it is not always appropriate to let too many employees know about tax planning initiatives that the parent company is using to manage the worldwide tax burden of the group. Loose lips sink ships' is an old adage that applies in this area. There are numerous examples of disgruntled former employees who knew only enough about a transfer pricing policy to suggest to the tax authority that a fraud might exist. In such cases, the employee is rarely in a position to know the whole story and, consequently, to understand that no fraud existed at all. The end result can be an awkward situation for the group in dealing with the tax authority. Subject to compliance with local laws that may govern disclosures to employees or trade unions, employees should be told only what they need to know to do their jobs properly and to support policies that directly affect them.

Impact on management/employee bonus schemes

Some of the most contentious situations faced by any transfer pricing analyst occur when employee compensation decisions or bonuses are tied to the profitability of the legal entity that is affected by pricing changes. In such situations, a transfer pricing policy change increases the income of some employees and reduces the income of others. Clearly, this creates significant problems within the group, as focus is shifted away from running the business into a discussion of transfer prices. Groups with significant cross-border transactions should consider establishing a method of compensating employees, which is not related to the vicissitudes of tax law. This is normally achieved by maintaining a mirror management accounting system independent of statutory and legal books of accounts and can measure employee contributions differently.

Accounting systems

All changes to a group's transfer pricing policies will affect the way in which transactions are accounted for, if only to the extent of their value. There may, however, be more significant implications. For instance, where a management services agreement is established for the first time, there will be an entirely new set of transactions to be dealt with, both in the company rendering the service and in the company receiving it and paying the fees. It may necessitate new account codes and possibly new procedures for authorising such payments. Furthermore, in order to render a charge for the management services, the price of those services has to be determined. Very often this involves an evaluation of the time spent by the executives performing the services, plus an analysis of the direct expenses incurred in providing them. The analysis of the charging company accounts in order to produce the basic information necessary to calculate the management fee can be time-consuming, and new accounting procedures may be necessary to ensure that these invoices can be produced quickly and efficiently. New computer reports and procedures are likely to be required and the information systems department of the group would therefore need to be involved in the implementation of any changes to transfer pricing procedures. Training would also need to be imparted to the employees recording transactions so that the cutover to the new policy is error-free and transaction reversals and rectification entries are minimised.

Managing changes to a transfer pricing policy

The audit trail

Tax authorities are requiring ever-greater amounts of information during their audits. As discussed in Chapter 7, tax authorities (particularly in the US) routinely ask for income statement data by product line and by legal entity to aid in evaluating the appropriateness of transfer pricing policies. This information is also of importance to the group in monitoring and developing its pricing policies, but the level of detail available will vary from company to company. It is particularly important to ensure that data is not lost when policy changes are made, that the transition from old to new systems is smooth and a full audit trail is preserved. It is also important that companies assess the degree to which accounting data that is not routinely prepared for business purposes may be required by a tax authority in a country in which they do business. In some countries, severe penalties are imposed for failure to provide the data that the tax authority requires. As in many areas of transfer pricing law and practice, the US is by far the most demanding authority in this regard. However, the US approach is gaining increasing credence in other countries, and most companies do not have the accounting systems required to develop these detailed income statements easily. Care must be taken, where possible, to ensure that accounting system enhancement programmes are designed with these criteria in mind. Having these processes built into a company's internal control process is typically best practice.

Documenting the changes

The documentation of the group's pricing policy forms an important part of the evidence supporting the values shown on invoices and eventually the profits reflected in the financial statements. In most countries, company directors have an obligation to conduct themselves and the company's activities in a businesslike way and to act in the company's best interests at all times. Proper documentation of the pricing policy and changes to it are therefore important parts of the audit trail supporting the actions of the directors. It is also important to document the reasons for the change so that it is clear to all tax authorities involved that the change produces an arm's-length result. In some countries, notably the US, contemporaneous evidence is required by law. Even where it is not, papers prepared at the time of the relevant transactions, clearly written and supported by appropriate evidence, will always be of great value.

7.

Dealing with an audit of transfer pricing by a tax authority

Introduction

Transfer pricing is an area in which tax authorities increasingly choose to focus when auditing the tax returns of businesses that have transactions with foreign affiliated entities. A number of reasons for this can be identified, including the following:

- Companies are becoming more international in their operations and therefore there are ever-growing numbers of cross-border transactions between affiliates.
- Tax planning increasingly focuses on the optimisation of the effective worldwide tax rate and on its stabilisation at the lowest possible level – a defensible transfer pricing policy is fundamental to the attainment of these objectives.
- Tax authorities are increasingly recognising that commercial relations between affiliates may fail to reflect the arm's-length principle.
- More and more jurisdictions are legislating, or codifying interpretations, on transfer pricing matters into their tax statutes.
- As tax authorities gain experience in transfer pricing audits, they are becoming more sophisticated and aggressive in their approach and more skilled in selecting cases that they believe are worth detailed investigation.

The approach of tax authorities in different jurisdictions to transfer pricing audits varies enormously. In some developing economies in particular, transfer pricing has not yet been identified as a key target for serious reviews; revenue controls are maintained through foreign-exchange control and withholding taxes. This trend has dramatically changed in recent years, even in these emerging economies, as new legislations are enacted and these economies have become more sophisticated in transfer pricing as a result of cross-training from revenue authorities of other jurisdictions. In others, a pricing audit is likely to consist of a fairly basic review of the company's intragroup transactions by a local tax inspector. Then there are jurisdictions where, due to the relative inexperience of the revenue authorities and the taxpayer and owing to recent legislation, transfer pricing arrangements are regularly taken up for audit and subjected to scrutiny, regardless of their acceptance in previous years. In these circumstances, if the local company and its tax inspector cannot agree on appropriate transfer prices, the matter may need to be resolved before the appropriate revenue commission and ultimately in court. Such appellate proceedings would normally be based on facts and relative perceived merits of the positions adopted by the taxpayer and the revenue authorities rather than on the pure technical merits of the case alone.

Under other jurisdictions (notably the US) a complex framework of extensive resources and procedures has been established to deal with transfer pricing investigations and disputes. In some countries, it has been suggested that the natural inclination of the local tax authority and government would be to apply fairly relaxed transfer pricing principles, only mounting a concerted transfer pricing attack where the prices

Dealing with an audit of transfer pricing by a tax authority

concerned fall outside a reasonable range. However, the aggressive US approach to transfer pricing has apparently caused these countries (Japan, Korea and Germany are notable examples) to seek to match the extensive resources devoted to transfer pricing in countries such as the US, UK and Australia, and to legislate to introduce clearer rules on the subject to protect its tax base from predatory tax authorities around the world.

Transfer pricing audits are as likely as other areas of taxation to be subject to legislative and procedural changes over time. This chapter, therefore, deals generally with those factors that should be addressed when dealing with any transfer pricing audit. The audit processes are covered specifically in the country sections and demonstrate the diversity of approach around the world. Perhaps the most important point to note is that all the tax authorities reviewed (as well as others) are continually building up their resources and experience in the transfer pricing area. Correspondingly, the increased attention paid by the tax authorities also leads to questioning by less experienced revenue agents.

The taxpayer has to consider whether to adopt a policy of responding in a passive manner to questions that seem to be leading nowhere or whether to take a proactive approach, which assumes that ultimately a defence of its transfer pricing policies will be required.

Establishing control of the audit process

It is crucial that the taxpayer establishes and maintains control of the audit process. Companies in the throes of a transfer pricing audit often ask how much information the local tax authority will require and how long the process will take. Unfortunately, unless the company is proactive in controlling the audit, the answer to this question tends to be 'How much information do you have'?

For the company to take control of the audit process, it must be able to take a firm stance. All too often, a tax audit highlights the lack of knowledge a group has about its own pricing policies and their implications. If the company finds itself in this position, it will need to take stock very rapidly and reach some broad conclusions about its inter-company arrangements. For instance:

- What functions, risks and intangibles exist in the legal entities between which the relevant transactions have occurred?
- What interpretation should be placed on this functional analysis (e.g. is the local company a contract rather than a full-fledged operating entity)? (*See Chapter 4.*)
- What is the information available to support the group's position?
- What very broad conclusions can be reached about the risks inherent in the tax audit – on balance, will the company win or lose if all the relevant information is examined by the tax authority?

Control of the audit process can be established and maintained only if the taxpayer devotes appropriate resources to this endeavour. Therefore, it is necessary to ensure that:

- Management support is obtained for the endeavour.
- A team of appropriate and highly competent individuals, consisting of tax and operational staff, are assigned to manage the audit process (this team should include non-local personnel and external advisors as appropriate) and are allowed to devote a sufficient time to the task.

- All the information required by the team is made available to it on a timely basis.
- A careful plan is established that sets out protocols on how the audit should progress and how liaison with the local tax authority (and overseas authorities) should be handled.

If the taxpayer's audit team is operating in the context of a well-planned and executed worldwide transfer pricing policy, its job will naturally be substantially easier than if prices within the international group have been set on an ad hoc basis, as a result of administrative convenience or tax imperatives existing in different locations.

Minimising the exposure

Tax exposure can be limited in a number of ways in the context of an imminent or ongoing transfer pricing audit. For example:

- Tax returns for prior years, which are not under audit, should be finalised and agreed with the local tax authorities as quickly as possible.
- If it is envisaged that additional tax will be payable as a result of the audit, action should be taken to limit interest on overdue tax and penalties if possible, perhaps by interim payments of tax. However, an additional tax payment might be regarded as an admission of guilt and the tactics of payment as well as the financial implications will require careful consideration.
- Depending on the circumstances, it may be advisable to plan to reach a negotiated settlement with the local tax authority in relation to prior years and agree arm's-length terms to apply in future periods – in such circumstances, one should also consider the impact of such settlement on overseas tax liabilities.

Settling the matter – negotiation, litigation and arbitration

Negotiation with the local tax authority representatives on transfer pricing issues is a critical element of the audit process in many jurisdictions. Successful negotiation requires, at least, the following:

- A capable, confident negotiating team.
- Full and up-to-date information on the issues under discussion.
- An understanding of local statutes, case law and practice.
- A well-laid-out strategy concerning the issues at hand, identifying what positions could be compromised and others on which the company would not budge.
- Experience of the general attitude of the local tax authority towards the type of issues under consideration.
- A clear view of the financial risks of reaching or not reaching agreement.

The old saying 'know thine enemy' is of crucial importance in pursuing a favourable outcome to a transfer pricing dispute. At all stages of the audit, the company will need to consider the nature and experience of the tax authority team. For example, is it dealing with a local tax inspector, a revenue commissioner in transfer pricing, a trained economist or a professional revenue attorney?

The implication of not reaching an agreement is, of course, ultimately, litigation in the local jurisdiction. The company needs to consider the implications of local litigation on transfer pricing issues very carefully, as the chances of success in the courts may vary widely in different countries. Again, the extent to which transfer pricing issues, being substantially questions of fact, can be escalated in the legal system would have to be

Dealing with an audit of transfer pricing by a tax authority

borne in mind relative to other available administrative relief measures. The burden of proof is different from jurisdiction to jurisdiction, and at various times local courts may reflect public concern that foreigners are shifting taxable income out of the country rather than the pure technical integrity of the matter. In these instances, the taxpayer may feel that it should not pursue its case through the local judicial system. The implication of a transfer pricing adjustment resulting in a liability is the payment of the tax demand. This presents a cash flow situation for the taxpayer, regardless of whether the company decides to pursue litigation or alternative dispute-resolution avenues. Furthermore, the company must consider the implications of the transfer pricing assessments and the dispute-resolution measures to be taken and how these matters should be disclosed on its publicly released financial statements. This is becoming evermore a critical matter in today's environment, where transparency of a company's accounting policies is required by public markets.

When negotiation or litigation has resulted in a tax adjustment, the company must consider whether an offsetting adjustment can be made in the other country involved. This may be through the mutual agreement procedures of the relevant income-tax convention or, alternatively, a special-purpose arbitration vehicle such as the European Arbitration Convention for countries that are part of the European Union (see Chapter 10). Considering all the avenues that are available to a taxpayer, it is critical to consider the appropriate timing of when to invoke one avenue versus the another (i.e. should the taxpayer pursue a mutual agreement procedure process if negotiations with the local inspectors fail, should litigation be pursued instead, or should both processes be initiated at the same time). The decision on these matters hinges on where the taxpayer believes it will be able to reach the best solution given the factors previously discussed.

Preparation

Negotiation, litigation and arbitration are all procedures that demand extensive preparation if the company is to protect its best interests. It should be borne in mind that individuals other than those directly involved in managing the audit process may be required to answer questions or give evidence and they must be adequately briefed to ensure that they can deal with the questions addressed to them.

The taxpayer's audit team must research the powers of the local tax authority and plan to meet its likely requirements. For example, the local tax authority may have the power to require the provision of substantial amounts of information about the group's transactions within a short time frame. Further, in view of protracted revenue audit or litigation proceedings, which may take place long after the transactions in question have occurred, the importance of documentation at every step (by way of work papers, notices, hearing memos, submissions and rejoinders) cannot be overemphasised.

- Any information that is to be provided to the local tax authority (verbal or documented) must be carefully reviewed by the audit team to ensure the following:
- All of the information is correct.
- All of the information is consistent with the tax returns and accounts of the relevant entities and other information which may be available to the local tax authority. The positive or negative implications of the information have been fully considered (i.e. does it support the existing pricing structure, and the functional analysis of the relevant entities' activities or does it identify a tax exposure?).

- Proper consideration has been given to the possibility that the information will be made available to other tax authorities and that the local tax authority may have sought information of other authorities under the exchange of information procedure in income tax conventions.

Dealing with adjustments to existing pricing arrangements

If an adjustment to the existing transfer pricing arrangement is agreed with the tax authority, it is necessary to consider what impact this has or will have on the commercial and tax positions of the relevant entities in past and future periods. The discussion in Chapter 6 (*see Tax audit settlements, Year-end adjustment, Retroactive price changes and Defensible late adjustments*) is relevant here.

In respect of past periods, the company must decide whether it can or should reflect the tax adjustment in commercial terms by raising appropriate invoices (although commercially desirable, this may not be possible in practice, demanding recourse to the dispute-retention procedures in bilateral tax treaties to seek to achieve relief – *see also Chapter 10* for notes on the arbitration procedure in the EU). Similarly, with regard to the future, it must decide whether to amend the transfer pricing arrangement to take the tax adjustment into account. A key factor in each of these decisions is the attitude of the tax authority in the country where the other affiliate is located – double taxation is a risk that most taxpayers are anxious to avoid. In addition to the direct tax issues, the company must consider whether the adjustments need to be reflected in tax returns for indirect taxes and customs duties. This may be the case where the transfer pricing adjustments are related directly to particular shipments of goods. Further, accounting and regulatory considerations must also be taken note of.

If the tax authority that would bear the cost of any simple adjustment refuses to accept its validity, it may be necessary to invoke competent authority procedures under a tax treaty or some other form of resolution (e.g. the European Union arbitration procedure – *see Chapter 10, European Union Arbitration Convention section*) in order to reach a satisfactory conclusion. Such processes are unfortunately very lengthy, but some form of negotiation or arbitration may be the only way to ensure the agreement of all the relevant tax authorities to the pricing policy on an ongoing basis.

Advance rulings

It may be possible to request an advance ruling on an acceptable pricing structure (an APA) from a tax authority. If mutual agreement is reached, this option provides relative certainty for the future by setting a precedent, which may be very attractive to the taxpayer. Countries vary in their willingness to provide advance comfort that a particular pricing arrangement or structure will not be disputed. This is a rapidly developing area because, as more countries become used to the process, it becomes more attractive for them to put resources into advance agreements, recognising that it is often significantly quicker and cheaper for the tax authority than *ex post facto* dispute resolution.

As a general rule, the greater degree of comfort provided, the more likely it is that a significant amount of detailed information will be required by the local tax authority to enable it to make such a ruling. This robust disclosure may be costly and time-consuming from an administrative point of view and may weaken the company's negotiating position in the future or on other issues that may arise.

Dealing with an audit of transfer pricing by a tax authority

In some instances, two or more tax authorities may be willing to work together to give a mutually agreed solution for the future. However, some authorities consider that they do not have sufficient resources to pursue many such projects.

Any APA or ruling is valid only as long as the fact pattern on which it is based remains in place. Therefore, if functions, risks or intangibles are, to a substantial extent, moved to different entities, a new agreement or ruling must be sought. Even during the tenor of the APA, it would be essential to maintain documentation establishing that the transfer pricing arrangements adhere to the terms of the agreement.

8.

Financial services

Introduction

Over the last several years and particularly since the 2008 global financial crisis transfer pricing issues within the financial services industry have been a major concern of tax authorities around the world. Recent developments in the regulatory environment along with the unrelenting fiscal pressure imposed by governments across the globe and the complexity of the issues at stake in the industry hint at the fact that such scrutiny will prevail in the foreseeable future.

The industry covers numerous business activities within which, and across which, many complex transfer pricing issues have been identified. Exploring their depth is not possible in a single chapter and as such, this chapter covers only the main issues and approaches to common types of transactions associated with banking and capital markets, insurance and investment management activities.¹

Some of the features of the financial services industry which, in part, contribute to its complexity from a transfer pricing perspective are explored below. Perhaps one feature that, while not wholly restricted to the financial services industry, is more prevalent in this industry, is the impact that regulation, global integration and the other factors mentioned below tend to have commercially, and the limits that they place on businesses and their ability to structure their operations to deal with pricing challenges. Other developments include the impact that the global financial crisis has had on credit markets, the recent court case decisions (i.e., General Electric Canada) regarding the treatment and pricing of intercompany guarantees, and the Euro crisis, all of which have contributed to the intense scrutiny the transfer pricing issues associated with funding transactions and structuring of such funding both in and out the financial services industry have gathered.

Regulatory environment

Most parts of the financial services industry are subject to significant levels of governmental regulations to protect the integrity of the global financial system as well as consumers. Historically, the regulation has involved myriad rules and regulators at the local country level, although more recently there has been a move towards more consistency at the international level through the development of, for example, the Basel measures² by the Bank for International Settlements (BIS) and within the European Union (EU). The US 2010 Dodd-Frank Wall Street Reform Act has imposed a series of restrictions on banks, and to a lesser extent, insurance companies to limit their abilities to engage in risky behaviour. In the wake of the 2008 financial crisis,

1 For further analyses please refer to PwC's April 2012 '*Clarifying the rules; Sustainable transfer pricing in the financial services sector*' for additional details.

2 The 'Basel' measures are made up of the 'Basel I', 'Basel II', 'Basel 2.5' and 'Basel III' reform measures designed to strengthen the regulation, supervision and risk management within the banking sector.

Financial services

the OECD, the European Union (EU) and the International Monetary Fund (IMF) concluded that solutions to ensure that the financial sector made 'fair and substantial contributions' to the macro-economy introduced the pathway for 'bank tax levies' that have been adopted and implemented by many European countries over the past two years.³ Such levies raise transfer pricing issues that need to be addressed from a holistic perspective as levy bases are not uniform and tax rates vary significantly across different jurisdictions. The impacts of these regulations materialise, among other things, into the corporate and operating structures that financial institutions have been employing over the past few years.⁴ Any transfer pricing analysis should therefore be mindful of such restrictions. Conversely, operating structures accepted by the regulators may provide evidence that the arrangements should also be accepted for transfer pricing purposes.

Global integration

Like other industry sectors, the financial services industry has been witnessing a trend towards more globally and regionally integrated business units, with less focus on the results of individual countries and greater focus on the aggregate business unit results. This, in turn, increases the challenges of identifying and monitoring the pricing of cross-border transactions and reduces the inherent comfort that businesses have the internal checks to ensure that each country has been appropriately remunerated.

While these observations are true for many other industries, the challenges are greater for a sector such as the financial services sector where capital is fungible, not dependent on major plant or factories and does not involve the flow of tangible products.

Complexity and speed

Certain sectors of the financial services industry are highly innovative in their development and use of new and complex products and also in the speed (i.e., statistical arbitrage trading) with which they have exploited and come to rely on new technology. One of the key features of the industry is its concentration: a relatively small number of individual firms based in a few countries across the globe may be largely responsible for managing substantial assets and risks with increasingly complex interactions with other teams, products and countries. Any analysis of the transfer pricing position should reflect an understanding of not only the products involved but also the overall businesses and the systems used to manage them so as to adequately allocate their embedded expenses.

Capital

The availability and velocity of capital at the macroeconomic level is critical to the success of all businesses. It allows key investments to be made and ensures cash is available when needed to keep growing existing businesses and starting up new ones. Within the financial services industry capital plays a more fundamental role inasmuch as its level might be regulated and therefore shape the business's operations and structures. As exemplified by certain of the so-called Basel requirements, the nature and level of capital held affects both the extent and the prices at which businesses are willing and able to transact with one another. In this context, the remuneration of

.....
3 The objectives of the bank levies were to cover the fiscal cost of the direct public support to financial institutions and help reduce excessive risk taking.

4 The divestiture of risky financial assets of certain banking institutions' balance sheets over the past two years and their subsequent focus on their core banking activity is a prime illustration of such impact.

capital is to be carefully examine and the preferences of local authorities taken into account when establishing such remuneration.

Branch profit allocation

While transfer pricing has traditionally concerned itself with cross-border transactions between separate legal entities, the financial services industry, particularly in the banking and insurance sectors, has historically operated through branches in an attempt, among other things, to alleviate the regulatory constraint requirements on capital. Attributing the profits or losses of branches raises issues similar to those in traditional transfer pricing. The OECD reviewed how profits and losses of branches should be determined and the extent to which branches should be treated as if they were separate legal entities dealing with one another. In July 2010, the OECD published final reports (Parts I, II, III, and IV) on the attribution of profits to permanent establishments which provide guidance with respect to such profits and losses allocations.

The branch profit allocation topic and its concomitant permanent establishment threshold determination have, more than ever, continued to be at the forefront of transfer pricing policy design considerations both at the business and tax authorities levels around the world.

Head-office services⁵

Regardless of whether parties are related, when a service is rendered, it is expected that the recipient will remunerate the service provider for the activities performed at arm's length. In a transfer pricing context, Shared services refers to the provision of a service by one part of an organisation or group where that service had previously been provided by more than one part of the organisation or group. Shared services are designed to create convergence and streamline an organisation's functions such as certain back-office or administrative functions, human resources, finance, and certain functions within middle or front offices to enable organisations to take advantage of economies of scale and creation of synergies. Thus from a transfer pricing perspective, the pricing of multiple intercompany transactions need to be determined and documented. With the growing speed of global integration, many organisations within the financial services sector have already established shared service centres performing centralised services.

In the financial services world, the shared services can be broadly broken down into two types of services: management and product-related services. Management services are typically associated with the back office or administrative support. Product services vary depending on the specific financial sector in which the organisation is classified (i.e. banking, investment management, or insurance). Within the banking industry, for example, functions such as loan processing, data validation, and treasury/capital management are often centralised in shared service locations.

For most tax authorities, these services are an easy and understandable target when analysing transfer pricing within a financial institution. They have transposed into the financial services sector the experience with intra-group service charges they gained and honed in the non-financial service sectors. As such, a shared service is

⁵ Please refer to PwC's April 2012 Financial Services 'Clarifying the rules; Sustainable transfer pricing in the financial services sector' for additional details.

Financial services

often the first transaction that is queried during a transfer pricing audit. To hedge against undesirable outcomes during a transfer pricing audit, as highlighted in the OECD Guidelines,⁶ the transfer pricing documentation of intercompany shared services transactions should clearly demonstrate (i) whether services have in fact been rendered and a benefit has been conferred,⁷ and (ii) that the intra-group charge for such services is in accordance with the arm's-length principle.⁸ Additionally, shareholders activities (i.e., activities considered not beneficial to the recipient) should clearly be identified as they cannot be charged out.

Given the subjective nature of the pricing process and the relative ease in understanding the underlying transactions (compared with other more complex financial services transactions), it can be expected that tax authorities will focus on, from both the recipient and provider perspectives, the issues of what constitutes a service and what is the proper arm's-length return for the provision of such a service.

As a result, many organisations have employed systematic approaches to identify and document the nature of a service and the ultimate beneficiaries. The OECD Guidelines provide a framework to develop a policy; however, thought needs to be given to local rules in various jurisdictions to ensure compliance. Given this, the transfer pricing policy needs to be evaluated for implementation factors and establishment of a robust defence during a tax authority challenge.

IT services⁹

Transfer pricing issues arising from the use of technology are common to all financial institutions. Technology often represents one of their most significant costs, has connection and usage in the front-, middle-, and back-office operations and spawns the whole globe making IT services a perfect target for tax authorities. In general, transfer pricing policies for technology-related services differ based on a variety of relative factors, such as customisation of the technology and its purpose and use within the front-, middle- and back-office functions of the institution.

Technology activities can generally be categorised as follows: technology infrastructure, applications, and other ancillary activities. The infrastructure and related network elements refer to the 'pipes' and hardware that transmit information within and between the financial institution, its various affiliates, and/or external sources. The applications refer to the software applications – proprietary software and/or customisation of third-party-developed software – used within a financial institution and their ongoing management and maintenance. The ancillary services relate to the adaptation for 'local' use, the data entry (including data conversion), the installation and training services.

All else being equal, front-office technology is perceived by tax authorities to have higher relative value versus middle- or back-office technology due to its direct tie to revenue generation and the related importance of ensuring performance and controls.

6 OECD Guidelines, Chapter VII, B(i), Paragraph 7.6. for additional guidance.

7 In general, an activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position or that may reasonably be anticipated to do so. On the other hand, for an indirect or remote benefit, the service is not considered to provide a benefit to the recipient.

8 The OECD Guidelines identify two arrangements by which organisations seek to charge for intra-group services: the Direct Cost Method and the Indirect Cost Method.

9 Please refer to PwC's April 2012 'Clarifying the rules; Sustainable transfer pricing in the financial services sector', for additional details.

However, the 2008 financial crisis has increased the focus on risk assessment and has therefore raised the stature of middle-office applications. In addition, the reach and life of the technology will most likely become contentious points of discussion under a transfer pricing audit.

To ensure compliance with local transfer pricing regulations, financial institutions have relied on licensing, cost sharing, and contract research and development (R&D) transfer pricing policies. Numerous considerations such as the distinction of legal and economic ownerships, the availability of third party data, the reliability of projections need to be accounted for in the transfer pricing policy design process.

From a planning perspective, the diversity of models and the multiple activities involved provide useful opportunities to align tax objectives with the broader operational objectives of the technology function. From a compliance and support perspective, it is important for the tax department to consider the implications of the internally determined model of technology development and support in terms of the anticipated distribution of returns or costs among relevant affiliates.

Funding considerations¹⁰

The recent developments in the financial services industry architecture partially triggered by the changes in the regulatory environment has led many non-financial services companies to seek alternative funding channels as terms and conditions extended by credit providers have been substantially more conservative in recent years. As a result, multinational enterprises have devoted significant resources developing treasury business models that promote a higher degree of self-funding. Consequently, sources of cheaper funding for capital market actors have depleted revitalising the transfer pricing issues surrounding the pricing of liquidity premia and their allocations. A comprehensive transfer pricing analysis in the context of a global banking business would therefore need to address these considerations.

Going forward

Planning and management of intercompany transactions in the financial services industry from a transfer pricing perspective is an exceptionally challenging task given the inconsistency of transfer pricing rules and practice across territories. There are however some common practices that can be identified to lighten some of the compliance burden. For instance, developing transfer pricing planning policies addressing the main intercompany transactions in an organisation resting on the common best practices identified in the industry. In addition, in light of the recent trends observed in the resources devoted by governments towards facilitating access to programs such as the US Advanced Pricing and Mutual Agreement, financial institutions should consider such alternatives for their most sophisticated intercompany transactions.

Banking and capital markets

Introduction

From the traditional lending of funds and financing of trade flows, banks' activities have extended to retail deposit-taking, lending, credit cards and mortgages to private client wealth management, commercial loans, asset-backed financing and financial risk

¹⁰ Please refer to PwC's April 2012 'Clarifying the rules; Sustainable transfer pricing in the financial services sector', part V for additional details.

Financial services

management products, and into capital markets' activities including equity brokerage, bond dealing, corporate finance advisory services and the underwriting of securities. Over the last century, banks and capital markets' groups have expanded across the globe, in part to service their internationally active commercial clients and in part to track the flow of capital from developed countries to newer markets in search of higher returns.

The traditional lending activity involves a bank borrowing funds from various investors, such as depositors, and earning a spread by lending to borrowers at a higher interest rate based on the bank's credit assessment of the borrower. However, due to enhanced competition, over the years, the spread earned by banks has reduced considerably. Consequently, banks have made an increasing percentage of their total income from non-lending activities, by leveraging off their infrastructure and network in the financial markets to provide value-added services from straightforward foreign currency trades to more complex structured products.

As the 2008 financial crisis unfolded and the banking sector became the focus of attention of governments all over the world, additional layers of regulations, on an already heavily regulated sector, were designed and have been implemented ever since in an attempt to rein in the systemic risks attributable to these non-traditional lending activities. The ripple effects of these new regulations have started to permeate the banking sector both from an organisational and operational point of views granting a careful re-examination of current transfer pricing policies in place for the major actors in the industry.

This section considers the main types of cross-border transactions and activities in traditional banking and capital markets groups.

Global trading

From a transfer pricing perspective, both the US Treasury department and the OECD guidelines have provided guidance regarding the definition of global trading operations along with the transfer pricing methods available in such context.^{11,12}

Under both sets of guidelines, a global trading operation involves the execution of customer transactions in financial products where part of the business takes place in more than one jurisdiction and/or the operation is conducted on a 24-hour basis. A simple example would be where a salesperson in one country introduces a customer to the trader located in another country who is responsible for trading the relevant financial product followed by the execution of the customer transaction by the trader. Because of the inherent complexity of the transactions at stake that typically involve a mix of technology, sophisticated trading skills and unfold across multiple tax jurisdictions, the design and documentation of transfer pricing policies continue to be extremely complex and challenging in this context.

Historically, given the large amounts at stake, many multinational banks have resorted to advance pricing agreements/advanced pricing and mutual agreements (APAs/APMAs) as a way of addressing the uncertainty resulting from pricing this type of activity. Adopting an APA/APMA approach has its own risks, including the potential

¹¹ Treasury Regulations 'Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged in a Global Dealing Operation', March 1998.

¹² OECD Reports Part III, July 2010.

mismatch between the speed with which global trading businesses develop and the length of time an overall APA process might take. It is also a time-consuming and resource intensive exercise and the practical difficulty of negotiating APAs across more than a few jurisdictions might appear particularly daunting at times. Recent developments from fiscal authorities in the US and Europe indicate that taxpayers' concerns over the difficulties of the APA process have been acknowledged and attempts to respond in a pragmatic fashion have been implemented.

Fee-based businesses

Fee-based businesses range from relatively high-volume, low-fee-based businesses such as equity brokerage to the relatively low-volume, high-fee-based businesses such as corporate finance advisory activities and the management, underwriting and distribution of new issues of securities for clients.

Even within such well-established businesses as equity brokerage, there can be a wide range of operating structures within a group and a significant variety of products and services provided to clients. Substantial differences may also exist between the products, markets and exchanges of different countries, including not only in the volatility and liquidity of products but also, for example, in the settlement risks and costs involved. Difficulties can also arise in extrapolating from data on relatively small trading volumes to potentially much larger volumes handled within a group.

The relatively low-volume, high-fee-based businesses can be particularly challenging from a transfer pricing perspective, particularly as many of the transactions are unique. Several years may have been spent investing in a client relationship before a structured transaction emerges and when it does, specialists from several countries with different expertise may be involved in the final transaction.

Treasury and funding

The funding of a bank, both on a short-term basis, for example to meet withdrawals by depositors and to fund new loans, and on a longer term basis as part of the overall management of the capital of a bank, is an intrinsic part of the activities of a bank. Although many of the transfer pricing issues surrounding financing transactions apply equally to intragroup funding within banking groups, the nature, amount and term of internal funding has been significantly affected by the latest changes in the regulatory environment along with the available liquidity in the marketplace post the 2008 financial crisis. For banks operating in the US, the advent of the Volcker Rule, a section of the Dodd-Frank Act which prohibits banks from engaging in proprietary trading and from owning and investing in a hedge fund or private equity fund, has triggered funding reallocations across banks' businesses lines impacting the operating structures for raising and managing funds. Given the sensitivity of tax authorities towards funding transactions, even straightforward money market transactions or repurchase transactions must be carefully examined to ensure that each party to the transaction is remunerated according to the arm's-length standard.

Cross-border services

As alluded to above, banking and capital markets groups generally undertake many centralised activities (i.e. management services), including inter alia the provision of central human resources, legal, accounting, internal communications and public relations' activities. The past few years have witnessed an increase in the number and quality of the tax administrations' audits related to the allocations, across business

Financial services

participants, of such expenses. A number of Asia-Pacific, European and US tax authorities have recently devoted a significant amount of resources auditing such transactions and paid a particular attention to the characterisation of the services provided, the identification of the benefits conferred, the costs associated with the provision of the services and the profit elements attributable to the service providers.

In response to the financial crisis, actors in the banking sector have increasingly centralised their credit and market risk management activities along with their regulatory compliance and reporting ones. In addition, banks are also often heavily reliant on partially developed IT systems, communication links and external data feeds leading to challenging transfer pricing issues revolving around the pricing of the technology used and the allocation of its costs.

Other issues in banking and capital markets

The above comments are by no means exhaustive. Other important but difficult issues include the transfer pricing treatment of relationship managers. Developments in the banking sector have resulted in an increasing focus on trading and fee-based activities leading to corresponding changes in the perception of the role of general banking relationship managers. This in turn leads to a more difficult question of whether the relationship management function remains an originator of wealth or has perhaps become merely a consumer of cost.

Similarly, research has historically been treated as an overall cost to a business. Developments since the late 1990s suggest that the role of research may need to be reassessed as the market for research becomes increasingly sophisticated and independent from the multinational group, leading in some cases perhaps to a potential comparable uncontrolled price (CUP) approach.

Credit derivatives is another area where there have been significant developments recently, not only in the trading area where customers have been increasingly willing to purchase protection and lower their credit exposure but also in the use of credit derivatives internally by banking groups, for example as part of the centralised management of credit risks associated with loan portfolios.

Insurance

Introduction

An insurance policy is a contract that binds an insurer to indemnify an insured against a specified loss in exchange for a set payment, or premium. An insurance company is a financial entity that sells these policies.

Insurance policies cover a wide range of risks. Broadly, these can be classified as:

- general insurance (motor, weather, nuclear, credit), and
- life insurance (pension, term).

The major operations of an insurance company are underwriting, the determination of which risks the insurer can take on and rate-making, the decisions regarding necessary prices for such risks, claims management and appropriate investment of the sizeable assets that an insurer holds. By investing premium payments in a wide range of revenue-producing projects, insurance companies have become major suppliers of capital, and they rank among the largest institutional investors.

Reinsurance

Reinsurance is insurance purchased by insurers. Under a reinsurance arrangement, the reinsurer agrees to indemnify an insurer (known as the cedant under a reinsurance contract) against part or all of the liabilities assumed by the cedant under one or more insurance or reinsurance contracts.

In consideration for reinsuring risks, the ceding insurance company pays a premium to the reinsurer. Although reinsurance does not legally discharge the primary insurer from its liability for the coverage provided by its policies, it does make the reinsurer liable to the primary insurer with respect to losses sustained under the policy or policies issued by the primary insurer that are covered by the reinsurance transaction.

Reinsurance is generally purchased to enhance the risk diversification of the insurers' portfolio, to stabilise their annual results, and to increase efficiently their premium-writing capacity.¹³ It may also be used to facilitate the growth of an insurer's new products or aid its entry into new lines of business.

The two methods by which risk is ceded through reinsurance contracts are:

- Treaty reinsurance – A contractual arrangement that provides for the automatic placement of a specific type or category of risk underwritten by the primary insurer.
- Facultative reinsurance – The reinsurance of individual risks whereby the insurer separately rates and underwrites each risk. Facultative reinsurance is typically purchased by primary insurers for individual risks not covered by their reinsurance treaties, for excess losses on risks covered by their reinsurance treaties and for 'unusual' risks.

The two major forms of reinsurance are proportional reinsurance and excess-of-loss reinsurance. Premiums received from treaty and facultative reinsurance agreements vary according to, among other things, whether the reinsurance is on an excess-of-loss or on a proportional basis.

- Proportional reinsurance – The two types of proportional insurance are:
 - Quota share – The risk is shared according to pre-agreed percentages.
 - Surplus share agreement – The primary insurer selects the amount of liability it wishes to retain on the policy and then cedes multiples, known as 'lines', of its retention to the insurer. Losses and premiums are divided between the company and the reinsurer proportionally with respect to the portion of risk undertaken.
- Excess-of-loss reinsurance – The reinsurer indemnifies the primary insurer for all covered losses incurred on underlying insurance policies in excess of a specified retention. Premiums that the primary insurer pays to the reinsurer for excess-of-loss coverage are not directly proportional to the premiums that the primary insurer receives, because the reinsurer does not assume a proportional risk. Furthermore, the reinsurer generally does not pay any ceding commissions to the primary insurer in connection with excess-of-loss reinsurance.

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¹³ An insurer's gross underwriting capacity (i.e. its ability to write business) is limited by law or regulation based on the amount of its statutory surplus. The greater the ratio of premiums written or liabilities to such surplus (i.e. its leverage ratio), the less likely it is that the regulator will consider the surplus to be sufficient to withstand adverse claims experience on business written. Through reinsurance, an insurer can increase its gross volume of business written, while maintaining a healthy ratio between risk retained and surplus.

Financial services

A company that provides reinsurance can, in its turn, engage in an activity known as 'retrocession'. Retrocession is defined as a transaction in which a reinsurer cedes to another reinsurer all or part of the reinsurance it has previously assumed. The ceding reinsurer in a retrocession is known as the 'retrocedent', while the assuming reinsurer is known as the 'retrocessionaire'.

Intragroup reinsurance arrangements are typically the most material transfer pricing transactions for most insurance groups and therefore a focal point for governments and tax authorities around the globe. Over the past few years, the transfer pricing environment surrounding insurance and reinsurance transactions has evolved such that, when conducting a transfer pricing analysis, special care should be taken to ensure that (i) capital requirements are being met by the insurers and (ii) the substance of the transactions is carefully documented.

In 2009, the European Union enacted the Solvency II directive thereby introducing economic risk based solvency requirements which have led to an increased consolidation within the industry to take advantage of the synergies and economies of scale and an increase appetite for companies to operate through branches. This in turn raises significant transfer pricing challenges in light of the July 2010 OECD Part IV publication on the attribution of profits to permanent establishments of insurance companies.

In the US, the 2011 Neal Bill (a revised version of the so-called 2009 Neal Bill) was introduced with the intent of eliminating the deductions for reinsurance premiums paid by a US insurance company to its off-shore non-taxed related affiliates. As a consequence, although many group reinsurance companies still reside in jurisdictions with benign tax and regulatory regimes, such as Bermuda, an increasing number of those have now chosen to establish their operations in treaty countries.

As described above, reinsurance transactions are generally complex in nature and many contracts are bespoke to address the particular requirements of both the reinsured and the reinsurer. Transfer pricing support typically comprises a combination of the following approaches:

Commercial rationale: The first requirement in support of a reinsurance arrangement is to demonstrate the commercial rationale behind the transaction. Tax authorities can seek to re-characterise the transaction if it would clearly not have been entered into with a third party. This is particularly critical given the OECD members' current focus on an anti-avoidance agenda in respect of reinsurance transactions and business restructuring.

Internal CUPs: In some cases, a group reinsures portions of the same business to related and unrelated parties, which may provide a strong CUP. In other cases, a group may have previously reinsured with an external reinsurer before establishing a group reinsurer. Care needs to be taken to demonstrate that the contracts are comparable, taking into account the mix of business, layers of risk, volume, expected loss ratios, reinsurance capacity, etc.

Pricing process: For complex non-proportional reinsurance, the most appropriate transfer pricing support may often be derived from being able to demonstrate that the pricing process for internal reinsurance contracts is exactly the same as that for external reinsurance. This involves due diligence on the actuarial modelling and

underlying assumptions, as well as the underwriting decision, which evidences the process of negotiation, challenge and agreement on the final price. The use of this approach has been strengthened by the US services regulations, which expanded the indirect evidence rule by reference to an insurance-specific example.

Cost of capital: Many large proportional reinsurance contracts are difficult to price using either of the above methods, as they often involve multiple classes of business that are not commonly found in the marketplace. In such cases, it is often necessary to return to first principles and address the capital requirements and appropriate return on capital based on the expected volatility and loss ratios of the portfolio of business, as well as the cost of acquiring and supporting the business, thereby addressing the pricing from both the cedant's and reinsurer's perspectives. Additionally, ratings agencies may provide guidance and support for the pricing process through the benefits in the sources and uses ratio due to capital relief obtained through reinsurance transactions.

Centralisation

Insurance groups generally undertake many centralised activities (i.e. management services), including inter alia the provision of central human resources, legal, accounting, internal communications and public relations' activities. The past few years have witnessed an increase in the number and quality of the tax administrations' audits related to the allocations, across business participants, of such expenses. European and US tax authorities have recently devoted a significant amount of resources auditing such transactions and paid a particular attention to the characterisation of the services provided, the identification of the benefits conferred, the costs associated with the provision of the services and the profit elements attributable to the service providers.

Specific centralisation issues can also arise when global insurance policies are sold to multinationals where negotiation, agreement and management of risk occur at the global or regional head-office level. In such cases, even where the local insurance company/branch is required to book the premium, the reality may be that the local entity is bearing little or no risk. Alternatively, where risk is shared among the participants, consideration needs to be given to how the central costs of negotiation should be shared.

Investment and asset management

The return earned from investing the premium collected contributes to the ability of insurance companies to meet their claims obligations. To the extent that such investment and asset management capabilities are concentrated in certain parts of the overall group, a charge is made for the services provided to other members of the group. Specific factors that may influence the pricing of such services include the type of assets managed, level of activities carried out, risk involved, volume of transactions, expected returns and expenses of providing such services.

The specific issues to be considered are described in more detail in the *Investment Management* section below. However, it is worth noting here that, as insurance groups often have very large sums to manage and the level of funds under management represents a key business factor in pricing investment management services, comparables used in the broader investment management sector may need to be adjusted for the sale of invested assets before being applied within an insurance group.

Financial services

Financing and financial guarantees

As with banking, many of the issues surrounding financing transactions apply equally to intragroup financing within insurance institutions. These include intragroup loans and loan guarantees. However, certain financing issues are specific to the insurance sector.

The provision of financial guarantees is an important aspect of insurance transfer pricing. Such guarantees can include claims guarantees, net worth maintenance agreements and keep-well arrangements. Pertinent factors that need to be considered include the type of security or collateral involved, the differential credit ratings between guarantee providers and recipients, market conditions, and type and timing of the guarantee.

Brokerage and agency activities

With the increasing internationalisation and consolidation in the insurance sector, insurance brokers and agents are becoming increasingly integrated. As such, brokerage/commission sharing becomes increasingly complicated, resulting increasingly in the use of profit split as a primary or secondary supporting method to adequately represent each participant's contributions.

Other issues in insurance

Insurance companies are increasingly expanding into new areas of business, with a view to diversifying the risks associated with the modern insurance industry. As a result, we are seeing insurance groups undertake many of the activities that have traditionally been associated with the banking and capital markets industry. The resurgence of insurance derivatives is part of the general trend of using capital markets solutions to solve insurance industry problems. Transfer pricing associated with the trading of insurance derivatives often raises similar issues described above for global trading within banks, as discussed above.

One specific issue that arises reflects the history of insurance groups. As insurance groups have grown, typically through acquisition, complicated group structures and non-standard transactions have arisen as a result of regulatory restrictions and historical accident. Understanding the history behind such transactions often plays an important part in explaining how the transfer pricing approach must be evaluated within an appropriate commercial context.

Investment management

Introduction

Investment management activities permeate the entire financial services industry. Insurance companies have a core need to manage their funds, and banks, following the enactment of the Volcker Rule, have been searching for new investment channels to manage the capital they used to devote towards their own proprietary trading desks. Although many investment management businesses are still part of a wider banking or insurance operation, there is also a significant number of independent investment management firms whose sole business it is to manage assets on behalf of their clients. In all cases, assets are reinvested on a segregated basis or, more commonly, on a pooled basis through the medium of a notional or legally distinct investment fund.

The diverse and global nature of the investment management industry gives rise to a huge variety of investment fund types. Fund types include securities or bond funds, hedge funds, property funds, private equity funds, futures and options funds, trading funds, guaranteed funds, warrant funds and fund of funds. These funds can be further subdivided into different share or unit classes incorporating different charges, rights and currency classes.

Within each type of fund are different strategies of asset management. Investors select funds based on performance and their aversion to risk. Funds can either passively track an index or be actively managed. Indexed funds or trackers are benchmarked to a defined market index. The fund managers are passive insofar as they do not attempt to outperform the index through stock selection. This contrasts with the actively managed fund where the managers select assets with the aim of outperforming the market or the benchmark. As a result of these strategies, different remuneration schemes for the investment managers have been devised to adequately reflect their contributions to the overall performance of the funds.

Factors such as the increasing mobility of capital and technical advances in the field of communications have contributed to the large number of jurisdictions with thriving investment management industries. In many cases, investment managers offer services from offshore domiciles to investors in selected target countries for certain legal, regulatory or tax requirements. Investment advisory, marketing and fund-accounting services are often then delegated to onshore subsidiaries, which benefit from better access to a skilled workforce.

Fees for managing assets are typically charged on an *ad valorem* basis (i.e. as a percentage of assets under management) and have recently decreased due to the increasing competition in the industry. However, charges and charging structures still vary depending on the nature of the funds in which the investment is made, the investment profile of the fund, the investment objectives themselves, and the brand name recognition surrounding the investment manager. Private equity and venture capital vehicles may charge investors based on the committed capital pledged to the investment vehicle over time.

Investment funds can give rise to a number of different charges for investors, including:

Front-end loads: A charge made on the monies committed by an individual investor on entering the fund and paid by the investor. This is common in retail funds where an independent financial advisor (IFA) brings clients' monies to the fund and, in return, expects a proportion of the load.

Management fees: A charge (usually a fixed percentage) made on the net asset value of the fund and paid directly by the fund to the fund manager.

Trailer fees: A fee payable to distributors (e.g. IFAs) by the fund manager from the gross management fee for the referral of clients' monies. The fee is normally calculated as a proportion of the net assets referred by the distributor and is usually payable by the fund manager until the investor withdraws their monies.

Financial services

Performance fees: Fees typically paid in addition to a base management fee by niche market funds (e.g. hedge funds and private equity funds) as well as for the management of large segregated funds. The industry recognises three broad classes of investors: institutional, retail and private client.

Below, the main investment management sub-industry categories involving significant cross-border flows of products and services are considered in more detail.

Asset management

Asset management typically comprises overall asset allocation and the asset research, selection and management of individual securities, with a view to meeting the objectives of the portfolio or fund. It is common for these functions to be segregated to take advantage of local/specialist knowledge and expertise (commonly referred to as subadvisors).

Investment management groups may have potential internal comparables relating to institutional mandates. In addition, there is some publicly available information in respect to both investment management and subadvisory fees. These should be used carefully, since specific factors influence the pricing of such services, including the type of assets managed, scope of activities carried out, risk involved, volume of transactions, expected returns and expenses of providing such services.

Marketing, distribution and client servicing

In considering appropriate arm's-length fees for marketing, distribution and client servicing, one of the most important considerations is the type of customer. For example, fees are usually higher for retail investors than for institutional investors. This reflects both the additional costs associated with attracting funds for retail investors and also the greater bargaining power of institutional investors, due to their larger size of investment. Again, owing to the different business models applicable to different types of customer, funds and investment strategy, great care needs to be taken in attempting to make use of potential comparables – internal and external. Industry intelligence and anecdotal evidence should be accounted for in the comparable analysis as financial arrangements for distribution and capital-raising services are often highly discrete or depend on the type of client and asset class managed.

Administration and other centralised activities

As for banking and insurance groups, investment management groups or subgroups generally undertake many of the same types of centralised activities (i.e. management services), including inter alia the provision of central human resources, legal, accounting, internal communications and public relations' activities. The considerations highlighted in the context of the banking and insurance industries relating to the identification of the services provided, the entities providing the services, the entities receiving the services, the costs involved and the application of a markup apply equally here.

Consideration needs also to be given to the development of bespoke investment technologies, which act to enhance investment performance or to centralise risk and decision-making. In addition, the track record and skills of the portfolio managers are highly important in the investment management business, while the ownership and development of brand and other intangible assets needs to feature prominently in any transfer pricing analysis.

In 2011 and 2012, the alternative investment industry performance rebounded significantly from the post 2008 financial crisis era and is expected to keep growing at a superior pace in the foreseeable future. Despite the recent performance trend, investors have maintained a significant amount of pressure on fees they are willing to pay to fund managers. As in the case of the insurance industry, the major factors currently affecting the industry are globalisation, structural changes, and changes in the capital market regulatory environment.

With new regulations in place (i.e. the 2010 Dodd-Frank Act, BASEL III) to prevent future credit crisis and market collapses, certain types of business activities have been restricted affecting the future profit, revenue, and assets of management of the industry. More stringent capital and liquidity standards have been proposed, which will hamper risk-taking or liquidity in the capital markets and increase compliance costs in the banking industry leading investors to turn to less regulated environments. Further, the Volcker Rule, scheduled to go into effect in July 2014, by prohibiting banking entities from (i) investing in or sponsoring private equity funds, venture capital funds or hedge funds or from (ii) conducting proprietary trading is likely to increase the industry's assets under management as investors seeking high returns will go to hedge funds and private equity firms once they become the only source of relatively unrestricted capital left in the market. Additional regulations aimed at regulating the alternative investment industry (i.e. the European Alternative Investment Fund Managers Directive) will likely increase the compliance burden of European investment funds while decreasing the number of non-European investment managers operating in Europe and therefore the overall competitiveness of the European market.

As these ongoing changes unfold, tax authorities have recently increased their number of transfer pricing audits mainly in relation to the remuneration of offshore managers. Additional considerations such as the value-added tax impacts, when relevant and possible, should be weaved into the transfer pricing policies as these represent expenses for the investment managers.

Real estate

In the wake of the 2008 financial crisis, institutional investors have increased their allocations into the real asset market as sales of distressed real estate assets by banks have boosted the availability of prime properties in key locations. However, given the recent market events, investors are now requiring more frequent reporting on the assets they invest in and also request higher transparency. The coming years will continue to witness significant major regulatory changes as regulators keep on focusing on investor protection and harnessing systemic risks. To cope with these challenges, constraints and increasing costs pressure, real estate fund managers have been rethinking their business models and organisational structures. The concomitance of these trends has enhanced the visibility of the industry in the eyes of tax authorities around the world in general and in the US, in particular where an investment vehicle, the real estate investment trust (REIT) has risen to prominence due to its preferential tax treatment.

A REIT is a 'pass-through' entity that can avoid most entity-level federal tax by complying with detailed restrictions on its ownership structure and operations. As such, its shareholders are taxed on dividends received from the REIT but the entity itself is generally not subject to taxes as it generally redistributes all of its income in the form of dividends. A taxable REIT subsidiary (a TRS) provides a REIT with the ability

Financial services

to carry on certain business activities that could disqualify it if engaged in directly by the REIT.

Transactions between a REIT and its TRS are analysed under the section 482, transfer pricing regulations and subject to the arm's-length standards. Such transactions include providing services to tenants, sharing resources, leasing transactions and financing transactions. In developing these investment structures, the challenges are (i) to determine the right mix of debt and equity and setting the appropriate interest rate on the debt component, and (ii) to ensure that the ancillary services performed by the TRS are appropriately remunerated as available third party comparables are typically difficult to obtain.

Sovereign wealth funds (SWF)¹⁴

Over the last decade as nations become richer and increasingly wiser about financial planning, the number and the wealth of the SWFs have dramatically increased. From an international tax standpoint, there is no conventional definition of an SWF. Generally, the term refers to a state-owned fund invested into a variety of financial assets (stocks, bonds, real estate, commodities, and other financial instruments). Conceptually, the SWF is only one of the types of investment vehicles used by sovereign states to invest their accumulated wealth, along with public pension funds, state-owned enterprises or sovereign wealth corporations.

An understanding of the functional profile of the sovereign wealth funds is fundamental to the understanding of transfer pricing matters for SWFs. Generally, in the asset management market, SWFs are unique in that they are established, funded by, and managed under mandates designed by a sole shareholder, the sovereign state. Each fund has its own unique reasons for creation, source of funds, and objectives. Depending upon the tax laws of the home country or the structure of the investments, some SWFs may be tax exempt. Given state ownership, many SWFs do not publically report investment activity.

Sovereign investment corporations have certain unique features that make them different from non-sovereign investment houses – they are established, funded by, and managed under mandates designed by a sole shareholder (the sovereign state), have large pools of assets under management, and may receive special tax treatment. They also have features that make them similar to non-sovereign investment managers – they operate as independently managed commercial investment companies, are managed on commercial principles to create and maximise long-term value to their shareholders, and are subject to the same competitive market pressures as any other player. They also operate through affiliates established around the world, as relevant to their mission, to enhance their visibility into the opportunities offered by the regional markets and to facilitate their investments.

From a business operational standpoint, the relationships between affiliates and the parent sovereign investment companies are structured in the same way as the inter-company relationships of any other multinational. These transactions may consist of one or a combination of business management services, business support services, market research services, investment advisory services, loan origination services,

¹⁴ Please refer to PwC's April 2012 'Clarifying the rules; Sustainable transfer pricing in the financial services sector', part III for additional details.

licensing of intellectual property, inter-company financing, and other types of inter-company transactions.

Although the transfer pricing method and concepts are the same as those available for the analysis of mainstream investment managers, because of the unique structure of SWFs, the challenge is often the selection and use of the pricing data available in the public domain, assuming the CUP method is the best/most appropriate method, and how to determine the necessary adjustments. However, various public databases provide industry-specific data for separate accounts and fund of funds to construct robust benchmark ranges of advisory fees, and to appropriately adjust these ranges (if such adjustments are possible) to reflect primarily the substance of the inter-company advisory functions for a single sovereign investor.

9.

Transfer pricing and indirect taxes

Customs duty implications

Goods moved across international borders and imported from one customs' jurisdiction into another are potentially subject to customs duties and, in some cases, to other duties and taxes such as value added tax (VAT) (which are beyond the scope of this book). In determining the transfer price for such goods, consideration must be given not only to the corporate income-tax repercussions but also to the customs duty implications and, in certain circumstances, there may be an apparent conflict between the treatment of a transaction for the purposes of the two regimes. Careful planning is then necessary to achieve a price that satisfies the requirements of the tax and customs authorities without incurring excessive liabilities.

WTO Valuation Agreement

Most countries levy *ad valorem* duties and have complex regulations governing the determination of the value of imported goods for customs' purposes. All references in this book to customs' valuation (unless otherwise stated) are to the World Trade Organisation (WTO) Agreement on implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the WTO Valuation Agreement), formerly known as the GATT Customs Valuation Code. Under the Uruguay Round Agreement, all members of the WTO were required to adopt the WTO Valuation Agreement within a specified period; however, some developing countries have not done so. Nevertheless, the laws of most trading countries are now based on the WTO Valuation Agreement.

The basic principle of the WTO Valuation Agreement is that, wherever possible, valuation should be based on the 'transaction value' – the price paid or payable for the goods when sold for export to the country of importation, subject to certain prescribed conditions and adjustments. The most significant condition for acceptance of the transaction value by the customs authorities is that the price has not been influenced by any relationship between the parties. While different countries have widely varying standards to determine whether companies are 'related' for direct tax purposes, the WTO Valuation Agreement offers a worldwide standard for customs' purposes, which is more narrowly defined than many direct tax laws. Persons, whether natural or legal, are deemed to be related for customs' purposes under the WTO Valuation Agreement if:

- they are officers or directors of one another's businesses
- they are legally recognised partners in business
- they are employer and employee
- there is any person who directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them
- one of them directly or indirectly controls the other*
- both of them are directly or indirectly controlled by a third person

- together they directly or indirectly control a third person, and
- they are members of the same family.

(*Control for this purpose means that one person is legally or operationally in a position to exercise restraint or direction over the other.)

Relationship between customs and tax rules

Although the customs valuation rules are broadly similar to the OECD transfer pricing rules discussed elsewhere in this book, there are some significant differences and it cannot be assumed that a price that is acceptable to the revenue authorities will necessarily also conform to the customs' value rules.

At a basic level, a tax authority focuses on the accuracy of a transfer price as reflected on a tax return (annual basis aggregated across the entire business). Conversely, a customs' authority applies duties against the value of the merchandise at the time of entry into a customs' territory (at a transactional level, product type by product type). Consequently, an immediate potential conflict arises.

In addition to this inherent difference, the two governmental authorities (tax and customs) are working at cross-purposes. On the one hand, a low value for customs' purposes results in lower duties, while, on the other hand, this same low value results in a higher income/profit in the country of importation and results in higher taxes.

Although variations on the same theme, value for transfer pricing and for customs' purposes share a common founding principle: the price established for goods traded between related parties must be consistent with the price that would have been realised if the parties were unrelated and the transaction occurred under the same circumstances. This principle is colloquially known as the arm's-length principle.

Intangibles

Import duty is not normally applied to the cross-border movement of intangible property. However, the value of intangibles may form part of the customs' value of imported goods if they both relate to, and are supplied as, a condition of the sale of those goods. Consequently, some commissions, certain royalties and licence fees, contributions to research and development (R&D), design, engineering and tooling costs, and other payments made by the buyer of the imported goods to the seller may be subject to duty if certain conditions are fulfilled. Conversely, certain costs and payments that may be included in the price of imported goods are deductible in arriving at the customs' value or can be excluded if they are invoiced and/or declared separately from the goods themselves.

The Brussels' definition of value

Those few countries that do not subscribe to the WTO Valuation Agreement (typically developing countries such as Côte d'Ivoire and Montserrat) continue to rely upon an older international code – the Brussels' definition of value (BDV) – which is based on the principle of an entirely notional 'normal' value. Under the BDV, there need be no connection between the customs' value and the price paid for the goods, so that the customs implications of importing goods into these countries have little or no significance for transfer pricing.

Transfer pricing and indirect taxes

Specific duties and fixed values

Not all products are assessed a duty based on their value. Some products are assessed specific duties (e.g. a fixed amount per gallon/litre). In addition, some countries (e.g. Lebanon and Sri Lanka) levy specific duties on certain categories of imported goods so that the actual price paid for them does not impact the duty owed. It is important to note, however, that many countries require the value declared to be 'correct', regardless of whether it impacts the amounts of duty paid, and have penalty provisions for 'non-revenue loss' violations. Similarly, some countries apply fixed or official minimum values for certain goods, which also makes the transfer price irrelevant as a method of determining the value of imported goods for customs' purposes. However, these latter practices are gradually disappearing as the countries concerned adopt the WTO Valuation Agreement.

Sales taxes, value added taxes and excise duties

Generally, the value of imported goods for the purposes of other *ad valorem* duties and taxes tend to follow the value for customs' purposes. There are, however, special rules in many countries and, while a detailed discussion of these is outside the scope of this book, these rules must be taken into account when planning a transfer pricing and business policy.

Antidumping duties/Countervailing duties

Anti-dumping duties are levied when, as the result of a formal investigation, it is determined that domestic producers have been or may be damaged because imported goods are sold in the country in question at less than a fair value, having regard to the price at which the same goods are sold in the country of export or, in certain cases, in a third country. In theory, it may appear that, if goods are sold at a dumped price, that price will not be acceptable to the revenue authority in the country of export, although the revenue authority in the country of import would presumably have no problem with it. In practice, however, because dumping is a product of differentials between prices in two markets, it is possible for a transfer price to offend the anti-dumping regulations while being acceptable to the revenue authorities or vice versa. Although, the need for the aggrieved industry to make its case and the administration to be satisfied that the dumping is causing injury mean that dumped prices do not necessarily result in the imposition of anti-dumping duties.

Whereas anti-dumping duties are assessed against companies for their business practices, countervailing duties are assessed based on government subsidies or assistance. These cases target the actions of all trading entities in a particular industry, which are receiving some kind of export-generating assistance from the government of the exporting country. As with anti-dumping duties, the government subsidies can impact the transfer price of goods by removing some of the costs from the price of the exported goods. Accordingly, the transfer price would then be artificially low. However, and as is the case with anti-dumping duties, the aggrieved industry must bring forth the case to the importing country's government. The complainants must show that they have been harmed or will be harmed by the abnormally strong trading position of the entities that received the government subsidies.

Establishing a transfer pricing policy – technical considerations

Where the proposed transfer pricing policy relates to international movements of goods that attract customs duties or other taxes on imports, it is necessary to determine whether the policy will:

- meet the requirements of the customs authority in the country of importation, and
- create opportunities for tax and customs' planning to reduce the values for customs' purposes without prejudice to the transfer pricing policy.

When traders use the transfer price as the value for customs' purposes, they exercise an option that is both convenient and rife with pitfalls. The parties to the transaction must be able to demonstrate that, at the time the customs' value was reported, supporting documentation was available to demonstrate that the transfer price was determined using acceptable valuation methods and applicable data. In essence, the customs' value reported by related entities must mimic that which would have been established in an arm's-length transaction according to customs' rules. It is interesting to note that several customs' authorities have issued written guidance specifically stating that a transfer pricing study, in and of itself, is not sufficient to support customs' value requirements.

Adjustments

Before attempting to validate the transfer price for customs' purposes, it may be necessary to make certain adjustments to deduct those items that can be excluded from the customs' value of the goods, even though they are included in the price, and to add those items that must be included in the customs' value, even though they are excluded from the price.

Costs and payments that may be excluded from the transfer price of goods when included in such price include the following:

- Costs of freight, insurance and handling that are excluded by the regulations of the country of importation (these costs are not always excludable).
- Costs that relate to such activities undertaken after the goods have left the country of export.
- Import duties and other taxes (including sales and value added taxes and excise duties) that are levied on importation of the goods into the country of import.
- Charges for construction, erection, assembly, maintenance or technical assistance undertaken after importation on goods, such as industrial plant, machinery or equipment if separately itemised.
- Charges for the right to reproduce the imported goods in the country of importation.
- Buying commissions.

Certain costs may be excluded from the customs' value if they are separated from the price of the goods. The method of excluding these costs and payments – known as price unbundling – is explained later.

It is important to note that there may also be other costs and payments that must be included in the customs' value (added to the price) of the goods when not included in

Transfer pricing and indirect taxes

the transfer price. The costs and payments that must be added to the transfer price for customs' purposes (if they are not already included) are as follows:

- Commissions (other than buying commissions).
- Freight, insurance and handling charges up to the point designated in the rules of the country of import (this can vary by country).
- Royalties, if they both relate to the imported goods and the underlying rights were sold as a condition of the sale of the goods by the supplier (this also can vary by country).
- Assists (i.e. the value of goods and services provided free of charge or at a reduced cost by the buyer to the seller for use in connection with the production or sale of the goods).
- Any quantifiable part of the proceeds of resale of the goods by the buyer that accrue to the seller (other than dividends paid out of the net profits of the buyer's overall business).
- The value, if quantifiable, of any condition or consideration to which the transfer price is subject as per the rules of the country of import.
- Any additional payments for the goods, which are made directly or indirectly by the buyer to the seller, including any such payments that are made to a third party to satisfy an obligation of the seller.
- The cost of containers treated as one with the imported goods.
- The cost of labour and materials in packing the goods.

Validation of the transfer price for customs purposes

The WTO Valuation Agreement provides quantitative and qualitative criteria for validating a price of goods. The quantitative criteria defined below are, however, dependent upon the existence of values for identical or similar goods that have already been accepted by the customs' authority in question (or, in the case of the EU, by a customs' authority in another member state). In practice, therefore, unless there are parallel imports into the same customs' territory by buyers not related to the seller, these criteria are not applicable. The quantitative criteria are:

- The price paid approximates closely to a transaction value in a sale between a seller and unrelated buyer at or about the same time.
- The price paid approximates closely to the customs' value of identical or similar goods imported into the same customs' territory at or about the same time.

The qualitative criteria are not specifically defined, although the explanatory notes to the WTO Valuation Agreement do provide some examples. Essentially, the customs' authority must be satisfied that the overseas' supplier and the importer trade with each other as if the two parties were not related. Any reasonable evidence to this effect should be sufficient, but the following circumstances, in particular, should lead the customs' authority to conclude that the price has not been influenced by the relationship:

- The price is calculated on a basis consistent with industry pricing practices.
- The price is the same as would be charged to an unrelated customer.
- The price is sufficient for the seller to recover all costs and make a reasonable profit.
- The use of an alternative method of valuation (e.g. deductive or resale-minus method) produces the same customs' value.

If the application of any of the above criteria confirms that the proposed transfer pricing policy yields transaction values that are acceptable values for customs' purposes, no further action is necessary other than to determine whether any adjustments need to be made to the price and whether prior application should be made to customs for a ruling.

Since the objective of the tax and customs' rules is to arrive at a price that is not influenced by the relationship between the parties, there should be no substantial difference between a transfer price that meets the requirements of both tax authorities and one that constitutes an acceptable transaction value for customs' purposes. However, given the degree of flexibility inherent in both sets of rules, some variation is inevitable and, in certain cases where this flexibility has been exploited for commercial or income-tax purposes, the difference may be sufficient to result in a transfer price that is unacceptable to the customs' authority or results in an excessive liability to customs' duty.

Transfer prices below the acceptable customs value

If none of the methods described above enables the transfer prices to be validated for customs' valuation purposes, because they are lower than the acceptable value, the taxpayer has the following options:

- Modify the transfer pricing policy.
- Submit valuation for customs' purposes on the basis of an alternative method of determining value.

The choice between these two options depends upon the circumstances in each case, but the following factors need to be considered:

- The interest of the customs' authority in the country of import is, in principle, the same as that of the revenue authority in the country of export: both are concerned that the transfer price may be too low. A transfer pricing policy that produces prices unacceptable for customs' purposes, may, therefore, not be acceptable to the exporting country's revenue authority.
- The methods of validating a transfer price are based, for the most part, on the application of the alternative methods of valuation to determine whether their use will yield a customs' value that is significantly different than the actual transfer price. The results of the validation exercise will therefore indicate the customs' values likely to be acceptable to the customs' authority under each method. The alternative methods must be applied in strict hierarchical order, except that the importer has the option of choosing the computed (i.e. cost plus) or deductive (i.e. resale-minus) method of valuation and is free to choose the method that yields the lower customs' value.

Transfer price exceeds acceptable customs value

If the application of the validation methods demonstrates that the transfer price is higher than the value that could be justified for customs' purposes, the taxpayer has the following options:

- Consider the scope for unbundling the transfer prices.
- Modify the transfer pricing policy.
- Submit valuation on the basis of an alternative method.

Transfer pricing and indirect taxes

The transfer price may exceed the acceptable customs' value of the imported goods because it includes elements of cost and payments that need not be included in the customs' value. An exercise to 'unbundle' the transfer price and to separate those elements may result in a customs' value that is significantly less than the transfer price. Most jurisdictions have no legislative requirement to reconcile the value of imported goods for customs' purposes with the inventory value of those goods for corporate income-tax' purposes. Where such a requirement does exist, however – notably in the US – due account can be taken of those elements that form part of the inventory value but are not required to be included in the value for customs' purposes. If the unbundled transfer price still exceeds the acceptable customs' value, the taxpayer should consider whether the transfer price does in fact meet the requirements of the revenue authority in the country of importation.

Corporate income tax is levied only on the profits of a transaction, whereas customs' duties are paid on its full value, irrespective of whether a profit or loss is made. In certain circumstances, notably where there are losses, a high transfer price – even if it is acceptable to the revenue authorities – may result in a net increase, rather than a reduction, in the overall tax burden when the increased duty liability is taken into account.

Customs' authorities do not normally entertain the argument that a transaction value is unacceptable solely because it has been inflated as a result of the relationship between the buyer and seller of the goods. It may be, however, that the circumstances surrounding the transactions between the buyer and seller are such as to preclude valuation on the basis of the transfer price, namely:

- The price is subject to some condition or consideration that cannot be quantified (e.g. the goods are supplied on consignment and the transfer price is dependent upon when, to whom and in what quantity the goods are resold).
- An unquantified part of the proceeds of the resale of the goods by the buyer accrues to the seller (other than in the form of dividends paid out of the net profits of the buyer's total business).
- The seller has imposed upon the buyer a restriction that affects the value of the goods in question (e.g. they can be resold only to a certain class of purchaser).
- The goods are supplied on hire or lease or on some other terms that do not constitute a sale of the goods (e.g. on a contingency basis).

Alternative methods of valuation

Once it is established that the imported goods cannot be valued for customs' purposes on the basis of the transaction value, the link between the transfer price for commercial and income-tax' purposes and the value of the goods for customs' purposes is broken. The taxpayer is then free to determine a transfer price without regard to the customs' implications, irrespective of whether the price so determined is higher or lower than the value of the goods for customs' purposes, except for countries like the US where the inventory value for tax purposes cannot exceed the customs' value. Several transfer pricing methods (TPMs) are available, many of which are sufficiently flexible to apply to a variety of transaction types. Traditional TPMs are the CUP method, the cost-plus method, and the resale price method. Other methods are the profit split and the transactional net margin methods.

The alternative methods of customs' valuation are similar to some of the methods used to validate transfer prices for income-tax' purposes, but the WTO Valuation Agreement requires that they be applied, with one exception, in strict hierarchical order as set out below:

1. **Value of identical goods.** The transaction value of identical merchandise sold for export to the same country of importation and exported at or about the same time as the goods being valued. The value of the identical merchandise must be a previously accepted customs' value, and the transaction must include identical goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued.
2. **Value of similar goods.** As in (1) except that the goods need not be identical to those being valued, although they must be commercially interchangeable.
3. **Deductive value.** A notional import value deduced from the price at which the goods are first resold after importation to an unrelated buyer. In arriving at the deductive value, the importer may deduct specific costs – such as duty and freight in the country of importation and either his/her commission or the profit and general expenses normally earned by importers in the country in question – of goods of the same class or kind.
4. **Computed value.** A notional import value computed by adding to the total cost of producing the imported goods, the profit and general expenses usually added by manufacturers in the same country of goods of the same class or kind. Note that, as an exception to the hierarchical rule and at the option of the importer, the computed valuation method can be used in preference to the deductive valuation method.

The valuation of identical or similar merchandise is similar to the CUP method. The CUP method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted. While simple on its face, the method is difficult to apply. The fact that any minor change in the circumstances of trade (e.g. billing period, amount of goods traded, marking/branding) may have a significant effect on the price makes it exceedingly difficult to find a transaction that is sufficiently comparable.

The deductive value method is similar to the resale price (RP) method. The RP method determines price by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross markup from the sale price to an unrelated third party, with the appropriate gross margin being determined by examining the conditions under which the goods/services are sold, and comparing the said transaction to other third-party transactions. Consequently, depending on the data available, either the cost-plus (CP) or the RP method will be most the appropriate method to apply.

The computed value method is similar to the cost plus (CP) method. The CP method is determined by adding an appropriate markup to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with the appropriate markup being based on the profits of other companies comparable to the parties to the transaction. Amounts may be added for the cost of materials, labour, manufacturing, transportation, etc. Given the variables required for the proper application of this method, it is most appropriately used for the valuation of finished goods. As a matter of practice, some customs administrations do not accept the use of this method by

Transfer pricing and indirect taxes

importers given that the accounting for costs occurs in the country of export, which makes verification by local authorities difficult.

If it proves impossible to find a value under any of the above methods, a value must be found using any reasonable method that is compatible with the WTO Valuation Agreement and is not specifically proscribed. In practice, customs authorities often adopt a flexible application of the transaction value rules or one of the alternative methods in order to arrive at an acceptable value.

Implementation of the customs' pricing policy

The procedures for declaring the value of imported goods to customs' authorities vary from country to country. In most cases, however, some form of declaration as to the value of the goods is required at importation and the importer may be required to state whether the seller of the goods is a related party and, if so, whether the relationship has influenced the price.

In some cases – such as where identical goods are sold to an independent buyer in the same country of importation at the same price – the importer can declare the transfer price with any necessary adjustments as the value for customs' purposes. In most cases, however, the position is less clear and, where the local rules permit, the importer is strongly advised to seek a definitive ruling in advance from the customs' authority or, at least, to obtain the authority's opinion as to the validity of the values that it intends to declare.

Strictly speaking, the WTO Valuation Agreement places the onus on the customs' authority to prove that a price has been influenced by a relationship between the parties. In practice, however, the importer would be well advised – even if it is not intended to seek an advance ruling or opinion – to validate transfer prices for customs purposes and to maintain the necessary records, calculations and documentation for use in the event of a customs' audit or enquiry.

Transfers of intangibles

Intangibles per se are not subject to import duty, but when supplied as part of a package of goods and services, the value of intangibles may constitute part of the customs' value of the imports. When a package of goods and services is supplied for a single, bundled price, customs' duty is paid on that price in full, unless it contains any elements of cost that can be separately quantified and is permitted to be deducted from the price. As explained previously, it is up to the importer and the foreign supplier to unbundle the price so as to separately quantify and invoice the value of those costs that do not have to be added to the customs' value of imported goods if they are not already included. However, the following categories of intangibles are, subject to certain conditions, required to be included in the customs' value of imported goods:

- Payments by the importer, in the form of royalties or licence fees, for the use of trademarks, designs, patents, technology and similar rights, provided that the rights in question relate to the imported goods and that the payment therefore is a condition of the sale of the goods by the seller to the buyer.
- Intangible 'assists', except where the work is undertaken in the country of importation.
- Payments for computer software (subject to the options described in the GATT decision of 24 September 1984).

- Payments for the right to resell or distribute imported goods (but excluding a voluntary payment by the buyer to acquire an exclusive right to resell or distribute the imported goods in a particular territory).
- Design, development, engineering and similar costs that represent part of the cost of manufacturing or producing the imported goods.

Royalties and licence fees

This is the most complex area of customs' valuation and each case has to be examined carefully to determine whether a liability to import duty arises. The following guidelines are helpful:

1. The key consideration in determining whether a royalty or licence fee is dutiable is the nature of the rights for which the payment is made. The basis on which the payment is calculated is usually not relevant.
2. Generally, if the imported goods are resold in the same state in which they are imported, any royalties or licence fees payable as a condition of the importation of those goods are likely to be dutiable. For example, if imported goods are resold under the manufacturer's trademark – whether it is affixed to the goods before or after importation – the corresponding royalty payment is dutiable, even if the payment is based on income from sale of the goods in the country of importation.
3. However, where goods are subjected, after importation, to substantial processing or are incorporated into other goods, such that the resulting product does not have the characteristics of the imported goods, it is likely that the royalty or licence fee is not considered to relate to the imported goods, provided that the rights in question relate to the finished product. An example of this would be where the rights conferred on the buyer enable him to manufacture a product using the seller's technology, patents or know-how or to sell that product under the seller's trademark. In such circumstances, it is unlikely that the royalty payments would be regarded as part of the customs' value of raw materials or components imported by the buyer from the seller for incorporation in the finished product. It may be necessary, however, to include at least part of the royalty in the customs' value of the imported components if those components contain the essential characteristics of the finished product (*see point [4] below*).
4. Difficulties frequently arise where the imported materials or components are considered by the customs' authority to contain the essential characteristics of the finished product. For example, the buyer may be paying a royalty for technology that supposedly relates to the manufacture of the finished product in the country of importation. However, if the process of manufacture is, in reality, no more than a simple assembly operation, customs may take the view that the technology is incorporated in the imported components rather than the manufacturing operation and deem the royalty to be dutiable. Another example is where the seller's particular expertise or speciality is clearly incorporated in one key component, which is imported. As a result, royalties paid for a company's unique technology which is incorporated in a single imported semiconductor device could be deemed dutiable even if the whole of the rest of the system is manufactured in the country of importation from locally sourced parts.
5. In circumstances where an importer is manufacturing some products locally using the affiliate's designs, know-how and materials or components, while importing others as finished items from the same or another affiliate, care must be taken to distinguish the rights and royalties applicable to each. In such cases, it would normally be expected that the seller would recover all its research, development

Transfer pricing and indirect taxes

and design costs in the price of the products that it manufactures and exports to the buyer; it is inappropriate therefore to charge royalties for those products.

6. The decision of whether royalty and licence fees are dutiable may be subject to varying interpretations in different countries. Some countries, for example, may consider periodic lump-sum licensing fees to be non-dutiable charges, provided that payments are not directly related to specific importations.
7. Cost-sharing agreements (i.e. for R&D) can prove problematic if adequate documentation is not maintained, establishing what portion of development costs relates to the import of products. In such instances, the local import authorities may take the position that all such costs in a general pooling of costs are considered dutiable.

In the case of the products manufactured in the country of importation, however, a royalty or licence fee is the only way in which the owner of the intangible can recover its costs. However, if a royalty refers to 'the right to manufacture and distribute the company's products in the territory', it will be deemed to relate to the imported products as well as those manufactured in the country of export. Alternative wording – "the right to manufacture the company's products in country A and to sell such products as it manufactures in the territory" – may avoid unnecessary liability to duty. Payments for the right to reproduce imported goods in the country of importation are specifically excluded from the customs' value of imported goods.

Intangible assists

Intangible assists consist of designs, specifications and engineering information supplied by the buyer of the imported goods to the seller free of charge or at reduced cost. If the work is undertaken within the country of importation, such assists are not dutiable, but if the work is undertaken in the country in which the goods are manufactured or in any other country, the assists are deemed to be part of the customs' value of the imported goods.

There are different interpretations of what is meant by the word 'undertaken'. Some customs authorities accept, for example, that work undertaken by the buyer's designers who are based in the country of importation but who actually designed the product in the country of manufacture would not result in a dutiable assist; others, however, would take the opposite view. However, even if work is performed in the country of importation but paid for by the foreign seller and recharged to the importer, it may constitute a dutiable cost as representing part of the price paid or payable for the imported product. The value of an assist is the cost to the buyer of producing or acquiring it, and it is not necessary to add a markup or handling fee.

Interest

Interest incurred by the manufacturer of imported goods is deemed to be part of the cost of producing the goods and should therefore be included in the price. However, where the importer pays interest – to the seller or a third party – under a financing agreement related to the purchase of the imported goods, that interest need not be included in or added to the customs' value of imported goods, provided that:

- The financing agreement is in writing (although this need only be a clause in the agreement for the sale of the goods).
- The rate of interest is consistent with contemporary commercial rates of interest for such transactions in the country in which the agreement is made.

- The buyer has a genuine option to pay for the goods promptly and thereby avoid incurring the interest charge.
- The interest is separately invoiced or shown as a separate amount on the invoice for the goods.
- In some countries, such as the US, the interest must be treated as an interest expense on the books and records of the importer.

Computer software

Contracting parties to the WTO Valuation Agreement may value software for use with data processing equipment on one of two alternative bases, namely:

1. The full value of the software, including the carrier medium (disk, tape, etc.) and the program data or instructions recorded thereon.
2. The value of the carrier medium only.

The second option applies only to software in the form of magnetic tapes, disks and similar media. Software on the hard disk within a computer or embedded in semiconductor devices (firmware) is dutiable on the full value. Similarly, this option does not extend to software that includes audio or visual material. Although this exclusion was originally intended to cover leisure products, such as computer games, movies and music, more and more serious software now incorporates audio and visual material and, in some jurisdictions, may be subject to duty on the full value.

The terms of the present valuation options on software dated from 1985 have been overtaken by advances in technology and commercial practice in the data processing industry. Furthermore, the Information Technology Agreement (ITA) has resulted in most movements of computer software becoming subject to a zero rate of duty. It is inevitable therefore that importers will face anomalies and uncertainties in the valuation of software unless or until the WTO Valuation Agreement is updated to reflect these developments. However, it is worth noting that software and other goods transmitted electronically do not attract customs duty even if, in their physical manifestation, they would be dutiable (e.g. music CDs, videos).

Design, development, engineering and similar charges

The costs of these activities are normally expected to be included in the price paid for the imported goods. However, there are circumstances in which companies may wish to recover these costs from their affiliates by way of a separate charge. Furthermore, the affiliate may be supplied not with finished products but only with components on which it is not normal to seek to recover such costs.

Generally speaking, any payment for design and similar expenses that relates to imported goods is regarded as part of the customs' value of those goods and an appropriate apportionment will be made and added to the price of the goods. Costs for research, if properly documented as such, are not subject to duty.

Where components are supplied to the buyer and a separate charge is made relating to the design of the finished product that is manufactured in the country of importation, some difficulty may arise. If the components are purchased by the seller from third-party suppliers, the costs of design are likely to be included in the supplier's price and no further action is necessary. However, where some or all of the components are produced by the seller and design costs have not been included in the price, it will

Transfer pricing and indirect taxes

be necessary to attempt to allocate an appropriate proportion of the total charge for design to the components in question.

The impact of transfer pricing policy changes

Where the basis of customs' valuation is the transaction value – the price actually paid or to be paid for the imported goods – any change in the method of determining the transfer price may affect the validity of that price for customs' purposes. It may also trigger a requirement to notify the customs authority if the buyer holds a ruling that is subject to cancellation or review in the event of a change in commercial circumstances.

If the proposed change in pricing arrangements is significant, the validation exercise described previously must be repeated to determine whether the new policy produces an acceptable value for duty purposes. Examples of significant changes are:

- A shift in the allocation of profit from one entity to another.
- A shift of responsibility for certain functions from one entity to another.
- A change in the transaction structure, such as the interposition or removal of an export company, a foreign sales corporation or a re invoicing centre.
- Any changes in pricing levels that exceed normal commercial margins of fluctuation.

Provided that the changes represent realistic responses to changes in commercial circumstances, there should be no difficulty in validating the new prices for customs' valuation purposes. However, where no such justification for the changes exists – and particularly where the price change is substantial – it may be difficult to explain satisfactorily why the prices now being proposed have not previously been charged since the commercial circumstances are substantially unchanged.

If the proposal is to increase prices, the customs authority may take the view that the values previously declared, based on the current transfer pricing policy, were too low and, depending upon local regulations, they may be able to recover substantial arrears of duty and to impose penalties. Conversely, even if the customs authority accepts that the current transfer prices are higher than commercial circumstances justify, there will probably be no basis for claiming repayment of duties overpaid, even if the seller credits the buyer with the difference between the existing and proposed prices on a historical basis.

The impact of retrospective transfer price adjustments

The WTO Valuation Agreement contains no specific provisions for dealing with adjustments to transaction values and, therefore, the rules and practice in each country determine how customs authorities respond if a price already paid is subject to subsequent adjustment for commercial or corporation tax' purposes.

The transaction value principle states that the price for the goods 'when sold for export to the country of importation' should represent the customs' value of those goods. Provided, therefore, that the price paid or agreed to be paid at that time was not in any way provisional or subject to review or adjustment in the light of future events, specified or otherwise, that price must be the customs' value of the goods. If, subsequently, that price is adjusted as a result of circumstances that were not foreseen at the time of the sale for export – or that, if they had been foreseen, were not expected

or intended to lead to a price adjustment – there appears to be no provision under the WTO Valuation Agreement that would either:

- in the event of a downward adjustment, allow the importer to recover duty overpaid, or
- in the event of an upward adjustment, allow the customs authority to recover duty underpaid.

However, it is likely that, so far as customs authorities are concerned, the above is true only of occasional and non-recurring adjustments. If, for example, a company were to make a practice of reviewing its results at the end of each fiscal year and decided to reallocate profit between itself and its affiliates, it is probable that customs would take the view that such adjustments were effectively part of the company's transfer pricing policy, even if no reference to it appeared in any written description of that policy. In those circumstances, subject to any statute of limitations, they would be likely to seek arrears of duty and possibly also penalties for all previous years in which upward adjustments had been made. While some customs jurisdictions may give credit for any downward adjustments in assessing the amount of duty due, it is unlikely that they would accept a claim for repayment where a net overdeclaration of value could be substantial.

Where a company's transfer pricing policy specifically provides for periodic review and retrospective price adjustment – for example, to meet the requirements of the IRS and other revenue authorities – customs will certainly regard any adjustments as directly applicable to the values declared at the time of importation. Any upward adjustments will therefore have to be declared and the additional duty paid. Downward adjustment, in some countries, may be considered post-importation rebates and consequently claims for overpaid duties will not be accepted. However, in the US, importers may take advantage of the Custom's Reconciliation Program, which provides the opportunity to routinely adjust the value of imported goods and either collect or pay duties.

In addition, in the US, a specific IRS provision (1059A) requires that the inventory basis for tax purposes does not exceed the customs' value (plus certain allowable adjustments). Therefore, the possibility exists that the IRS authorities could disallow any upward price adjustment in the event it causes the inventory taxable basis to exceed the customs' value. To avoid penalties for failing to declare the full value of imported goods and to ensure that duty can be recovered in the event of price reductions, it is recommended that any transfer pricing policy that involves retrospective price adjustments should be notified to customs in advance. Some authorities are amenable to arrangements whereby provisional values are declared at the time of importation and subsequent adjustments are reported on a periodic basis, provided they are accompanied by the appropriate additional duties or claims for repayment.

As an alternative to the above, it may in some cases be in the importer's interests to take the position that, at the time of importation, there is no transaction value because the eventual price for the goods cannot then be determined. In that event, the importer could seek valuation under one of the alternative methods described above.

Transfer pricing and indirect taxes

The impact of international structure

The structure of a transaction chain that involves at least one cross-border movement between different customs' jurisdictions can have a significant impact on duty liabilities. Transaction values exist only where there is a price for imported goods between two separate legal entities in a sale whereby ownership of the goods and the attendant risks pass from the seller to the buyer. In the absence of such a sales price between the exporter and importer, the customs' value must be based on another sales' transaction, if there is one, or on one of the alternative methods of valuation described above. The following examples illustrate the impact of various structures on the value of imported goods for duty purposes:

- Where an exporter uses a subsidiary company in the country of importation as its distributor, and the latter buys imported goods as a principal and resells them to end-customers, the price between the two companies is, in principle, acceptable for customs' purposes. However, this is not the case where the distributor is merely a branch of the exporter and part of the same legal entity. In that event, unless there is another transaction value, duty is payable on the selling price to the end-customer, including the gross margin of the branch.
- Similarly, there is no transaction value if the subsidiary merely acts as a selling agent or commissionaire for the exporter and does not own the imported goods. Again, duty is payable on the selling price to the end-customer, including, in this case, the subsidiary's commission.
- Transactions involving re-invoicing operations that merely issue a new invoice in a different currency and do not take title or risk in respect of the imported goods are ignored for customs' purposes, as are those involving foreign sales corporations (FSCs), which are remunerated by way of commission. However, transactions involving FSCs that act as principals may provide a basis of valuation.

The customs laws of the EU and the US (but not, at present, any other jurisdiction) recognise a transaction value, based on a sale for export to the country of import even when there are subsequent sales in the supply chain (successive or first sale concept). This means, for example, that if a manufacturer in the US sells goods for USD80 to a US exporter who, in turn, sells them to an importer in the EU for USD100, the latter can declare a value of USD80 for duty purposes, even though USD100 was paid for the goods. Acceptance of the price in the earlier sale is conditional upon the following factors:

- The goods being clearly intended for export to the country of importation at the time of the earlier sale.
- The price being the total consideration for the goods in the earlier sale and not being influenced by any relationship between the buyer and seller.
- The goods being in the same physical condition at the time of the earlier sale and at importation.

Apart from allowing duty legitimately to be paid on what is, in most cases, a lower value, the 'successive sales' concept in the EU and 'first sale' approach in the US also have the benefit of decoupling the value of imported goods for duty purposes from the values of those goods for the purposes of determining the taxable profits of the importer and exporter. Japan also provides for duty reduction based on a principle very similar to that which underlies the 'first sale' programmes in the US and EU, albeit in a more complex manner.

Dealing with an audit of pricing by an indirect tax authority

For similar reasons to those advanced by the tax authorities, customs authorities are taking an increasing interest in the validity of values declared by importers on the basis of transfer prices between related parties. The principal areas on which they focus their inquiries are:

- Whether the transfer price allows full recovery of all relevant costs, including general and administrative overheads and relevant R&D.
- Whether the addition for profit occurs on an arm's-length basis.
- Whether all appropriate additions have been made for royalties, R&D payments and assists.

Traditionally, customs authorities have tended to operate in a vacuum, with no consideration for the commercial or tax environments within which transfer pricing policies are developed and implemented. This has led to considerable frustration as companies have tried to defend to customs' officers prices that are not only commercially justifiable but have already been accepted by the revenue authorities. However, this situation is changing in some jurisdictions where customs authorities are making efforts to understand the OECD Guidelines and are increasingly interfacing and cooperating with their direct-tax revenue colleagues. It is unlikely that greater knowledge and understanding will lead to fewer customs valuation audits – indeed, the opposite is more likely to be the case – but it should mean that they are less troublesome for importers.

As for tax purposes, the availability of documentation that describes the company's overall transfer pricing policy and demonstrates how individual transaction values have been calculated is essential. In addition, a similar approach to customs' value documentation should also be undertaken. This can start with the transfer pricing documentation and include the appropriate additional analysis required by customs. In addition, where the position is complex and there is likely to be any contention as to the correct values, it is strongly recommended that the facts and legal arguments be presented to the customs authority before the relevant imports commence and, as advisable, a formal ruling or opinion obtained. Although these will not preclude subsequent audit, the latter should then be confined to verification of the relevant facts rather than involve arguments about issues of principle.

Strategy based on balance and leverage

A prudent company will take the same care and documentation approach for customs as it does for transfer pricing. Considering the above, it can be argued that an importer's sole reliance on a transfer pricing analysis would likely not be sufficient to support the proper appraisal of merchandise for customs' valuation purposes. To believe and act otherwise runs the risk of being subjected to fines, penalties or a mandated application of an alternative customs' valuation method that may be difficult and costly to implement and sustain. Indeed, the belief that if a taxpayer has done a transfer pricing study then its customs' value must be correct has been proven wrong time and time again.

Still, a transfer pricing analysis and related documentation can be leveraged to provide a basis from which a customs' value may be derived and supported. This assumes, of course, that all required statutory adjustments are applied and other relevant considerations are factored in. The potential benefits to global traders from finding an

Transfer pricing and indirect taxes

appropriate balance in the transfer pricing and customs' valuation nexus are many and include the following:

- A foundation for establishing inter-company pricing policies for customs' purposes that help to decrease accounting issues that are created by gaps, lack of coverage, or contradictions among inter-company pricing initiatives.
- The ability to significantly reduce the potential of a customs' audit as well as the financial exposure related to penalties associated with non-compliance of customs' regulations.
- A global (or at least multijurisdictional), long-term coordinated inter-company customs' valuation documentation compliance solution that considers products/product line, market conditions, and other key economic factors.
- A basis for proactively managing value adjustments to achieve arm's-length results required under tax and customs' regulations.
- A foundation for pursuit of advanced pricing agreements that may also be considered by customs authorities as evidence of an appropriate arm's-length result.
- The ability to identify planning opportunities related to the valuation of merchandise and intangibles (e.g. royalties, licence fees, research and development, warranties, marketing and advertising, cost-sharing arrangement) via alternative methods of appraisalment.
- The development of limits to customs authorities' ability to interpret Art. 1.2(a) and (b) of the WTO Customs Valuation Agreement relating to the acceptability of using the transfer price as an initial basis for the customs' value of imported merchandise.
- Enhanced financial reporting compliance related to inter-company cross-border transactions to satisfy obligations under Sarbanes-Oxley reporting requirements.

10.

Procedures for achieving an offsetting adjustment

Introduction

Early consideration should be given to the procedures that might be followed to obtain compensating adjustments in other jurisdictions should a transfer pricing audit lead to additional tax liabilities in a particular jurisdiction. The attitudes of revenue authorities vary and will depend upon the overall circumstances (such as whether they consider that the taxpayer has deliberately sought to reduce their taxes by what they perceive to be 'abusive' transfer pricing).

Generally, no scope is available with which to make adjustments in the absence of a double tax treaty or multi-country convention. However, it might be possible to render further invoices in later years reflecting pricing adjustments, although these types of adjustments are frowned upon and attract scrutiny from the tax authority of the receiving jurisdiction. Very careful attention needs to be paid to the legal position of the company accepting retroactive charges and to other possible consequences, particularly to indirect taxes. Nevertheless, in a few cases this may afford relief.

The ability to seek relief under the mutual agreement procedure process and, more particularly, under the European Union Convention, which is discussed in this chapter, is sometimes cited by taxpayers as if it is an easy solution to transfer pricing problems. This is not the case and should certainly not be viewed as allowing taxpayers to avoid paying careful attention to the implementation of a coherent transfer pricing policy and to its defence on audit.

Competent authority

Competent authority procedures for the relief of double taxation are typically established in bilateral tax treaties and must always be considered when a tax authority proposes an adjustment to prices. For instance, where a US subsidiary accepts that the price of each widget sold to it by its UK parent should be reduced by, say, £10, to satisfy the US Internal Revenue Service, will the UK Inland Revenue accept a corresponding reduction in UK taxable income? This type of question involves consultation with the competent authorities. Virtually all double tax treaties contain provisions similar to those set out in Article 25 of the OECD Model. These provide that a taxpayer may petition the competent authority of the state in which he/she is resident where the actions of one or both of the treaty partners "... result or will result for him/her in taxation not in accordance with the provisions of [the double tax treaty]".

In the course of an audit, a taxpayer needs to consider whether reference should be made to the competent authority procedures and at what stage. It is necessary to pay attention to the required procedures and, more particularly, to the statute of limitations under each treaty. Adjustments may not be possible after a tax liability has become final, and only if the other revenue authority is prepared to give relief will

Procedures for achieving an offsetting adjustment

double taxation then be avoided. While in general, revenue authorities consider that their enquiry should have been concluded before they begin discussions with the other revenue authority, they may be prepared to delay the finalisation of any assessment and, in particularly complex cases, may be willing to operate the procedure in parallel with the conduct of their audit. However lengthy or uncertain they are, the competent authority procedures remain the main process through which a taxpayer can hope to avoid double taxation after paying tax in respect of a transfer pricing adjustment.

It is significant to note that the Mutual Agreement Procedure under a double tax treaty ordinarily provides an alternative process of dispute resolution and is an option available to the taxpayer in addition to and concurrently with the prevailing appellate procedures under domestic law. The reference to the competent authority is to be made by the aggrieved party impacted by taxation not in accordance with the treaty. Consequently, the reference would be made by the taxpayer, which has or may suffer double taxation arising from the adjustment to the transfer price of an associated enterprise, rather than the enterprise itself.

Further, it is important to recognise that the charter of the mutual agreement procedure process is to mitigate taxation not in accordance with the treaty and not a means of eliminating the tax impact of a proposed transfer pricing adjustment. The mutual agreement procedure is a negotiation process between the competent authorities and ordinarily involves a compromise on both sides, by way of reaching a consensus on the acceptable transfer prices. During the mutual agreement procedure process, it is advisable for the taxpayer and its associated enterprise to provide inputs to respective competent authorities on an ongoing basis so that an effective and acceptable settlement is expeditiously reached. The taxpayer is at liberty to accept the agreement reached by the competent authorities or decline the arrangement (and by consequence revert to remedies under domestic law). The taxpayer may also withdraw its reference to the competent authorities during the negotiation process.

European Union arbitration convention

Background

On 23 July 1990, the representatives of Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and the UK jointly approved a convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (Convention 90/436). This multilateral convention represented a unique attempt to solve some of the difficulties faced by multinational enterprises in the transfer pricing area.

There were a number of procedural difficulties that made its use difficult, due to the modifications required to ratify the original treaty, to reflect the accession of Finland, Sweden and Austria, and also to the ratifications needed to extend the life of the original treaty beyond 31 December 1999. These procedural difficulties have now been overcome, thanks to the work of the EU Joint Transfer Pricing Forum. In November 2006, the Council Convention was amended with the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and the Slovak Republic in the European Union and entered into force on 1 November 2006.

The scope of the Convention

The Convention is designed to apply in all situations in which profits subject to tax in one Member State are also subject to tax in another as a result of an adjustment

to correct non-arm's-length pricing arrangements. The Convention also provides that relief is available under its terms where there is a risk of losses being doubly disallowed. However, the Convention is not applicable in any circumstance in which the authorities consider that the double taxation arises through deliberate manipulation of transfer prices. Such a situation arises in any instance where a revenue authority is permitted to levy a 'serious penalty' on the business concerned. This is considered in more detail below (see *The advisory commission*).

The businesses that can benefit from the Convention are those that constitute 'an enterprise of a contracting state'; this specifically includes permanent establishments of any enterprise of a contracting state. No further definition of these terms is included in the Convention, although it is stipulated that, unless the context otherwise requires, the meanings follow those laid down under the double taxation conventions between the states concerned. The intention was undoubtedly that all businesses of any description which have their home base within the European Union (EU) should receive the protection of the Convention, regardless of their legal form. Consequently, a French branch of a German company selling goods to an Italian affiliate would be covered. However, a French branch of a US company selling goods to an Italian affiliate would not be covered. It is important to note that the Convention is drawn up in terms that recognise not just corporations but also other forms of business, subject to tax on profits.

The required level of control

In drafting the Convention on transfer pricing, the European Commission recognised that Member States use widely varying definitions of the level of control required between affiliated businesses before anti-avoidance law on transfer pricing can apply. The Convention's definition of control for these purposes is accordingly very widely drawn indeed. It merely requires that one Member State enterprise "participates directly or indirectly in the management, control or capital of an enterprise of another contracting state" and that conditions are made or imposed between the two enterprises concerned such that their commercial and financial relationships differ from those that would have been made between independent enterprises. A similar definition deals with the situation where two or more Member State businesses are controlled by the same person.

Regarding the profits to be attributed to a permanent establishment, the Convention follows the OECD Model Treaty, requiring that the permanent establishment be taxed on profits that it might be expected to make if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

Adjustments to profits

The Convention makes no attempt to interfere with the processes by which the tax authorities of any one Member State seek to make adjustments to the profits declared by a business operating in their country. However, where a contracting Member State does intend to make an adjustment on transfer pricing grounds, it is required to notify the company of its intended actions in order that the other party to the transaction can give notice to the other contracting state. Unfortunately, there is no barrier to the tax adjustment being made at that stage. As a result, Member State businesses still face the cash-flow problems associated with double taxation until such time as the authorities

Procedures for achieving an offsetting adjustment

agree to make offsetting adjustments. If this double taxation cannot be eliminated by agreement between the two countries concerned, then the remaining provisions of the Convention may be used to gain relief. To address these issues, the Council of the European Union adopted a Code of Conduct for the effective implementation of the Convention wherein it has recommended Member States to take all necessary measures to ensure that tax collection is suspended during the cross-border dispute resolution procedures under the Arbitration Convention. As of September 2006, 16 Member States had allowed the suspension of tax collection during the dispute resolution procedure and other states were preparing revised texts granting this possibility.

Mutual agreement and arbitration procedures

The Convention provides for an additional level of protection to Member State businesses over and above anything available under the domestic laws of the states concerned or through the existing bilateral treaties. The protection available begins with the presentation of a case to the competent authority of the contracting state involved. This presentation must take place within three years of the first notification of the possible double taxation. The procedures require that all the relevant competent authorities are notified without delay and the process is then underway to resolve the problem, regardless of any statutory time limits prescribed by domestic laws.

If the competent authorities are unable to reach an agreement within two years of the case first being referred to them, they are obliged to establish an advisory commission to examine the issue. The Convention provides that existing national procedures for judicial proceedings can continue at the same time as the advisory committee meets, and that if there is any conflict between the procedures of the arbitration committee and the judicial procedures in any particular Member State, then the Convention procedures apply only after all the others have failed.

Serious penalty proceedings

There is no obligation on Member States to establish an arbitration commission to consider pricing disputes if “legal and administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of transfers of profits ... one of the enterprises concerned is liable to a serious penalty”. Where any proceedings are currently underway, which might give rise to serious penalties, the normal due date for the establishment of the arbitration committee is deferred until the other proceedings are settled.

The term ‘serious penalty’ is somewhat subjective and has different meanings from one country to another. However, the Member States have included, as part of the treaty, unilateral declarations on their view of the meaning of ‘serious penalty’ for these purposes.

The advisory commission

When an advisory commission is needed, it is established under the chairmanship of an individual possessing the qualifications required for the highest judicial offices of his/her country. The other members of the commission include a maximum of two individuals from each of the competent authorities involved and an even number of independent persons of standing, to be selected from a list of such people drawn up for the purpose by each contracting state. The task of the advisory commission is to determine, within six months, whether there has been a manipulation of profits,

and, if so, by how much. The commission makes its decisions by simple majority of its members, although the competent authorities concerned can agree together to set up the particular detailed rules of procedure for any one commission. The costs of the advisory commission procedure are to be divided equally between all the contracting states involved.

In reaching its decision, the advisory commission may use any information, evidence or documents received from the associated enterprises concerned in the transactions. The commission can also ask the competent authorities of the contracting states involved to provide it with anything else it requires, but there is no obligation on the contracting states to do anything that is at variance with domestic law or normal administrative practice. Furthermore, there is no obligation on them to supply information that would disclose any trade secret, etc. which might be contrary to public policy. There are full rights of representation for the associated enterprises involved to speak before the advisory commission.

Resolution of the problem

Once the advisory commission has reported, the competent authorities involved must take steps to eliminate the double taxation within six months. They retain the discretion to resolve matters as they see fit, but if they cannot agree on the necessary steps to be taken, they must abide by the decision of the advisory commission.

Term of the convention

The Convention came into force on 1 January 1995 for an initial period of five years. However, it was agreed in May 1998 that the Convention would be extended for at least a further five-year period. During this time Austria, Finland and Sweden joined the EU and became parties to the Convention. The original protocol for accession of new Member States required that all parties had to satisfy each accession, and consequently extensions to membership required lengthy procedures to ensure the continued life of the Convention. As a result of the work with the EU Joint Transfer Pricing Forum, it is anticipated that as new countries join the EU they will accede to the Arbitration Convention by a simpler process.

Interaction with non-member states

The Convention recognises that countries other than the Member States of the EU may be involved in transfer pricing disputes with EU businesses. The Convention simply notes that Member States may be under wider obligations than those listed in the Convention and that the Convention in no way restricts these obligations. There is no comment on the way in which third-country disputes might be resolved.

Experience of the Convention

While the Convention is already perceived by the EU members as being a major step forward in the development of worldwide tax policies designed to resolve pricing issues, there is little practical experience of its use (the first ever advisory commission set up under the Convention only met on 26 November 2002 to begin looking at a Franco-Italian matter). It is understood that there is now a backlog of more than 100 cases that might go to arbitration, following the resolution of the procedural problems faced by the Arbitration Convention. The EU Joint Transfer Pricing Forum will monitor the work to make sure matters are followed through on a timely basis.

Procedures for achieving an offsetting adjustment

Further EU developments in transfer pricing

Within Europe, the EU Commission struggled for many years to attain agreement on a common tax base for European businesses or common tax rates across the EU states. This is politically highly difficult to achieve and there remains little likelihood of substantial agreement in this area in the foreseeable future. However, the Commission convinced Member States that there was no political logic in favour of continuing the problems experienced by multinationals when they faced double taxation as a result of transfer pricing adjustments being made by tax authorities. The Arbitration Convention represents the statement that, from a purely pragmatic point of view, it must be reasonable to eliminate such double taxation of profits.

The European Commission would like to go much further. Instead of rectifying double taxation after it has occurred, the Commission would like to see a mechanism for preventing it in the first place. A number of Commission officials have stated their wish to see possible transfer pricing adjustments being discussed among the competent authorities before they are made, such that any offsetting adjustment could be processed at the same time as the originating adjustment. Some Commission officials want to go even further than this and create a regime for multilateral advance pricing agreements on pricing issues within the EU.

It is clear that the European authorities firmly support the use of the arm's-length principle in transfer pricing. They are on record, via the Convention, as stating that they do not approve of double taxation. Most of the Member State tax authorities have privately expressed the view that, however desirable, advance pricing agreements represent an unacceptably high administrative burden. Information on the use of the Convention within Europe has been lacking. However, this was remedied in October 2001 when a Commission working paper published a summary for 1995 to 1999. During this period, 127 intra-EU transfer pricing cases were referred to the Arbitration Convention or to a bilateral treaty mutual agreement procedure (it is interesting to note the total number of cases rises to 413 when non-EU country counterparties are brought in). The paper estimated that 85% of the cases had been satisfactorily resolved, removing double taxation in an average timescale of 20 months. In its recent communication in February 2007, the European Commission revealed that none of the 24 cases for which the taxpayer had made the request for mutual agreement procedure prior to January 2000 was sent to arbitration commission.

Recognising that considerable numbers of transfer pricing cases are never referred to competent authorities for resolution, the Commission identified transfer pricing as a major concern for cross-border business. To review the tax position on transfer pricing in the EU and to consider pragmatic ways in which the burden on business could be relieved, in early 2002 the Commission proposed the establishment of the EU Joint Transfer Pricing Forum. This was a radical step, in that membership would include both government personnel and representatives from business. In addition to the chairperson, the forum now includes 25 Member State representatives and 10 business representatives (the author is one of the 10) together with Commission membership and observers from the OECD and EU accession states.

The forum's work resulted in two formal reports. The first was published on 27 April 2004 and was adopted by the ECOFIN Council on 7 December 2004. The material is available on the Commission websites and contains detailed guidance on the operation of the Arbitration Convention, including practical matters relevant to time limits

and the mutual agreement procedures. The Council adopted the Code of Conduct recommend by the EU Joint Transfer Pricing Forum in full.

The second report of the EU Joint Transfer Pricing Forum was completed in mid-2005 and set out a proposal for documentation standards across all Member States. The Commission adopted the proposal on 10 November 2005. In June 2006, the Council of the European Union adopted a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union. This Code of Conduct standardises the documentation that multinationals must provide to tax authorities on their pricing of cross-border, intragroup transactions.

Considering the recent achievements within the EU and the need to ensure a monitoring of implementation of codes of conduct and guidelines and the examination of several issues, the EU Joint Transfer Pricing Forum has been renewed for a new mandate of two years. The Commission has endorsed the Joint Transfer Pricing Forum's suggestions and conclusion on advance pricing agreements and on this basis released guidelines for advance pricing agreements in the EU. Going forward, the Joint Transfer Pricing Forum will continue to examine penalties and interest related to transfer pricing adjustments and focus on the important area of dispute avoidance and resolution.

International updates in cross-border dispute resolution

Taking a cue from the EU Arbitration Convention, OECD countries have agreed to broaden the mechanisms available to taxpayers involved in cross-border disputes over taxation matters by introducing the possibility of arbitration if other methods to resolve disagreements fail. The background for this initiative goes back to February 2006, when the OECD released a public discussion draft entitled '*Proposals for improving mechanisms for resolution of tax treaty disputes*'. This public discussion draft essentially dealt with the addition of an arbitration process to solve disagreements arising in the course of a mutual agreement procedure and the development of a proposed online manual for an effective mutual agreement procedure.

The OECD received numerous comments on the public discussion draft and followed it up with a public consultation meeting in March 2006. As a result of these comments and meeting, the Committee of Fiscal Affairs of the OECD approved a proposal to add to the OECD Model Convention an arbitration process to deal with unresolved issues that prevent competent authorities from reaching a mutual agreement.

The proposed new paragraph to the Mutual Agreement Procedure Article of the OECD Model Convention (paragraph 5 of article 25) provides that in the event the competent authorities are not able to reach agreement in relation to a case presented to the competent authority for resolution within a period of two years from the presentation of the case, it may be submitted to arbitration at the request of the taxpayer. It is left to the discretion of the member countries as to whether the open items may be submitted for arbitration if a decision on these issues is already rendered under domestic law.

Issues of treaty interpretation would be decided by arbitrators in the light of principles incorporated in the Vienna Convention on the Law of Treaties, whereas the OECD Guidelines would apply in respect of transfer pricing matters.

Procedures for achieving an offsetting adjustment

Finally, the OECD has recently developed a Manual on Effective Mutual Agreement Procedure explaining the various stages of the mutual agreement procedure, discussing various issues related to that procedure and, where appropriate, bringing out certain best practices.

Part 2: Country-specific issues

11.

Africa Regional

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Introduction

Transfer pricing continues to be a major concern for fiscal authorities around the world, and Africa is no exception. Revenue authorities in African countries are sceptical of the tax compliance levels of multinationals operating in the African continent and more often than not tend to view inter-company pricing policies as profit-extraction techniques. In some African countries, the revenue authorities have requested assistance from more developed tax authorities with transfer pricing training and development of their own staff. Transfer pricing is one of the hot topics in the African tax arena and many tax authorities focus on it as a mechanism to protect and increase their tax base.

Southern Africa

In Southern Africa, South Africa continues to be the most active country in legislating on transfer pricing matters. Section 31(2) of the South African Income Tax Act (SA Income Tax Act) requires connected parties to deal at least at arm's length in respect of cross-border transactions. A detailed Practice Note 7 (PN7) provides guidelines on how companies should conduct their cross-border related party dealings. It also sets out the Commissioner's views on documentation and other practical issues. Amendments to the transfer pricing legislation were made in 2010 and 2011. The revised legislation applies to years of assessment commencing on or after 1 April 2012. The South African Revenue Service (SARS) is currently in the process of preparing an Interpretation Note (IN) to replace PN7 and Practice Note 2 (PN2) (which deals with thin capitalisation) which will provide guidance on the practical application of the new legislation. However, the timing of the release of the new IN is currently not known.

In terms of the new transfer pricing legislation, companies that do not self-assess their transfer pricing policies in order to comply with section 31(2), face an adjustment to their taxable income which is subject to corporate income tax at 28%. In addition to the primary adjustment, there is also a secondary adjustment whereby the adjusted amount is regarded as a deemed loan on which interest at a market related rate is deemed to accrue and be taxable in the hands of the taxpayer.

In Botswana, the Revenue Authority is applying general anti-avoidance provisions to attack cross-border transactions between connected parties. We are aware of a number of ongoing audits and assessments issued by the Botswana Revenue Authority.

In Lesotho, section 113 of the Income Tax Order of 1993, titled 'Transfer Pricing', provides the Commissioner with wide discretionary powers to re-characterise transactions between associates for Lesotho tax purposes. In practice, this section has, to date, rarely been used by the Lesotho Tax Authority. However, recently, the Lesotho

Africa Regional

Tax Authority has started to focus more on transfer pricing and accordingly, cross-border transactions may therefore be challenged in the future.

Malawi introduced transfer pricing regulations in July 2009. The regulations set out guidelines to determine the arm's-length prices of goods and services and provide guidance on the type of records and documentation that taxpayers should submit to the Malawi Revenue Authority (MRA) upon request.

Mozambique has a basic transfer pricing regime that only provides general guidance on transfer pricing. This guidance does not address any further regulations or provisions regarding transfer pricing implementation or methods.

Transfer pricing legislation was introduced in Namibia in May 2005 and a Practice Note on its application was issued in September 2006. While Namibia's Directorate of Inland Revenue is not yet fully geared to conduct full-scope transfer pricing compliance investigations, it has indicated that it will work closely with SARS and, if necessary, will request task teams from SARS to assist in carrying out transfer pricing audits.

In Swaziland, transfer pricing does not appear as yet to be a prominent issue.

In Zambia, transfer pricing legislation exists in Sections 97A to 97D of the Zambian Income Tax Act, which introduces the arm's-length principle. The Income Tax (Transfer Pricing) Regulations 2000 also provide further definitions regarding the extent of application of the transfer pricing provisions. In March 2005, a draft Practice Note was issued by the Zambia Revenue Authority (ZRA), which provides detail on how the ZRA applies the transfer pricing rules. The enforcement of the legislation by the ZRA has, however, not been as aggressive as expected. However, it would be difficult to mount a defence of 'non-existence of transfer pricing legislation' when the ZRA begins to police the legislation actively.

Zimbabwe, at present, does not have specific transfer pricing legislation. The 'old-style' legislation has not been tested to any great extent. It has been announced that the introduction of transfer pricing legislation (based on South African law) is being considered and we understand that a revised draft Act has been prepared. However, it is not certain when the law will come into force as the revised draft Act has not been distributed to interested parties for comment (to date). When implemented, it is anticipated that Zimbabwe will follow the Organisation for Economic Co-operation and Development (OECD) rules on transfer pricing.

East Africa

In East Africa, the Kenya Revenue Authority (KRA) has engaged two Kenyan multinationals in the High Court in transfer pricing litigation. In July 2006, transfer pricing rules were introduced in Kenya, providing guidance on the application of the arm's-length principle.

Although Tanzania has not issued detailed transfer pricing regulations, the main part of the tax legislation (section 33 of Tanzania Income Tax Act) contains specific transfer pricing provisions and, in the past, the Tanzania Revenue Authority (TRA) has raised transfer pricing audit queries, including requests for transfer pricing documentation in respect of multinationals operating in Tanzania.

In Uganda, transfer pricing regulations were introduced in July 2011. The Uganda Revenue Authority (URA) has also published a Practice Note in May 2012 which sets out the documentation requirements to be met by all multinational enterprises in respect of their related party transactions. The URA considers transfer pricing a major area of tax leakage and, as a result, it has generally become more vigilant in respect of transfer pricing issues. It has also been strengthening its transfer pricing compliance enforcement efforts following the new transfer pricing regulations. Further, the URA has embarked on routine transfer pricing audits with one of them culminating into litigation. The URA is part of the Africa Tax Administrators Forum (ATAF), which has identified transfer pricing as one of its key issues of focus for the Region.

West Africa

Ghana has transfer pricing regulations that require transactions between associated parties to be conducted at arm's length and empowers the Commissioner-General of the Ghana Revenue Authority (GRA) to distribute, apportion or allocate inclusions in income, deductions, credits or personal reliefs between the associated persons as is necessary to reflect the chargeable income or tax payable which would have arisen if the transaction had been conducted at arm's length. However, no detailed guidance has historically been provided by the GRA on how the arm's-length basis should be determined.

In Nigeria, transfer pricing rules have been gazetted with a commencement date of 2 August 2012 and are effective for basis periods beginning after the commencement date. Whilst the requirement to apply the arm's-length principle has always existed in Nigerian legislation, what has been lacking is guidance on how to apply it. The new regulations suggest that the introduction of transfer pricing rules will see the Federal Inland Revenue Service adopt a more principle based approach to evaluating the application of the arm's-length principle by taxpayers.

Sub-Saharan Francophone Africa

Sub-Saharan Francophone Africa covers nine countries, namely Cameroon, Ivory Coast, Chad, Gabon, Senegal, Congo, Madagascar, Equatorial Guinea, and Guinea Conakry. Four of these countries (Cameroon, Ivory Coast, Chad, and Gabon) have internal legal regulations which require the application of the arm's-length principle in their tax legislation, and the other countries are either in the process of formulating country specific legislation, or rely on international principles of transfer pricing.

A number of African jurisdictions are currently implementing specific transfer pricing regulations. These are discussed in more detail below.

Ghana

Introduction

In Ghana, the Internal Revenue Act, 2000 (ACT 592) as amended and its associated regulations (the Ghana Internal Revenue Act) have provisions that require transactions between associated parties to be conducted at arm's length. The Ghana Internal Revenue Act also empowers the Commissioner-General of the Ghana Revenue Authority (GRA) to distribute, apportion or allocate inclusions in income, deductions, credits or personal reliefs between the associated persons as is necessary to reflect the chargeable income or tax payable which would have arisen if the transaction had been conducted at arm's length. However, no detailed guidance has historically been

Africa Regional

provided by the Ghana Internal Revenue Act or the GRA on how the arm's-length basis should be determined.

Anticipated development in transfer pricing

On 31 July 2012, the Transfer Pricing Regulations, 2012(L.I.2188) were gazetted and laid before the Parliament of Ghana. The Parliament of Ghana approved the L.I 2188 in September 2012.

L.I. 2188 deals with the application of the arm's-length principle in transactions between connected persons and also information, documentation and penalties. L.I. 2188 also gives greater clarity on the application of the arm's-length principle contained in the Ghana Internal Revenue Act. The L.I. 2188 also appears to give considerable discretionary powers to the Commissioner-General of the GRA in the assessment of transactions subject to transfer pricing adjustments.

Transactions covered by transfer pricing regulations

The Transfer Pricing Regulations apply to transactions between parties in a controlled relationship both locally and internationally. Specifically, these are:

- A transaction between persons who are in a controlled relationship.
- Dealings between a Permanent Establishment (PE) – a separate legal entity – and its head office.
- Dealings between a PE and other related branches of that PE.
- A transaction between a taxpayer and another taxpayer who are in a controlled relationship.
- A transaction between a tax payer and another taxpayer who are in an employment relationship. This means that interest free loans or highly subsidised loans and benefits given to an employee by an employer at non-market interest rate will become subject to transfer pricing adjustments.

A transaction referred to in the above paragraphs include:

- The purchase and sale of goods.
- The purchase, sale, lease or use of tangible and intangible assets.
- Provision of management, technical and other intra-group services.
- Provision of finance and other financial arrangements.
- Rent and hire charges.
- Any other transaction that may affect the profit and loss of the entity.

Permissible transfer pricing methods

The Transfer Pricing Regulations provide the following widely used transfer pricing methods as approved methods to be used to determine the price of transactions between parties in a controlled relationship:

- The comparable uncontrolled method.
- The resale price method.
- The cost-plus method.
- The transactional profit split method.
- The transactional net margin method.

In choosing an appropriate transfer pricing method, a person should defer to one of the methods listed above as prescribed by LI 2188.

Nonetheless, an application can be made to the Commissioner-General by a person who intends to enter into a transaction whose arm's-length price cannot be determined by the methods specified above. In making the application, the person is required to prove that none of the existing methods can be reasonably applied and also the proposed method will result in a price that will be considered to be arm's length.

Also, the Commissioner-General is mandated to use a method other than the methods provided for under the regulations. A transaction can be deemed to be at arm's length if the evaluation method used yields a range of indicators which are of equal reliability within which the relevant indicator of the transaction falls.

Filing details of transactions

Persons who engage in transactions with controlled parties are required to maintain documentation of the transaction for that period. In addition to this, the person is required to file returns on income in accordance with section 72 of the Ghana Internal Revenue Act.

The following information is required to be furnished by the person who engages in transactions with a controlled party:

- The arm's-length range as determined by the person under examination and the rationale for the use of that range.
- Details of transactions between the person and other associated persons.
- Information on the principal activities of each person in the group and the business relationships existing among the associated persons.
- The consolidated financial statements of the group.
- Information on each associated party including business related information and functions, risks and assets employed by that associated person.
- What the Commissioner-General considers relevant.

The Commissioner-General may make a request for information and the taxpayer is required to comply with the request within the required time frame. Upon the request, a person shall provide contemporaneous documentation regarding the transactions under scrutiny.

Transfer pricing audit

On receipt of the returns filed, the Commissioner-General may examine the amount charged or credited to the final accounts in respect of a transaction to determine whether the amount is within the arm's-length range.

The Commissioner-General may adjust the taxable profit of a person if he is satisfied after the examination that the amount charged or credited to the final accounts of that person is not within the arm's-length range. In his examination, the Commissioner-General may select a transfer pricing method that he considers appropriate.

Penalties

A tax due and payable resulting from an adjustment by the Commissioner-General is deemed to be an additional tax. The penalties due on offences under the Act on fraud, failure to file returns and underpayment of tax are also applicable under LI 2188.

Africa Regional

Burden of proof

In Ghana, the burden of proof is on the taxpayer to demonstrate that the controlled transactions have been conducted in accordance with the arm's-length standard.

Resources available to the tax authorities

A specialist transfer pricing unit is expected to be set up within the GRA to handle transfer pricing issues.

Risk transactions or industries

In general, all multinationals are at risk of transfer pricing investigations.

Advance pricing agreements

The Transfer Pricing Regulations are silent on whether the GRA would enter into advance pricing agreements with taxpayers.

Thin capitalisation

Issues of thin capitalisation are covered by Section 71 of the Ghana Internal Revenue Act.

Thin capitalisation rules apply to borrowings between exempt controlled resident entities¹ (excluding financial institutions) and their exempt controllers.

Under the thin capitalisation rules, interest and realised foreign exchange losses related to borrowings from exempt controllers will not be fully deductible where the ratio of exempt debt to exempt equity exceeds 2:1. The amount of interest and foreign exchange differences that will be disallowed will be those that are attributable to borrowings in excess of the above ratio.

Kenya

Introduction

Kenya has always had a general provision within its tax legislation requiring transactions between non-resident and resident-related parties to be conducted at arm's length. However, until 2006, no guidance had been provided by the revenue authorities on how the arm's-length standard was to be met. This failure to provide guidance led to protracted disputes between taxpayers and the Kenya Revenue Authority (KRA), culminating in a landmark case involving the Commissioner of Income Tax and Unilever Kenya Limited (the Unilever case). The judgment of the High Court in the Unilever case led to the introduction of transfer pricing rules in July 2006, which provide guidance on the application of the arm's-length principle.

Statutory rules

Section 18 (3) of the Kenyan Income Tax Act, Chapter 470 of the Laws of Kenya requires business carried on between a non-resident and a related Kenya resident to be conducted at arm's length and gives the commissioner the power to adjust the profits of the Kenya resident from that business to the profits that would be expected to have accrued to it had the business been conducted between independent persons

¹ Exempt-controlled resident entity means a resident entity in which 50% or more of the underlying ownership or control of the entity is held by an exempt person, in this section referred to as the exempt controller, either alone or together with an associate or associates.

dealing at arm's length. The Kenyan Income Tax (Transfer Pricing) Rules, 2006, Legal Notice No. 67 of 2006 (transfer pricing rules) published under section 18 (8) of the Kenyan Income Tax Act with an effective date of 1 July 2006, provide guidance on the determination of arm's-length prices.

Under section 18 (3) of the Kenyan Income Tax Act and the transfer pricing rules, persons or enterprises are related if either of them participates directly or indirectly in the management, control or capital of the other or if a third person participates directly or indirectly in the management, control or capital of both. Control is not specifically defined in this section, but is elsewhere defined in the Kenyan Income Tax Act to mean the holding of shares with voting power of 25% or more. In practise this definition has been adopted for transfer pricing purposes. The definition of related parties has been expanded to include relationships with natural persons, and the section has been amended to ensure that it is not interpreted only in an anti-avoidance context. Prior to the amendment, there may have been an (untested) legal interpretation that the KRA could make transfer pricing adjustments only if it could prove a tax avoidance motive. The transfer pricing rules state that they apply to transactions between branches and their head office or other related branches. Doubts as to the legitimacy of this provision have arisen in light of the restrictive application of section 18 (3) to 'resident persons', which excludes branches. Notwithstanding, the widely held view is that it is prudent for branches to apply the transfer pricing rules in their dealings with their head offices and other branches for two reasons. Firstly, the intention that, at the local level and at the international level in the OECD, the arm's-length principle should be extended to branches is clear. Secondly, the arm's-length principle is an implicit requirement in other sections of the Kenyan Income Tax Act, for instance with respect to the requirement for reasonableness of allocation of head-office costs incurred by branches.

Transactions subject to adjustment include: the sale or purchase of goods; sale, transfer, purchase, lease or use of tangible and intangible assets; provision of services; lending or borrowing of money; and any other transactions that affect the profit or loss of the enterprise involved.

The transfer pricing rules do not make it an express statutory requirement for taxpayers to complete supporting transfer pricing documentation. However, Rule 9 (1) gives the Commissioner permission to request information, including documents relating to the transactions where the transfer pricing issues arise and a non-comprehensive list of the documents that the Commissioner may request is provided in Rule 9 (2). Rule 10 similarly requires a taxpayer who asserts the application of arm's-length pricing to provide supporting documentation evidencing the taxpayer's analysis upon request by the Commissioner. The KRA has interpreted these provisions to mean that a taxpayer is required to have documentation in place in readiness for any such request from the Commissioner.

The documents which the Commissioner may request are required to be prepared in or to be translated into English and include documents relating to:

- The selection of the transfer pricing method and the reasons for the selection.
- The application of the method, including the calculations made and price adjustment factors considered.
- The global organisation structure of the enterprise.
- The details of the transactions under consideration.
- The assumptions, strategies and policies applied in selecting the method.

Africa Regional

- Such other background information as may be necessary regarding the transaction.

In providing guidance on the nature of documentation required, Rule 9 (2) does not include any hard and fast rules for compiling documentation or the process that taxpayers should follow.

The rules specify that the five primary methods specified in the OECD Guidelines may be used to determine the arm's-length nature of the pricing for goods and services in transactions between related parties. In circumstances where one of the five methods cannot be used, another method approved by the Commissioner of the KRA can be applied.

No special penalties apply in respect of additional tax arising from a transfer pricing adjustment. However, the general penalty applies – currently 20% of the principal tax and late payment interest of 2% per month.

The KRA has seven years from the year in which the income in question was earned in which to make an assessment. For years in which fraud, intentional negligence or gross negligence on the part of the taxpayer is suspected, there is no time limit in which the KRA must make an assessment in respect of transfer pricing.

Controlled foreign companies

The concept of controlled foreign companies is not a feature of Kenyan tax law, and Kenya does not have any rules that would deem a foreign company controlled by Kenya residents to be resident for transfer pricing purposes. However, where an entity is managed and controlled in Kenya, it will be considered to be resident in Kenya and transactions between the entity and another non-resident entity will be captured under the transfer pricing rules.

Other regulations

For financial years ending on or after 31 December 1999, companies are required to disclose all transactions with related parties under IAS 24. The wide definition of 'related parties' in IAS 24 ensures that financial statements prepared in accordance with IFRS will provide the KRA with information concerning related party transactions, and this will likely be the starting point for KRA enquiries into transfer pricing.

In 2010, the KRA introduced a schedule to the annual tax return requiring taxpayers to declare whether they have any related party transactions, their quantum and whether they have prepared transfer pricing documentation. The schedule applies to 31 December 2010 year ends onwards, but appears only when a taxpayer completes its return online.

Legal cases

Of the two transfer pricing cases instituted before the courts in Kenya, the Unilever case is the only one on which a judgment was delivered. In this case, the High Court of Kenya endorsed the use of OECD Guidelines in the absence of detailed guidance from the KRA. The government's response to this judgment was the introduction of the transfer pricing rules, which are largely based on the OECD Guidelines. There have been no court cases since the introduction of the transfer pricing rules.

Burden of proof

In Kenya, the burden of proof is on the taxpayer to demonstrate that the controlled transactions have been conducted in accordance with the arm's-length standard.

Tax audit procedures

Beyond the requirement to produce documentation in support of the application of the arm's-length principle, the transfer pricing rules do not contain any guidance to taxpayers as to what they may expect in connection with a transfer pricing investigation.

The KRA regards transfer pricing as a potentially major revenue earner and it takes a rigorous approach to audits. The KRA regularly requests transfer pricing documentation from taxpayers with cross-border-related-party transactions with the intention of risk profiling them for the purpose of conducting transfer pricing audits. All multinationals are potential targets for a transfer pricing audit, and those multinationals with transactions which fall within the provisions of section 18 (3) and the transfer pricing rules should develop and maintain properly documented and defensible transfer pricing policies. The present recommendation is that documentation should, where possible, be contemporaneous and regularly updated. Until KRA practice in this respect is clearly established, taxpayers are advised to regularly update their transfer pricing documents, especially where there are changes in the operations.

Resources available to the tax authorities

A specialist transfer pricing unit has been established within the Domestic Taxes Department of the KRA and it is responsible for conducting transfer pricing audits. Investment has been made in developing specialist expertise within the KRA through training locally and abroad. Additionally, the KRA is a member of the African Tax Administrators Forum, a technical body supported by the OECD.

Use and availability of comparable information

Use

The transfer pricing rules, which are based on the OECD Guidelines, are the basis for determining an acceptable transfer pricing methodology. Within the context of these rules and guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

Availability

Information on the performance of listed public companies in Kenya is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available. Although the KRA has in the past confirmed that, under certain circumstances, it would accept the use of financial databases used elsewhere in the world, and specifically Amadeus/Orbis, the KRA has recently advocated for the use of local comparables or for applying geographic adjustments to overseas comparables.

Risk transactions or industries

In general all multinationals are at risk of transfer pricing investigations.

Africa Regional

Competent authority

Little information is available on the process for competent authority claims. Experience suggests that the competent authority process has not been widely used in Kenya. The lack of experience and the limited number of double tax agreements means that competent authority claims or reliance on MAP to resolve disputes will be problematic.

Advance pricing agreements

Kenya has no procedures in place by which a taxpayer might achieve an advance pricing agreement to its transfer pricing policy. In general terms, the KRA is reluctant to give binding rulings regarding practices or policies adopted by a particular taxpayer or group of taxpayers. This same reluctance is to be expected in connection with agreements or rulings on transfer pricing matters.

Anticipated developments in law and practice

The KRA intends to introduce Practice Notes to assist taxpayers in their review of their transfer pricing policies.

Liaison with other authorities

Although customs and income tax are under the same authoritative body, they are administered by distinct and separate departments within the KRA, and there is very little sharing of information between the two departments. However, KRA is on a general drive to improve its systems, and better cooperation between the various authorities is expected in the near future.

OECD issues

Kenya is not a member of the OECD, but does follow the OECD Guidelines and models.

Joint investigations

The KRA has not teamed with any other tax authorities for the purposes of undertaking a joint investigation into transfer pricing. However, the KRA is part of the African Tax Administrators Forum, a body that is partly responsible for enhancing the technical expertise of African tax authorities.

The amendment of the Kenyan Income Tax Act in 2011 which allows the Minister for Finance to enter into an arrangement with the government of other countries with a view to conclude Tax Information Exchange Agreements will allow the KRA to exchange information with other tax jurisdictions and enhance the audit of multinational companies. This provides a scope for exchange of information during a joint investigation by the KRA and revenue authorities in other tax jurisdictions.

Thin capitalisation

The relevant sections of the Kenyan Income Tax Act which deal with thin capitalisation are sections 4A (a), 16(2)(j) and 16(3).

Thin capitalisation rules apply where financial assistance is granted to a resident company by a related non-resident company, which alone or together with no more than four other persons, controls the resident company, and the loan exceeds the greater of:

- three times the sum of the revenue reserves and the issued and paid-up capital of all classes of shares of the company, or
- the sum of all loans acquired by the company prior to 16 June 1988, and still outstanding at the time of determining the thin capitalisation status of a company.

An interest payment on that part of the loan that exceeds the permissible ratio of 3:1 is not deductible for tax purposes. In 2010, the Kenyan Income Tax Act was amended to provide for deemed interest on non-interest-bearing loans from non-resident related parties. The deemed interest is calculated at the average 91-day Treasury Bill rate and is not deductible.

Thin capitalisation rules are typically designed to prevent erosion of the tax base through excessive interest deductions in the hands of companies that obtain financial assistance from non-resident affiliates.

Interest free loans

Where a related non-resident entity provides an interest free loan to a resident Kenyan company, the KRA may deem a market related interest rate on such a loan. This can be particularly punitive in relation to thinly capitalised companies.

Namibia, Republic of

Introduction

Namibia introduced transfer pricing legislation on 14 May 2005 in the form of section 95A to the Namibian Income Tax Act. The legislation is aimed at enforcing the arm's-length principle in cross-border transactions carried out between connected persons. During September 2006, the Namibian Receiver of Revenue issued Practice Note 2 of 2006 (PN 2/2006) containing guidance on the application of the transfer pricing legislation.

Statutory rules

Section 95A of the Namibian Income Tax Act is aimed at ensuring that cross-border transactions by companies operating in a multinational group are fairly priced and that profits are not stripped out of Namibia to lower-tax jurisdictions. Section 95A achieves this objective by giving the Minister of Finance (by delegation to the Receiver of Revenue) the power to adjust any non-market-related prices charged or paid by Namibian entities in cross-border transactions with related parties to arm's-length prices, and to tax the Namibian entity as if the transactions had been carried out at market-related prices.

While section 95A requires that international transactions between connected persons must be fairly priced, the section is silent on the mechanisms that may be used for the determination of arm's-length prices. Further, it does not provide a definition of 'connected persons', nor does it prescribe any acceptable thin capitalisation ratios. The former two matters were addressed in PN 2/2006, but no guidance in respect of acceptable debt-to-equity ratios has been provided by the Receiver to date.

In terms of the normal penalty provisions of the Namibian Income Tax Act, penalties of up to 200% can be levied on any amount of tax underpaid. Consequently, the Receiver may invoke such provisions in the event where a taxpayer's taxable income is

Africa Regional

understated as a result of the prices charged in affected transactions being non-arm's length. Further, interest is charged on the unpaid amounts at 20% per annum.

Controlled foreign companies

Namibia does not currently have controlled foreign companies legislation.

Other regulations: Practice Note 2 of 2006

The objective of PN 2/2006, issued in September 2006, is to provide taxpayers with guidelines on how to determine arm's-length prices in the Namibian business environment. It also sets out the Minister's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.

PN 2/2006 includes definitions for the following terms, which were not initially defined in section 95A of the Namibian Income Tax Act:

- Advance pricing arrangement.
- Connected person.
- Controlled transaction.
- Uncontrolled transaction.
- Multinational.
- OECD Guidelines.
- Transfer prices.

PN 2/2006 is based on and acknowledges the principles of the OECD Guidelines. Nothing in it is intended to contradict the OECD Guidelines, and in cases where there is conflict, the provisions of the OECD Guidelines prevail in resolving any dispute. Amendments made to the OECD Guidelines are deemed to be incorporated into PN 2/2006.

A 'connected person' is defined in relation to a company as follows:

- Its holding company.
- Its subsidiary.
- Any other company where both such companies are subsidiaries of the same holding company.
- Any person who, individually or jointly with any connected person in relation to such person, holds (directly or indirectly) at least 20% of the company's equity share capital or voting rights.
- Any other company if at least 20% of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company. This will be the case where companies B and C each hold 50% of the equity share capital of company A; both companies, B and C, will be connected persons in relation to company A.
- Any other company, if such other company is managed or controlled by:
 - any person (A) who or which is a connected person in relation to such company, or
 - any person who or which is a connected person in relation to A.

Although it is accepted that Section 95A, by definition, can apply only between separate legal entities, PN 2/2006 also applies to transactions between a person's head

office with the branch of such person or a person's branch with another branch of such person.

PN 2/2006 indicates that a taxpayer is required to be in possession of transfer pricing documentation. If the Minister, as a result of an examination, substitutes an alternative amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Minister or in the courts.

PN 2/2006 expressly states that a taxpayer must demonstrate that it has developed a sound transfer pricing policy, under which transfer prices are determined in accordance with the arm's-length principle, and must document the policies and procedures for determining those prices.

Currently, no statutory rule requires that the transfer pricing policy be submitted to the Receiver as part of the annual income tax return. Taxpayers are, consequently, required to prepare and maintain a transfer pricing policy and present it in support of the prices adopted under international transactions in the event that the Receiver conducts a transfer pricing audit. However, PN 2/2006 states that in the event that the taxpayer cannot present a transfer pricing policy, it will be very difficult for the taxpayer to successfully object against any transfer pricing adjustments and corresponding assessments issued by the Receiver.

Legal cases

No court cases have judged on this issue as yet.

Burden of proof

The burden of proof is on the taxpayer. However, in accordance with PN 2/2006, the taxpayer can be assured that the Receiver will not misuse the burden of proof through groundless or unverifiable assertions about transfer pricing.

Tax audit procedures and resources available to the tax authorities

The Ministry of Finance is aware that transfer pricing cases can present special challenges to usual audit or examination practices. Transfer pricing cases are fact sensitive and may involve difficult evaluations of comparability, markets, and financial or other industry information. The Ministry of Finance is still in the process of setting up a special unit to specifically deal with transfer pricing. The OECD and the SARS provide technical assistance to the Ministry of Finance.

Use and availability of comparable information

Use

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Therefore, any information gained on the performance of similar companies should be acceptable in defending a transfer pricing policy.

Availability

Information on the performance of public companies in Namibia is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not

Africa Regional

available publicly. Consequently, a search for comparables in Namibia is more often than not a futile exercise.

SARS uses the Orbis database (previously Amadeus database) to conduct comparable studies relying largely on European companies for comparability. It is envisaged that the Receiver will also follow this approach.

Risk transactions or industries

Apart from the primary sector, Namibia's economy is largely import driven, and major competitors in the Namibian private sector economy are subsidiaries of multinational companies. These often have limited capacity in terms of financial administration, product development and administration and strategic management, and, consequently, import these services from head offices or shared service centres situated elsewhere in the world. The remuneration for these imported services is often reflected as 'management fees' in the financial statements of the Namibian subsidiary.

It is envisaged that the Receiver will focus investigations on management fees when the transfer pricing unit is operative. It is imperative that taxpayers prepare and maintain sufficient contemporaneous documentation in order to be able to justify the arm's-length nature of these fees.

Advance pricing agreements

The Directorate of Inland Revenue has indicated in PN 2/2006 that, due to various factors, an advanced pricing agreement process will not be made available to Namibian taxpayers in the foreseeable future.

Anticipated developments in law and practice

Law

Because Namibia only introduced transfer pricing legislation relatively recently, further laws or amendments are not expected to be made in the near future. It is however important to note that, in terms of PN 2/2006, Namibia fully adopts the principles promulgated in the OECD Guidelines and that these take precedence over PN 2/2006. As a consequence, any changes to the OECD Guidelines are relevant to and are adopted in Namibia as part of PN 2/2006.

Practice

The Receiver is likely to establish its own transfer pricing unit and commence with transfer pricing audits.

Liaison with other authorities

The Receiver is likely to work closely with SARS and the OECD. It is also envisaged that SARS will assist the Namibian Revenue authorities in the performance of transfer pricing audits, especially in situations where the audited multinational entity has affiliates or establishments in both countries.

OECD issues

Namibia is not a member of the OECD, but enjoys observer status and does follow the OECD Guidelines and models.

Joint investigations

It is possible for the Receiver to join with the authorities of South Africa or any other country to jointly investigate a multinational group.

Thin capitalisation

Section 95A deals with thin capitalisation and provides that the Minister may, if any amount of financial assistance provided by a foreign connected person is excessive in relation to a company's fixed capital, disallow the deduction for income-tax purposes of any interest or other charges payable by the Namibian person on the excessive portion of the financial assistance provided by the foreign lender. No guidance is provided by section 95A or PN2/2006 as to what 'excessive' means. Therefore, each case should be considered by means of an arm's-length analysis of its facts.

Nigeria

Introduction

The Federal Inland Revenue Service (FIRS) released a draft version of the Nigeria transfer pricing regulations in July 2012. The Nigerian transfer pricing rules have subsequently been gazetted with a commencement date of 2 August 2012. It is effective for basis periods beginning after the commencement date. Whilst the requirement to apply the arm's-length principle has always existed in Nigerian legislation, what has been lacking is guidance on how to apply it.

Traditionally, the FIRS have not followed any defined principles in reviewing the arm's-length nature of related party transactions. For some categories of transactions, it has relied on the statutory approvals given by other regulatory authorities (e.g. National Office for Technology Acquisition and Promotion (NOTAP)). For other transactions, the FIRS' approach has been arbitrary.

The draft transfer pricing regulations suggest that the introduction of transfer pricing rules will see the FIRS adopt a more principle based approach to evaluating the application of the arm's-length principle by taxpayers.

Statutory rules

There are several sections within the Nigerian tax statutes which give taxpayers the obligation to ensure that related party transactions are conducted at arm's length. These include:

- Section 17 of the Personal Income Tax Act, 2004.
- Section 22 of the Companies Income Tax Act, 2004 (as amended by the Companies Income Tax (Amendment) Act 2007).
- Section 15 of the Petroleum Profits Tax Act, 2004.

The transfer pricing regulations provide guidance on the application of the arm's-length requirement of the above statutes. The requirements apply to both local and cross-border related party transactions.

Under the transfer pricing regulations, affected taxpayers will be required to put transfer pricing documentation in place to support the arm's-length nature of their related party transactions. Although there is a requirement to have this documentation in place at the time of filing the annual tax returns, there is no requirement to

Africa Regional

submit the documentation except if a request is made by the tax authorities. The documentation must however be provided within 21 days of such a request. There are also annual declarations on related party transactions which are to be made at the time of filing the annual tax returns.

There are no materiality thresholds for documentation. The regulations however include safe harbour provisions whereby a taxpayer could be exempt from the documentation requirements by the FIRS. This would apply where the controlled transactions are priced in line with the requirement of Nigerian statutory provisions (i.e. government regulated pricing) or where the prices of connected transactions have been approved by Government regulatory authorities and the FIRS is satisfied that they are at arm's length.

In addition, even though the regulations do not specifically state the type of information to be included in transfer pricing documentation, there are provisions which suggest that the OECD's recommended documentation approach will be an acceptable standard.

There are no specific penalties for not having documentation. Penalties and interest will however apply to transfer pricing adjustments.

Controlled foreign companies

The concept of controlled foreign companies does not exist under the Nigerian tax law and Nigeria does not have any rules that would deem a foreign company controlled by Nigerian residents to be resident for transfer pricing purposes.

Other regulations

NOTAP was set up to facilitate the transfer of technology by foreign enterprises to Nigerian enterprises. As part of its mandate, NOTAP has the power to approve all contracts involving the transfer of technology between a non resident company and a Nigerian company. These include contracts involving the use of intellectual property, the provision of management and technical services, secondments etc. Without NOTAP approval, the Nigerian beneficiary of the intellectual property or service will not be able to source the foreign exchange (from the Nigerian banking system) required to pay its non resident service providers.

At present, the NOTAP approval process does not involve any detailed or systematic arm's-length analysis. Currently, the FIRS uses the NOTAP approval as a basis for granting tax deductions for the relevant expense in many cases. The regulations suggest that the FIRS will consider granting deductions based on these approvals, it is likely that the FIRS will reduce its reliance on NOTAP approvals in favour of a more detailed analysis of the arm's-length nature of the relevant transactions using the OECD standards.

Given the potential for conflicts between the approved amount based on NOTAP's review and the arm's-length amount based on a transfer pricing analysis, it is pertinent that taxpayers proactively engage both regulatory authorities to reach a consensus on an appropriate methodology for pricing their transactions.

Legal cases

There are no specific court cases as yet on transfer pricing in Nigeria.

Burden of proof

The burden of proof that the conditions of the controlled transactions are consistent with the arm's-length principle is that of the taxable person. The regulations provide that this burden of proof will be satisfied if the taxpayer provides transfer pricing documentation which is consistent with the requirements of the regulations.

Tax audit procedures

There has been no transfer pricing specific tax audits in Nigeria. Transfer pricing type queries have so far been included as part of the general tax queries. Given the current focus on transfer pricing however, it is possible that the FIRS will soon commence transfer pricing specific audits.

It is expected that the current methodology employed for general tax audits will be largely maintained for transfer pricing specific audits. However it is expected that the FIRS will adopt a risk based approach using the information submitted by taxpayers on the annual transfer pricing declaration forms as a basis for identifying audit targets.

Tax audit reviews by the FIRS usually take the form of a desk examination or field audit. The desk examination is not typically an intensive exercise since the queries are usually limited to observations made by the FIRS on the submitted tax returns.

The field audit process (which is an intensive audit exercise) involves field visits by the FIRS to the taxpayer. Although the actual field exercise usually lasts between two to four weeks, the resolution of audit matters could take months or years.

A taxpayer who is unable to reach an agreement with the FIRS on any matter is allowed to make an appeal to the tax appeal tribunal. Where the tribunal's ruling is still not satisfactory to the taxpayer, the taxpayer has recourse to the courts.

Resources available to the tax authorities

Over the last two years, the FIRS have been involved in several capacity building initiatives. It has set up specialist transfer pricing units in its Large Taxpayer Offices. The transfer pricing team has been involved in several training seminars and workshops including those with ATAF, private transfer pricing consultants from within and outside Africa, and tax administrators from advanced tax jurisdictions. We understand that the FIRS is currently receiving support from development agencies who have expressed interest in helping tax administrators from developing countries improve their revenue generating capabilities.

Based on current initiatives, it is likely that ATAF and other interest groups such as development agencies will play a key role in ensuring that African tax administrators have the right resources to effectively enforce transfer pricing regulations.

In addition, it is possible that the FIRS will consider secondments from tax authorities with developed transfer pricing administration skills as well as the use of independent contractors in bridging their capacity gaps.

Africa Regional

Use and availability of comparable information

Use

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Within the context of these guidelines, information obtained in respect of similar transactions with or between unrelated parties would be acceptable in defending a transfer pricing policy.

Availability

Information on the performance of public listed companies in Nigeria is widely available in the form of published interim and annual financial statements. The use of this information for transfer pricing analysis is however limited since most of these companies are members of multinational groups with significant related party dealings. In addition, the numbers are too few to constitute a usable sample. Financial information for private companies is generally not available. This makes the search for comparables in Nigeria difficult.

Similar to the practice in other African countries, it is expected that the FIRS will accept the use of European comparables as a matter of expediency. It is however important to note that there are currently ongoing debates (in Africa) about what adjustments are required to be made to European comparables in order for the results to be more reflective of the African economic landscape.

Risk transactions or industries

In general, all multinationals are at risk of transfer pricing investigations. It is however likely that in the first years of the introduction of the legislation, the focus will be on persons with significant related party transactions and those with a history of consistent losses. Trends around Africa also suggest that management fees and intellectual property transactions will come under immediate focus.

Competent authority

The regulations recognise the mutual agreement procedure provisions which exist in Nigeria's double tax agreements. There is however little information available on the process for competent authority claims. Experience suggests that the competent authority process has been rarely used in Nigeria but discussions are ongoing on ways to improve this.

Advance pricing agreements

The regulations provide taxpayers with the opportunity to enter into advanced pricing agreements with the FIRS. Advanced pricing applications can however only be made where the annual value of the related party transaction is not less than 250 million Nigerian naira (approximately 1.6 million United States dollars).

Anticipated developments in law and practice

Law

The Nigerian transfer pricing rules have been gazetted with a commencement date of 2 August 2012. It is effective for basis periods beginning after the commencement date. For example, a company with an accounting year end of 31 December will be required to have transfer pricing documentation in place for accounting periods commencing 1 January 2013 rather than 2012.

Practice

Transfer pricing related queries from FIRS are on the increase. This trend is likely to accelerate now that the regulations have become law.

Liaison with other authorities

Information sharing among regulatory authorities (Customs, NOTAP etc.) on transfer pricing issues is not widespread. The FIRS has however routinely relied on the approvals issued by NOTAP as a basis for granting tax deductions in respect of expenses such as royalties for intellectual property, management services, technical services, etc.

Customs and income tax are administered by distinct and separate government agencies and there is very little sharing of information between the two agencies.

OECD issues

Although Nigeria is not a member of the OECD, the transfer pricing regulations clearly state that the provisions will be applied in a manner consistent with the OECD Transfer Pricing Guidelines. The OECD Guidelines will therefore be relevant for determining the arm's-length standard for Nigerian transfer pricing purposes.

In addition to references to the OECD Guidelines, the regulations also suggest that the United Nations Practical Manual on Transfer Pricing for Developing Countries will be used as a guide. This has the potential of creating issues in the event of a conflict between interpretations contained in the UN manual and the OECD Guidelines.

Joint investigations

The FIRS has not teamed with any other tax authorities for the purposes of undertaking a joint investigation into transfer pricing. This is however likely to change in the coming years.

The FIRS is a member of the ATAF, a body currently driving the adoption of transfer pricing regulations in Africa. The creation of ATAF has seen increased information sharing among African tax administrators.

As part of its transfer pricing agenda, ATAF is currently driving the adoption of an African agreement on mutual assistance on tax matters. This agreement is expected to provide a legal framework for multilateral exchange of information among member states as well as mutual assistance during tax audits. The text of this agreement was agreed among member states in August 2012.

Thin capitalisation

There are currently no thin capitalisation rules in Nigeria. There are however indications that thin capitalisation rules may soon be introduced.

Even though there are no thin capitalisation rules yet, there are instances where the FIRS has tried to apply transfer pricing principles (under the arm's-length provisions of the tax statutes) to re-characterise related party loans as equity especially if the Nigerian company is deemed to be highly geared.

Africa Regional

South Africa, Republic of

Introduction

Transfer pricing legislation has been in South African law since 1995, however, it has only been in recent years that the South African Revenue Service (SARS) has focused on this area. The rules require those subject to tax in South Africa to follow arm's-length principles in their dealings with *inter alia* connected persons who are not tax residents of South Africa. The transfer pricing rules were overhauled in 2010 and 2011 and apply to years of assessment commencing on or after 1 April 2012. The changes were introduced to focus on profit objectives rather than isolated transactions, to align with treaty wording referring to adjustments to profits rather than adjustments to price, and to de-emphasise SARS' concentration on the comparable uncontrolled price (CUP) method.

Historically, exchange controls have policed the flow of funds in and out of South Africa and have served as a protection against tax base erosion through inappropriate non-arm's-length transfer pricing. Technically, such non-arm's-length transfer pricing is a criminal offence in terms of SA's exchange control laws and regulations. It follows that having TP documentation in place that supports the arm's-length nature of the transfer pricing is accordingly a commercial necessity required to manage this potential exchange control risk.

While exchange control regulations continue to regulate the flow of funds from South Africa, the gradual relaxation of the exchange control rules has provided greater flexibility and freedom for the movement of funds offshore. As such, the authorities are becoming more reliant on SARS to police adherence to SA's transfer pricing rules in order to protect the country from tax base erosion through non-arm's-length transfer pricing. In this respect, we have seen increased audit activity by the specialist Transfer Pricing unit within SARS across all industries.

The years open to question by SARS depend on whether assessments (in respect of the years in which the relevant transactions took place) have prescribed² (generally speaking, assessments prescribe three years after the date of assessment) and whether SARS can argue that non-disclosure has taken place, in which case, earlier years of assessment can be reopened. SARS has raised assessments in respect of transfer pricing adjustments where the tax years are close to prescription, or reopened assessments for earlier years on the basis of non-disclosure. In practice, there are several examples, where SARS is applying current knowledge and practice, with a degree of hindsight, in the conduct of their TP audits, which appears to contradict the SARS Practice Note and the OECD Guidelines.

The South African government has indicated that it wants South Africa to become the 'gateway' into Africa, and it is looking into incentives to make South Africa more attractive as a hub for investments into Africa. The 2010 introduction of a headquarters company regime and the ongoing fine-tuning of the gateway legislation is part of this drive. Such companies are not subject to South African transfer pricing or thin capitalisation rules for the receipt and provision of financial assistance in back-to-back finance arrangements (subject to certain requirements) and going forward, similar relief will also apply to back-to-back licensing arrangements.

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2 Prescription in the South African statute of limitations.

Statutory rules

Section 31 of the SA Income Tax Act 58 of 1962 covers transfer pricing and thin capitalisation. In terms of the updated wording of section 31(2), a transfer pricing adjustment will arise where a transaction, operation, scheme, agreement or understanding constitutes an affected transaction and where:

- the terms or conditions are different to the terms and conditions that would have existed had those persons been independent persons dealing at arm's length, and
- it will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding.

Generally speaking, a transaction, operation, scheme, agreement or understanding will constitute an 'affected transaction' where it is directly or indirectly entered into for the benefit of either, or both, a South African resident taxpayer and an offshore connected party. The reference to direct and indirect is important as it potentially widens the application of the legislation.

The taxable income or tax payable by any person deriving a tax benefit must be calculated as if the transaction, operation, scheme, arrangement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length. To the extent that there is a difference between the actual taxable income and the taxable income calculated on the basis outlined above, there will be a transfer pricing adjustment to taxable income which is subject to corporate income tax at 28%. In addition, there will also be a secondary adjustment. The effect of the secondary adjustment will depend on whether the adjustment is made under the new or old legislation. Specifically:

- With the introduction of the new dividend withholding tax on 1 April 2012, Secondary Tax on Companies (STC) was abolished. As a result, if a transfer pricing adjustment is made post 1 April 2012 in respect of an earlier year of assessment under the old legislation, there is currently some uncertainty as to whether SARS could also deem the transfer pricing adjustment to be a deemed dividend on which STC is payable at a rate of 10%. There is a school of thought that suggests that this STC may no longer be levied, and whilst this interpretation has merit, the legal position is not clear.
- For all financial years commencing on or after 1 April 2012, in terms of the new legislation, the transfer pricing adjustment will be regarded as a loan on which a market related interest rate must be charged. Currently, the legislation is not clear on the date that the notional loan will arise or from which date the interest must be calculated. Also, the legislation does not allow for a mechanism to repay the notional loan.

SARS is currently in the process of preparing an interpretation note (IN) to replace PN7 and to provide guidance on the practical application of the new legislation. However, the timing on the release of the new IN is currently not known.

Section 31 of the SA Income Tax Act requires taxpayers to determine the taxable income, if different from that reported, that would arise from an arm's-length transaction. This places emphasis on self-assessment of the terms and results of the transactions with related parties and has implications for prescription and non-disclosure. It also allows SARS to re-characterise transactions for transfer pricing

Africa Regional

purposes and apply a whole-of-entity approach. This self assessment requirement is also conveyed in the questions found in the annual income tax return.

The Commissioner can also levy additional tax on transfer pricing adjustments which include interest on unpaid tax and penalties. This may be as much as 200% of the underpaid taxes. Recently, new legislation was also introduced which deals with tax administration. In terms of the new legislation, in addition to the 200% penalty, an understatement penalty may also be applicable. The amount of this understatement penalty is determined with reference to the degree of care or lack thereof that resulted in the understatement, and to the extent the taxpayer made voluntary disclosure or whether the taxpayer acted obstructively. This penalty ranges from 0% to 200%. SARS may remit this penalty if the taxpayer made the requisite disclosure by the time the return was due, and is in possession of a qualifying tax opinion. A qualifying tax opinion is one written by a registered tax practitioner, being a member of an appropriate professional body (e.g. the SA Institute of Chartered Accountants) and being appropriately registered as a tax practitioner with SARS, where the opinion supports the filing position taken by the taxpayer. It follows that where PwC provide a report on the TP documentation prepared by the taxpayer or otherwise confirm the appropriateness of the TP documentation prepared by PwC, such opinion serves to reduce the potential for penalties in terms of the Tax Administration Act. Please note that the Tax Administration Act is a very new piece of legislation and there is currently some uncertainty on how SARS will, in practice, apply certain provisions of this Act.

Although the SA Income Tax Act contains no explicit transfer pricing documentation requirements, SARS may (in terms of section 74 read with section 74A) require a taxpayer to furnish “information, documents or things as the Commissioner may require for the administration of the [SA] Income Tax Act”. In practice, SARS may require detailed transfer pricing information to be supplied within 14 days from the date of request.

What is of interest is the requirement (introduced in 2004 and clarified in the addendum to PN7) to furnish the transfer pricing documentation with the income tax return if held. It is arguable that this introduces a requirement to complete documentation, although SARS maintains there is no statutory requirement to do so. Also, it should be noted that, in terms of current SARS’ practice (specifically in the event that a taxpayer makes use of SARS eFiling), the system does not allow for the submission of transfer pricing documentation with the corporate income tax return, rather it must be available upon request from SARS.

What is critical is that where such documentation has been prepared, it must adequately reflect the current transfer pricing policies being implemented and be up to date. Erroneous, out-of-date or incorrect documentation could and has been argued to represent incomplete disclosure, resulting in prescription not applying to those years. This represents a significant risk to taxpayers who could remain open to a transfer pricing review from SARS for indefinite periods back to 1995. SARS have started to enter into agreements with taxpayers to extend the period within which an assessment prescribes – if agreed to by the taxpayer, this effectively provides SARS additional time to raise queries or assessments.

The income tax return requires a taxpayer to indicate whether it has cross-border transactions with connected persons and whether the taxpayer has prepared transfer

pricing documentation. Specifically, the 2011 and 2012 corporate income-tax return form requires taxpayers to answer yes or no to the following questions:

- Does the company have a transfer pricing policy document in support of the transfer pricing applied in the current year in relation to the transactions as defined in section 31?
- Did the company receive any financial assistance from a non-resident connected person or from an investor as defined in section 31(3) and Practice Note 2 (if YES, were the provisions of section 31 (3) and Practice Note 2 adhered to?).
- Has the company provided goods and services³ or anything of value (including transactions on capital account) to a non-resident connected person for less than arm's-length consideration?

To answer these questions accurately and prevent non-disclosure issues, as well as deal with the necessary exchange control compliance referred to above, some form of documentation or transfer pricing study needs to be undertaken.

In the event that transfer pricing documentation is available and a taxpayer does not submit it on request from SARS, failure to submit the documentation could arguably lead to prosecution under section 75 of the SA Income Tax Act.

Section 31 is also aimed at thin capitalisation and is discussed in more detail in a separate section below.

South Africa does not have transfer pricing rules in respect of domestic transactions, with the exception of gross sales for Mineral and Petroleum Resources Royalty Act purposes (from 1 March 2010).

Controlled foreign companies

The SA Income Tax Act deems any transaction undertaken between a controlled foreign company (CFC) and any connected person a transaction to which the transfer pricing provisions contained in section 31 apply. CFCs are non-resident companies in which more than 50% of the total participation or voting rights are held directly or indirectly by one or more South African residents. The result is that the SA Income Tax Act deems the CFC party to the transaction to be a South African resident for transfer pricing purposes.

This is increasingly becoming an area of scrutiny for SARS, as many multinationals based in South Africa do not identify the potential risk in transactions between CFCs. One of the stringent anti-diversionary rules requires that the transactions between CFCs and residents are conducted at arm's length before the specific business establishment exemption from CFC imputation can apply to these transactions.

Whilst the transfer pricing rules generally apply to transactions with CFCs, in terms of the 2012 Tax Amendment Bill, South African residents who grant financial assistance or the use of intellectual property to a CFC that has a foreign business establishment and also suffers a high rate of foreign tax (i.e. at least 75% of the amount of SA tax that would have been payable in respect of any taxable income of that CFC, had that CFC been tax resident in SA), could be excluded from the section 31 transfer pricing rules

.....
3 Goods and services include loans.

Africa Regional

for those transactions. On the other hand, all SA source interest and royalties earned by CFCs will be subject to the normal withholding tax rules and be exempt from normal income tax (as opposed to being exempt from withholding tax whilst being subject to the standard CFC imputation rules).

Other regulations

SARS issues PNs and INs that provide guidance on its interpretation and application of the SA Income Tax Act. PNs and INs are not law and their contents can therefore not be relied upon in terms of Court interpretation. They are intended to provide guidance to taxpayers on SARS' views and practical application of the law. They may, however, provide a taxpayer with a legitimate expectation on the manner in which SARS should apply the law, if the facts of the case are dealt with in the PN or IN.

Practice Note 2 (PN2) was issued in May 1996 and focuses on the interaction of the thin capitalisation rules and the transfer pricing rules. PN2 relates to the provision of financial assistance given by an overseas-connected party to a South African resident, but not vice versa. PN2 helps taxpayers identify levels of excessive debt under the thin capitalisation rules, as well as excessive interest rates under the transfer pricing rules. Financial assistance and thin capitalisation is a current focus area for SARS.

As previously noted, SARS is currently in the process of preparing an updated IN that will deal with financial assistance and thin capitalisation – the anticipated date of release is not yet known.

PN7 was issued in 1999 and provides guidance on transfer pricing. It is comprehensive and follows the approaches of the Australian and New Zealand guidance on TP.

Under accounting statement IAS24 (and the new IFRS requirements), companies are required to disclose all transactions with related parties. Following amendments to IAS24, additional related party information may need to be disclosed in future. Due to the rather wide definition of related parties, financial statements will now provide information to SARS on cross-border transactions with connected persons. Also, the requirements under the accounting standards must be able to support any statement made in the financial statements. Consequently, if a statement is made that all related party transactions are conducted at arm's length, the auditor needs to be confident that this can be supported. In the current risk averse climate, this places a greater onus on auditors and, in turn, greater pressure on multinationals to ensure their transfer pricing is in order. If a general statement is made that a related party transaction takes place at least at arm's length and this is not in fact the case, SARS could claim that the taxpayer made a fraudulent misrepresentation, resulting in possible penalties, and prescription not applying to the relevant years.

The introduction of legislation regarding reportable irregularities for auditors and tax practitioners also places strain on transfer pricing compliance. Transfer pricing in South Africa is discretionary and, therefore, identifying the existence of a transfer pricing exposure and quantifying this, without undertaking an extensive analysis, is problematic and raises concerns for auditors, tax practitioners and taxpayers alike.

Legal cases

As yet, no court cases have been brought in South Africa on transfer pricing. As a result of the increased focus of SARS, various transfer pricing assessments have been issued

in which adjustments have been made. Some of these adjustments have been appealed against and are likely to be tested through the courts.

Under the South African constitution, the courts are bound to consider international precedent (i.e. foreign case law) in the event that no local precedent is available. However, foreign case law is only of persuasive authority and is not binding on SA courts.

Currently, SARS is open to entering into settlement agreements rather than going to court. This is a positive development and does not infringe on the taxpayer's right to object and appeal (if the taxpayer is not satisfied with SARS' position).

Given the lack of court cases on transfer pricing, few advocates and judges have knowledge of transfer pricing. For this reason, taxpayers sometimes prefer to settle cases with SARS rather than going to court, or where available under the relevant treaty, to initiate competent authority claims. There are various alternatives available to taxpayers to resolve disputes with SARS. Specifically, taxpayers can:

- invoke Mutual Agreement Procedures (MAP)
- enter into a unilateral agreement with SARS without corresponding tax relief in another tax jurisdiction, or
- take the dispute to court.

Most, if not all, disputes in South Africa have been settled by the unilateral settlement procedure.

Burden of proof

In terms of section 31 of the SA Income Tax Act, the burden of proof lies with the taxpayer to demonstrate that the transfer pricing policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's-length standard.

Tax audit procedures

In the 2010/11 budget speech, the South African Minister of Finance indicated that transfer pricing is one of SARS' key focus areas.

SARS follows the OECD Guidelines in conducting transfer pricing investigations. However, going forward, it is likely that SARS will also consider the guidance from the recently released United Nations Practical Manual on Transfer Pricing for Developing Countries (UN Manual). The UN Manual states that whilst the OECD Guidelines have been particularly useful in providing a conceptual understanding of what is the nature of the arm's-length principle, there are instances when the OECD Guidelines fail to address the more practical aspects of how to apply the principles.

All multinationals are potential targets for a SARS audit – inbound investors as well as South African-based groups. Companies that fall within the provisions of section 31 of the SA Income Tax Act should take transfer pricing seriously and develop and maintain properly documented and defensible transfer pricing policies. Such documentation must be contemporaneous and regularly updated. Previously, SARS' practice was to accept that documents can be updated only every three years, or for changes in the operations. Currently, we recommend that benchmarking for non-core services be

Africa Regional

updated at least every three years. Furthermore, on the basis that tax is viewed as an annual event, taxpayers need to ensure the documentation is reviewed annually.

SARS also prefers the South African taxpayer to be the tested party, even though it may not be the least complex party to the transaction. The transfer pricing document must list every cross-border transaction entered into by the taxpayer, even though the transfer pricing document may not deal with a specific transaction in detail. This ensures that the taxpayer satisfies the requirement for full disclosure in its transfer pricing documentation.

SARS is actively auditing taxpayers on their transfer pricing and has indicated that it will place greater scrutiny on multinationals that have connected-party entities situated in low-tax jurisdictions. This line of enquiry tends to combine a challenge on residence of the low-taxed foreign entity, together with questions on the transfer pricing. We have also seen SARS issue transfer pricing questionnaires to multinationals to obtain information regarding their transfer prices. The focus of these is on comparability and characterisation of transactions.

SARS, as in South Africa generally, is experiencing a resource issue, which means many of the audits commenced take a long time to conclude. In addition, where transactions are with African countries that do not have a transfer pricing regime, solutions through the normal channels of mutual agreement procedures (MAPs) are unlikely to be successful.

Resources available to the tax authorities

A specialist unit within SARS conducts transfer pricing audits. This unit comprises highly skilled individuals who have previously been employed by professional firms. To help train personnel in the unit, SARS has sought advice and training from Revenue specialists in the United States, the United Kingdom and Australia. Over the last year, SARS has also recruited personnel (on a secondment basis) from other tax authorities (e.g. from the United Kingdom and Australia), and cooperation between SARS and overseas tax authorities has increased. SARS' transfer pricing representatives also regularly attend OECD conferences and training sessions.

Use and availability of comparable information

Use

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Within the context of these guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

However, going forward, it is likely that SARS will also consider the guidance contained in the UN Manual.

Availability

Information on the performance of public companies in South Africa is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available, which makes the search for comparables in South Africa difficult.

The UN Manual notes that the main challenge that South Africa encounters in determining the arm's-length profits is the lack of domestic comparables given that there are no databases containing South African specific or for that matter African specific comparable data. It is thus accepted that the most reliable comparables will suffice. As a result, SARS has indicated that it will accept the use of financial databases used elsewhere in the world, but the comparables may need to be adjusted for the South African market. Our understanding is that SARS uses Orbis (previously Amadeus) to conduct comparable studies, relying largely on European companies for comparability.

Based on the comments in the specific South African country chapter in the UN Manual, we understand that, in practice SARS, have attempted to make comparability adjustments, for example country risk adjustments based on publicly available country risk ratings, government bond rates etc. However these have been applied with caution and in specific circumstances.

Also, per the specific country chapter in the UN Manual, SARS states that it favours a more holistic approach to establishing whether or not the arm's-length principle has been upheld. By seeking to understand the business model of taxpayers across the value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group transactions and agreements etc, it is evident that SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate arm's-length level of profit has been achieved.

We have seen limited evidence of SARS relying on secret comparable information (i.e. information of competitors) it has access to when determining adjustments under audit. Although such supporting evidence could never be used in a court of law and this practice would not be confirmed publically, it places emphasis on the need for multinationals to have robust benchmarking to support related party transactions in order to rebut any proposed adjustments.

Risk transactions or industries

SARS' audit activity focuses on industries across all sectors. It has demonstrated its ability to research an industry and is being selective in targeting audits. In addition, SARS stated in its 2007 budget that intellectual property is a focus area. To date, however, we have not seen many queries from SARS regarding transactions involving intangibles. Accordingly, it is not clear what approach they would be following with regards to comparability for intangible transactions. It is suggested that SARS would follow a similar approach to that followed for normal/routine benchmarking studies. It should be noted that the South African exchange control regulations requires approval from the company's authorised dealer (usually the company's commercial bank) or the South African Reserve Bank ('SARB') where related parties enter into agreements for the use of intellectual property in South Africa. This exchange control approval may, as a condition of the approval, inter alia, require an audit firm to provide an opinion on whether the charges are fair and market related and correctly calculated.

South African companies that have related companies situated in lower-tax jurisdictions remain at a high risk of investigation. Such investigation is often two-pronged, testing residency together with transfer pricing. SARS has a stricter requirement for documentation and supporting evidence than many other countries.

Africa Regional

For instance, global documentation prepared by a group and rolled out throughout that group is not acceptable in South Africa without a sufficient level of localisation. SARS' focus until recently has been at the transactional level and it has preferred to accept analyses undertaken on a whole-of-entity basis, commonly adopted in the United States and Australia, only as a method of last resort. Further, SARS is at odds with the OECD in some respects, notably on the use of multiple-year data. SARS views tax as an annual event and adjustments for transfer pricing are viewed on a year-by-year basis, irrespective of the longer-term picture.

SARS does not look favourably upon transfer pricing adjustments (i.e. year-end adjustments, targeted returns or situations where a payment is made in respect of the indirect assumption of risk by a non-resident-connected person without the corresponding transfer of or change in functions performed by the South African entity). SARS views such adjustments as a profit-stripping mechanism and, as such, any transfer pricing adjustments raise a 'red flag' for SARS to raise queries or perform an audit. It is therefore important that appropriate legal agreements are in place to support pricing adjustments. SARS also states that the taxpayer cannot use hindsight and that year-end transfer pricing adjustments are arguably based on hindsight. This is a question of fact, depending on the legal agreements and related obligations that are in place.

The use of entrepreneur and limited-risk models in the African continent is not straight forward, as delivery and cost-saving mechanisms are not easy to implement. SARS is likely to focus on the functional profile of the taxpayer and whether any real risk and/or functions have been moved from South Africa. Business model changes need to be implemented carefully with robust documentation of the pre- and post-factual reality of the business and a paper explaining the commercial rationale why the parties agreed to enter into the new business arrangement is recommended.

Competent authority

Little information is available on the process for competent authority claims. Experience suggests that competent authority has not been widely used in South Africa. The lack of experience coupled with potentially difficult administrations in the rest of the continent mean that reliance on MAP to resolve disputes is problematic.

However, for transactions involving countries with a well-established MAP, its use provides a valuable defence mechanism against double taxation.

Advance pricing agreements

No procedures are in place by which a taxpayer might achieve an advance agreement on its transfer pricing policy, and none are expected for some time. In PN7, SARS specifically states that it is not in favour of adopting advance pricing agreements (APAs). Although it is understood that this initial view is starting to change at SARS, there are few available resources and therefore the introduction of an APA process in South Africa is likely to be some way off. SARS will not be bound by unilateral APAs that a taxpayer's connected parties may have agreed with other tax authorities.

Anticipated developments in law and practice

Law

The current requirements regarding the filing of transfer pricing documentation are not clear. Taxpayers are advised to submit the information requested in the brochure to

the income tax return form. If this cannot be done via e-filing, taxpayers are advised to ensure that such information is available for submission upon request.

PN2 and PN7 are being updated and the timing of the release of the new Interpretation Note is not yet known.

Practice

SARS has continued its drive to implement the transfer pricing legislation, and all multinational companies remain the focus of the authorities' attention. SARS is not restricting its focus to larger groups, but is taking a much wider view. For this reason, it is important for multinational companies to formulate and document transfer pricing policies in line with OECD Guidelines and the PNs as soon as possible. Going forward, taxpayers may also need to consider the comments from the UN Manual.

In the 2007 budget, SARS acknowledged the potential economic value locked in intellectual property and the tendency of multinationals to shift this value offshore. In response, SARS intends to impose measures to correct this. While South Africa is not a member of the OECD, it is an enhanced engagement country. SARS plays an active role at the OECD and has been involved significantly with the new releases on the attribution of profits to permanent establishments and conversion matters.

It is anticipated that financial assistance in the form of inbound loans, outbound loans and guarantee fees may become a focus area for SARS.

Liaison with other authorities

Although customs and income tax authorities are under the same authoritative body, generally speaking, historically, no information was shared between the two authorities. However, going forward, there is clear evidence of more cooperation between the two tax departments, particularly in terms of SARS' 'integrated audit', which seeks to apply a more holistic approach to tax compliance. Recent questionnaires circulated by the customs authorities include specific questions regarding transfer pricing. As a general point, SARS is improving its systems, and better cooperation between the various authorities is expected in the near future.

We have observed increased cooperation between SARS and the Reserve Bank. A South African resident needs Reserve Bank approval to remit funds from South Africa. The extent of the approval and vigilance of the banks depends on the nature of the payments. Cross-border payments to connected parties will first be reviewed and cleared by the Reserve Bank. There is a marked increase in SARB requests to review applicants' transfer pricing documentation in support of such transactions before approval is granted. In this regard, SARS has provided a 'working handbook' to the SARB to assist it with transfer-pricing-related matters. The SARB has also set up a working committee (PwC is represented on this committee) to discuss transfer-pricing-related matters in the exchange control context. The SARB follows a more commercial approach when approving payments. Where approval is required, it is given on a case-by-case basis. We have recently also seen SARS issue questionnaires to taxpayers, based on information obtained from the Reserve Bank, regarding taxpayer's cross-border transactions. These questionnaires suggest that, going forward, there is likely to be closer cooperation between the Reserve Bank and SARS regarding taxpayer's transfer pricing practices.

Africa Regional

Payment for the use of intellectual property and inbound services has always been a focus, and the Reserve Bank now requests a transfer pricing review by the auditors to ensure any payments are in accordance with the arm's-length principle. In recent years, two notable changes have been introduced: (1) the requirement to demonstrate a benefit not only to the recipient of an inbound service, but also to South Africa as a whole; and (2) a recent move to ensure that inbound as well as outbound licence fees for intellectual property have been correctly calculated and are fair and market related.

It is important that exchange controls are considered together with transfer pricing given that, in a South African context, these two matters effectively go hand in hand. There may be certain instances where policies or pricing may be considered arm's length from a transfer pricing perspective, but the Reserve Bank would either not allow the payment without specific approval, for example, manufacturing royalties can be capped at 6%, or it would not allow the transaction at all in the first instance, such as the sale of intellectual property from South Africa. Debt set-offs can also breach exchange control regulations, be voidable and represent a criminal offense.

The 2011 Tax Administration Act came into effect on 1 October 2012 and provides for a Voluntary Disclosure Programme to enable companies and individuals to regularise their tax affairs with relief in the form of reduced penalties and interest.

OECD issues

South Africa is not a member of the OECD, but it is an enhanced engagement country. South Africa actively participates in and provides input to OECD discussions and discussion papers. South Africa follows the OECD Guidelines and the 2010 changes to the guidelines issued by the OECD are being applied by SARS in their transfer pricing audits.

As noted earlier, going forward, taxpayers may also need to consider the contents of the UN Manual,

Joint investigations

It is possible for the South African tax authorities to join with the authorities of another country to jointly investigate a multinational group or share information from a South African audit with an overseas tax authority. Practically, we have started to see closer cooperation between SARS and other overseas revenue authorities.

Thin capitalisation

In terms of the old legislation (i.e. for all years of assessment commencing prior to 1 April 2012), the thin capitalisation rules were dealt with primarily by section 31(3). In terms of the old legislation, subject to clearance (see below), interest charged on that part of the loan which exceeds the permissible debt to equity safe harbour ratio of 3:1 was not deductible for tax purposes and was deemed to be a dividend under section 64C(2)(e)) of the SA Income Tax Act. STC is payable on the portion of the amount that is viewed as excessive.

A literal interpretation of the old wording of section 31 would lead to the conclusion that the concept of financial assistance would extend beyond interest-bearing loans to interest-free loans. However, the purpose of section 31(3) was to enable the Commissioner to determine an acceptable debt-to-equity ratio in order to disallow

a tax deduction for interest paid in relation to any excessive part of the debt. Consequently, the application of section 31(3) is limited, in practice, to interest-bearing debt only. Back-to-back loans are included in the financial assistance provisions and there remains uncertainty as to whether this results in unintentional domestic transfer pricing.

However, in terms of the new updated legislation, thin capitalisation is dealt with as part of the transfer pricing legislation contained in section 31(2) (i.e. there is no longer a separate section dealing with thin capitalisation, rather this is dealt with by the general rules). One substantial change between the old and new legislation is that financial assistance to South African branches are now also subject to the transfer pricing rules (specifically, the rules around financial assistance).

Guidance on thin capitalisation and the charging of excessive interest is provided in PN2. As noted earlier, SARS has indicated that an updated IN will be issued to provide guidance on the thin capitalisation rules. However, the timing of the release of the new IN is currently unknown. Accordingly, until such time as a new IN is issued, taxpayers are in practice relying on the contents of PN2.

PN2 provides for an acceptable debt-to-equity ratio of 3:1, within which the Commissioner does not generally apply thin capitalisation restrictions. This 3:1 safe harbour reflects the previous approach adopted by the Exchange Control Authorities. It is not a statutory ratio and taxpayers are free to apply to the Commissioner for relaxation from the ratio (preferably in the year when the company becomes thinly capitalised) where sound commercial reasons for variance exist. Taxpayers who comply with the safe harbour ratio are not required to justify shareholder loans, but are still required to supply information as requested in the annual income tax return. In determining the interest rates applicable for rand denominated loans, an interest rate of the weighted average of South African prime rate plus 2% is accepted as arm's length. For foreign-denominated loans, an interest rate of the weighted average of the relevant interbank rate plus 2% is considered as arm's length. This provides a safe harbour for determining arm's-length interest rates to be applied to inbound cross-border loans.

The safe harbour provisions apply only to inbound financial assistance and not financial assistance provided by a South African entity. Reliance on these provisions for outbound financial assistance is not appropriate and a robust arm's-length analysis is required.

Going forward, it is not clear whether the new IN will include any debt to equity safe harbours, however, preliminary indications are that if the IN were to include safe harbour ratios, the debt to equity ratio would be lowered from 3:1 to 2 or 1:1.

As noted earlier, the new rules apply to financial assistance provided to South African branches. It is thought that this will be applied by measuring the foreign equity versus the outstanding debt of the foreign subsidiary, as opposed to measuring at the South African branch level. However, in the absence of any specific guidance on the matter, it is not clear how the rules will be applied in practice.

In terms of recent amendments to the SA Income Tax Act, with effect from 1 July 2013, there will be a new withholding tax on interest with a domestic withholding tax rate of

Africa Regional

15%. The government is negotiating tax treaties to ensure that South Africa can collect this, at perhaps a treaty rate of 5%, although these negotiations are ongoing.

Sub-Saharan Francophone Africa

Introduction

Sub-Saharan Francophone Africa (SSFA) covers nine countries, namely Cameroon, Ivory Coast, Chad, Gabon, Senegal, Congo, Madagascar, Equatorial Guinea, and Guinea Conakry.

Four of these countries (Cameroon, Ivory Coast, Chad, and Gabon) have internal legal regulations which require the application of the arm's-length principle in their tax legislation and the other countries are either in the process of formulating country specific legislation, or rely on international principles of transfer pricing.

Some SSFA countries provide specific transfer pricing rules in their tax laws – for example in Cameroon, transfer pricing specificities include methods of determining associated-party pricing. These specific rules equally apply to foreign-controlled companies.

Taxpayers are required to indicate cross-border transactions with connected persons, and to prepare transfer pricing documentation – in some cases, this documentation is to be submitted to the Tax authorities upon notification of an impending tax audit.

In addition, taxpayers are expected to consider the following issues:

- Does the company have internal transfer pricing policy documentation which lays down rules for application of transfer pricing in its transactions?
- Do disparities exist between the treatment of transactions with resident parties, and those involving provision of goods and services or anything of value (including transactions on capital account) to a non-resident party?

Existence of Statutory rules

The following table summarises the existence and implementation of transfer pricing or arm's-length principle rules in SSFA countries:

Country	Is the arm's-length principle considered?	Are transfer pricing rules implemented?	Does the tax authority show interest in transfer pricing issues?
Cameroon	Yes	Yes	Yes
Ivory Coast	Yes	Yes	Yes
Chad	Yes	Yes	No
Gabon	Yes	Limited	No
Senegal	Yes	Limited	No
Congo	No	Yes	Yes
Madagascar	Yes	Yes	No
Equatorial Guinea	Yes	Yes	Yes
Guinea Conakry	Yes	Yes	Yes

Aspects to consider with regard to transfer pricing in SSFA:

- The definition of the relationship between parties, which triggers transfer pricing concerns.
- Benchmarking and related constraints.
- Keeping of documentation. Tax authorities usually ask for all documents relating to transactions between related companies, including methods used to determine prices employed.
- Wide discretion of tax authorities in the interpretation and application of transfer pricing rules.
- Where transfer pricing adjustments are concerned, arbitrary taxation may occur. This may equally be accompanied by fiscal interests and penalties, as well as criminal penalties for the Taxpayer.

Issues encountered with the application of transfer pricing rules include:

- Inadequacy and insufficiency of transfer pricing regulations to address increasing levels and complexities of international economic transactions. Recourse often has to be made to international principles, which may not always represent the local situation.
- Tax authorities sometimes carries out arbitrary interpretation and application of existing rules.
- Absence of suitable benchmarking tools.
- Difficulties in the application of transfer pricing laws.
- Regulations relating to transfer pricing documentation are often absent or unclear.

Tanzania

Introduction

The Tanzanian Income Tax Act 2004 contains transfer pricing rules that apply to transactions with resident and non-resident associates. The rules are still largely untested, and no guidance has been issued by the Tanzania Revenue Authority (TRA) on how the rules will be applied in practice.

Statutory rules

Section 33 of the Tanzanian Income Tax Act 2004 requires that any arrangement between associates must be conducted at arm's length.

Where a taxpayer has failed to meet the arm's-length standard, the Commissioner has wide powers to make adjustments, re-characterise and reapportion any amount or reallocate expenditures. The Tanzanian Income Tax Act does not specify a methodology for determining what constitutes an arm's-length price.

The legislation contains no explicit requirement for the taxpayer to prepare transfer pricing documentation, although section 33 of the Tanzanian Income Tax Act does require that the persons who are involved in the relevant transaction should "quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have arisen for them if the arrangement had been conducted at arm's length". This could be taken to imply that adequate documentation must be available to support the pricing of transactions between associates.

Africa Regional

Regulation 6 of the Tanzanian Income Tax Regulations 2004 provides that section 33 “shall be construed in such a manner as best secures consistency with the transfer pricing guidelines in the Practice Notes issued by the Commissioner pursuant to section 130 of the Act”.

To date, the TRA has not issued a Practice Note to clarify what approach it will follow to give effect to the transfer pricing provisions (although it has indicated that one will be issued in due course).

In the meantime, the TRA has stated that it will apply internationally agreed arm’s-length principles as set out in the UN and OECD Transfer Pricing Guidelines. Furthermore, the TRA has indicated that it will follow the ruling in the Kenyan tax case on transfer pricing (Unilever Kenya Limited – *see Kenya section*), which applied the OECD transfer pricing principles.

In addition to section 33, the general deductibility section within the Tanzanian Income Tax Act, section 11, provides that expenditure must be incurred wholly and exclusively in the production of income from the business. It would also be possible for the TRA to challenge the deductibility of an expense under this section if, for example, it considered the amount to be excessive or unsupported by suitable evidence.

Controlled foreign companies

A controlled foreign company may trigger the Tanzanian transfer pricing rules if it is deemed to be an associate of the local entity, according to that definition. However, a controlled foreign corporation is not itself deemed to be a resident of Tanzania for tax or transfer pricing purposes.

Other regulations

The TRA has yet to issue a Practice Note providing guidance on the application of the transfer pricing legislation.

The tax return form requires a taxpayer to disclose transactions with related parties, although this information tends to mirror the details already provided in a company’s financial statements.

Legal cases

No legal cases have been argued based on the current legislation. A number of TRA challenges are currently under objection, which may be tested through the courts.

Burden of proof

Under the provisions of section 33 of the Tanzanian Income Tax Act and the self-assessment regime, the burden of proof is on the taxpayer to ensure that transactions are carried out on an arm’s-length basis.

Tax audit procedures

No specific procedures have been laid down by the TRA in relation to transfer pricing investigations and, currently, queries on transfer pricing issues form part of the normal TRA audit process. TRA auditors have recently started to request copies of transfer pricing studies and reports.

Resources available to the tax authorities

The TRA has started training its staff on transfer pricing issues (including study tours to other countries). It has no dedicated transfer pricing unit, and queries are handled by the Large Taxpayers Department or Domestic Revenue Department as part of the normal process of reviewing a taxpayer's income-tax affairs.

Use and availability of comparable information

Use

The transfer pricing rules are the basis for determining an acceptable transfer pricing methodology (although no specific methodologies are prescribed). The TRA has indicated that it will apply internationally agreed arm's-length principles as set out in the UN and OECD Transfer Pricing Guidelines.

Availability

Information on the performance of companies in Tanzania is available only in the form of published or filed financial statements, with practical observance being more consistently followed by public companies and financial institutions. More detailed information is not generally available publicly. As a result, the use of Tanzanian comparables is not possible.

The TRA has not indicated whether it will accept the use of financial databases from elsewhere in the world; and given the lack of practice in this area, it is possible that this issue has not yet been considered.

Risk transactions or industries

There is no indication at present that certain types of transactions or industries are at higher risk of investigation than others. However, to date, the key area of focus by the TRA has been intra-group management fees (basis of calculation of the fee and evidence of services actually being provided), export sales of goods and interest-free funding.

Competent authority

The lack of experience coupled with potentially difficult administrations in wider Africa means that competent authority claims and/or reliance on Mutual Agreed Procedures to resolve disputes is problematic.

Advance pricing agreements

Regulation 33 of the Tanzanian Income Tax Regulations 2004 provides for the Commissioner to enter into a binding agreement on the manner in which an arm's-length price is determined. However, in practice, the TRA is reluctant to issue binding rulings, and this reluctance is likely to also apply to transfer pricing matters. We are not aware that any advance pricing agreements have been made to date.

Anticipated developments in law and practice

Given that the transfer pricing legislation in Tanzania is still relatively new and untested, it is likely that over time the TRA's policy on how the law will be applied and what evidence is required will become clearer, and it is hoped that a Practice Note will be issued to give guidance to taxpayers.

Africa Regional

Liaison with other authorities

Although customs and income tax are under the same authoritative body, they are administered by separate departments within the TRA and there is limited direct sharing of information between the two. However, it is likely that this practice of limited information sharing will change in the future. The recent introduction of the mandatory Electronic Fiscal Devices (EFDs) reporting taxpayers' transactions directly into the TRA database may boost the information-sharing process and provide TRA with more accurate information.

OECD issues

The TRA has indicated that it will follow OECD and UN transfer pricing guidelines.

Joint investigations

The TRA has not teamed up with any other tax authorities for the purpose of undertaking a joint investigation into transfer pricing. On rare occasions, it has taken advantage of the information-sharing provisions in double tax agreements.

Thin capitalisation

Prior to July 2010, section 12 of the Tanzanian Income Tax Act provided for a deferral of interest deductions in certain cases, including where a resident entity is held at least 25% by a non-resident. In such circumstances, the total amount that could be deducted in respect of interest incurred during the year was limited to the sum of:

- taxable interest income derived during the year, and
- 70% of the entity's total taxable income for the year, excluding interest income and expenses.

Any interest for which a deduction was denied could be carried forward to the next year of income.

From July 2010, this deferral provision was repealed and replaced by a thin capitalisation rule which provides that the interest deduction may not exceed the sum of interest equivalent to a debt-to-equity ratio of 7:3 (or 2.33 to 1).

The Tanzanian Finance Act 2012/13 added provisions to define debt as “any debt obligation excluding a non-interest bearing debt obligation, a debt owed to a resident financial institution and a debt obligation owed to a non resident financial institution on whose interest tax is withheld” and, equity as “(i) paid up share capital, (ii) paid up share premium, (iii) retained earnings on an unconsolidated basis determined in accordance with generally accepted accounting principles”. There are still some concerns about the non-exclusion of financial institutions. An additional practical difficulty is in the case where during the year there are changes in the debt and equity values. In such cases, in order to arrive at the values for thin-capitalisation calculation purposes, the debt and equity values are to be averaged on a monthly basis.

Uganda

Introduction

Prior to July 2011, transfer pricing was an abstract area in the tax legislation of Uganda. However, Section 90 of the Ugandan Income Tax Act, Chapter 340 has historically contained a general anti avoidance provision, to the effect that transactions

between associates must be conducted at arm's length. With the introduction of transfer pricing regulations in the 2011/12 budget statement, transfer pricing has become a reality and taxpayers have become more vigilant about transfer pricing and seek to remain compliant with the documentation requirements which were introduced by the regulations.

Statutory rules

Section 90 of the Ugandan Income Tax Act provides that in any transaction between taxpayers who are associates or who are in an employment relationship, the Commissioner General may distribute, apportion, or allocate income, deductions or credits between the taxpayers as is necessary to reflect the chargeable income the taxpayers would have realised in an arm's-length transaction. The relevant section also includes the transfer or license of intangible property between associates.

The Income Tax (transfer pricing) Regulations, 2011 were introduced under Sections 90 and 164 of the Ugandan Income Tax Act. The regulations apply to controlled transactions between associates, one of whom must be located in and subject to tax in Uganda. The term associate is not specifically defined in the regulations, however the regulations make reference to the definition contained elsewhere in the Ugandan Income Tax Act. Section 3 of the Ugandan Income Tax Act broadly defines an associate to include a company which controls 50% or more of the voting power in another company. The regulations are based on the Organisation for Economic Co-operation and Development (OECD) Guidelines and broadly set out the comparability factors to be considered, the recommended transfer pricing methods, application of the OECD methods, consistency with the arm's-length principle and documentation.

In line with the requirement to maintain documentation contained in the transfer pricing regulations, the Practice Note issued by the URA in May 2012 clarifies what is expected of taxpayers when preparing transfer pricing documentation. Some of the documentation requirements include:

- Company details, including ownership and organizational structure, operational aspects of the organisation etc.
- Details of transactions with related parties.
- How the arm's-length price has been determined, including a description of the method selected, functional analysis of the risks performed.
- Summary and conclusion as to whether the related party transactions comply with the arm's-length principle.

Whilst there is no requirement to submit the transfer pricing documentation to the URA, taxpayers must have the documentation in place prior to the due date for filing of the final income tax return for a given year of income.

Controlled foreign companies

The concept of controlled foreign companies is not a feature of Ugandan Income Tax law, and Uganda does not have any rules that would deem a foreign company controlled by Ugandan residents to be resident for transfer pricing purposes.

Other regulations

Companies are required to disclose all transactions with related parties under IAS 24. The wide definition of 'related parties' in IAS 24 ensures that financial statements

Africa Regional

prepared in accordance with IFRS will provide the URA with information concerning related party transactions, and this will likely be the starting point for URA enquiries into transfer pricing.

Legal cases

As at September 2012, the premier transfer pricing case between the URA and one of the multinational enterprises in Uganda is yet to be settled.

Burden of proof

In Uganda, the burden of proof with respect to transfer pricing is on the taxpayer to demonstrate that transactions were carried out at arm's length and that the chosen transfer pricing method is appropriate to the company's circumstances. In the event that the URA disagrees with the treatment accorded by the taxpayer to related party transactions, the Commissioner General would likewise have to demonstrate the inappropriateness of the taxpayer's method.

Tax audit procedures

The regulations do not specify the audit procedures to be taken in respect of transfer pricing. Generally, the URA's approach is to disallow expenses and then leave it up to the taxpayers to demonstrate the business case for claiming a deduction.

Resources available to the tax authorities

Currently, no specialist transfer pricing unit has been established within the Domestic Taxes Department of the URA. Transfer pricing audits are carried out by the domestic taxes team as part of the wider tax corporate tax audits and technical enquiries into transfer pricing are passed on to the Investigations Unit for further investigation. Investment has been made in developing specialist expertise within the URA through training locally and abroad. Additionally, the URA is a member of the African Tax Administrators Forum, a technical body supported by the OECD.

Use and availability of comparable information

Use

The transfer pricing rules, which are based on the OECD Guidelines, are the basis for determining an acceptable transfer pricing methodology. Within the context of these rules and guidelines any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

Availability

Information on the performance of public companies in Uganda is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available. The URA generally accepts the use of financial databases used elsewhere in the world.

Risk transactions or industries

In general, all multinationals are at risk of transfer pricing investigations. Additionally, as Uganda also has domestic transfer pricing, companies that engage in domestic transactions with related parties, whose value exceeds approximately 200,000 United States dollars per annum are also at risk.

Competent authority

Little information is available on the process for competent authority claims. Experience suggests that the competent authority process has not been widely used in Uganda. The lack of experience means that competent authority claims or reliance on MAP to resolve disputes will be problematic.

Advance pricing agreements

The transfer pricing regulations have provision for advance pricing agreements although these have not yet been tested. However, it is anticipated that the conclusion of advance pricing agreements may span over a long period of time.

Anticipated developments in law and practice

The main anticipated change in the coming 12 months is the outcome of the premier transfer pricing case between the URA and a taxpayer.

Liaison with other authorities

The URA is on a general drive to improve its systems, and better cooperation between the various authorities is expected in the near future.

OECD issues

Uganda is not a member of the OECD, but does follow the OECD Guidelines and models.

Joint investigations

The URA has teamed with other tax authorities for the purposes of undertaking a joint investigation into transfer pricing.

Thin capitalisation

Thin capitalisation is covered in Section 89 of the Ugandan Income Tax Act. Thin capitalisation rules apply where a foreign-controlled resident company which is not a financial institution has a foreign debt-to-foreign equity ratio in excess of 2:1 at any time during a year of income.

An interest payment on that part of the loan that exceeds the permissible ratio of 2:1 is not deductible for tax purposes.

Thin capitalisation rules are typically designed to prevent erosion of the tax base through excessive interest deductions in the hands of companies that obtain financial assistance from non-resident affiliates.

Zambia

Introduction

Transfer pricing legislation was first introduced in Zambia in 1999 and was subsequently amended in 2001 and 2002. The scope of the transfer pricing provisions for Zambia is contained in sections 97A to 97D of the Zambian Income Tax Act 1966, read together with the Transfer Pricing Regulations 2000 (the Zambian Regulations), as well as the final draft Practice Note (the Zambian draft Practice Note) issued by the Zambia Revenue Authorities (ZRA). The enforcement of the legislation by the ZRA has, however, not been as rigorous as expected. Conversely, it would be difficult to mount

Africa Regional

a defence of ‘non-existence of transfer pricing legislation’ when the ZRA begins to actively police the legislation.

Statutory rules

Section 97A of the *Zambian Income Tax Act* introduces the arm’s-length principle. The *Income Tax (Transfer Pricing) Regulations 2000* also provide further definitions regarding the extent of application of the transfer pricing provisions contained in the *Zambian Income Tax Act*. In March 2005, the *Zambian draft Practice Note* was issued by the ZRA which provides detail on how the ZRA will apply the transfer pricing rules. As Zambia does not tax on a worldwide basis, the legislation aims to counter tax losses brought about by non-arm’s-length pricing. Furthermore, the transfer pricing legislation applies only in situations where the effect of the associated-party pricing is to understate *Zambian* profit or to overstate *Zambian* losses.

Zambia’s transfer pricing policy applies not only to cross-border transactions but also to transactions between *Zambian* taxpayer residents who are wholly and solely within the *Zambian* tax jurisdiction (i.e. domestic transactions). This is to ensure losses are not effectively shifted between taxpayers or between sources by applying non-arm’s-length pricing. In addition, the transfer pricing legislation applies to companies as well as partnerships and individuals.

Section 97A (2) of the *Zambian Income Tax Act* states that the provisions relating to transfer pricing apply:

“where actual conditions having being imposed instead of the arm’s-length conditions there is, except for this section, a reduction in the amount of income taken into account in computing the income of one of the associated persons referred to in subsection (1), in this section referred to as the first taxpayer, chargeable to tax for a charge year, in this section referred to as the income year”.

The phrase ‘actual conditions’ is defined in section 97A(1) of the *Zambian Income Tax Act* as “conditions made or imposed between any two associated persons in their commercial or financial relations”.

‘Associated persons’ is defined as in section 97 (C) of the *Zambian Income Tax Act* where one person associates with another if one of the following applies:

- One participates directly or indirectly in the management, control or capital of the other.
- The same persons participate directly or indirectly in the management, control or capital of both of them.

Amendments to the transfer pricing provisions of the Income Tax Act

The 2008 amendments to the transfer pricing provisions of the *Income Tax Act* introduced specific provisions applicable to the mining sector.

The new subsections 97A (13) to (17) of the *Zambian Income Tax Act* deal with transactions for the sale of base metals and precious metals or substance containing base metals or precious metals between associated parties. The subsections state that the price applicable should be the reference price that is aligned with prices on the

London Metal Exchange or any other metal exchanges approved by the Commissioner General or to the Metal Bulletin.

New provisions under the Mines and Minerals Development Act

The provisions of section 97A of the *Zambian Income Tax Act* have also been cross-referenced to the new *Mines and Minerals Development Act* in determining arm's-length gross value and the norm value of minerals for the purposes of determining the mineral royalty payable to the government by mining companies.

Amendments to the Property Transfer Act

The *Property Transfer Tax Act* has also been amended and makes a direct reference to section 97A of the *Zambian Income Tax Act* for the purposes of determining the realised value for shares transferred.

Final draft Practice Note

The *Zambian draft Practice Note* states that in relation to a body corporate, one participates directly in the management, control or capital of the body corporate if they have 'control' over the body corporate. 'Control' means the power of a person to secure that the affairs of the body corporate are conducted in accordance with the wishes of that person. Such power would be derived from shareholding or other powers conferred by the constitutional documents of the body corporate.

The *Zambian draft Practice Note* states that a person indirectly participates in a second-person corporate if the first person would be a direct participant (hereinafter referred to as the potential participant) due to:

- rights and powers that the potential participant, at a future date, is entitled to acquire or will become entitled to acquire
- rights and powers that are, or may be required, to be exercised on behalf of, under the direction of, or for the benefit of the potential participant
- where a loan has been made by one person to another, not confined to rights and powers conferred in relation to the property of the borrower by the terms of any security relating to the loan
- rights and powers of any person with whom the potential participant is connected, and
- rights and powers that would be attributed to another person with whom the potential participant is connected if that person were himself the potential participant.

The *draft Zambian Practice Note* further includes in its definition of 'indirect participation' joint ventures that are able to use non-arm's-length prices to shift profits overseas for their mutual benefit. The rules apply only to transactions between at least one of the joint-venture parties (referred to as the major participant) and the joint venture itself and not between two joint ventures unless they are under common control.

The *Zambian draft Practice Note* states that although section 97A–97D of the *Zambian Income Tax Act* are inapplicable to transactions between branches and their head offices, the provisions are applicable to transactions between a *Zambian branch* of an overseas head office and associated companies of the overseas head office (wherever resident) or overseas branches of a *Zambian head office* and a person associated to the *Zambian head office* wherever located. Section 97C (3) of the *Zambian Income*

Africa Regional

Tax Act states that conditions are taken to be imposed by an arrangement or series of arrangements, or agreement or series of agreements. The definition is wide and includes:

- Transactions, understandings and mutual practices.
- An arrangement or agreement whether it is intended to be legally enforceable.

Further, the arrangement or agreement or series of arrangements or agreements may not have to take place between two related parties (e.g. ‘thinly capitalised’ taxpayers paying interest to third parties under finance arrangements guaranteed by associates). Section 97AA of the Zambian Income Tax Act is more specifically aimed at thin capitalisation and is discussed in more detail below.

Financial arrangements extend to interest, discounts and other payments for the use of money, whether these are receivable or payable by the person under review.

Controlled foreign companies

Zambia does not currently have controlled foreign company legislation.

Other regulations

Penalties and interest

If the ZRA makes a legitimate and reasonable request in relation to a tax return that has been submitted, or should have been submitted, a taxpayer may be exposed to the risk of penalties if the primary records, tax adjustment records, or records of transactions with associated entities are not made available. In addition, the taxpayer may be exposed to further risk if no evidence is made available within a reasonable time to demonstrate appropriate arm’s-length results of transactions to which transfer pricing rules apply or if the evidence made available by the taxpayer is not a reasonable attempt to demonstrate an arm’s-length result.

When considering whether a reasonable attempt has been made to demonstrate an arm’s-length result, the ZRA observes the same principles of risk assessment that it observes when considering whether to initiate a transfer pricing enquiry (i.e. the ZRA would expect a taxpayer acting reasonably to go to greater lengths in relation to making records and evidence available where risks are higher than it would where the risks are lower).

In terms of the general penal provisions, section 98 of the Zambian Income Tax Act, the Commissioner-General of the ZRA may levy a fine not exceeding 10,000 penalty units⁴ or subject the taxpayer to imprisonment for a term not exceeding 12 months, or may levy and subject the taxpayer to both the fine and imprisonment. Further, under section 100 of the Zambian Income Tax Act, a penalty for an incorrect return may be levied on the amount of income understated or expenses overstated. The penalty charged on the amount of income understated or expenses overstated may be levied at 17.5% in the event of negligence, 35% in the event of wilful default and 52.5% in the event of fraud. In addition, the late payment of tax is subject to a penalty of 5% per month or part thereof from the payment due date. Interest is also levied on the outstanding tax payable amount at the Bank of Zambia discount rate plus 2% (currently this interest is approximately 11% per annum).

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⁴ One penalty unit equates to Kwacha 180

Documentation

The Zambian draft Practice Note states that the following records should be kept to avoid exposure to penalties:

- Primary accounting records.
- Tax adjustment records.
- Records of transactions with associated businesses.

Legal cases

PwC is not aware of any court cases on this issue as yet.

Burden of proof

In accordance with section 97C of the Zambian Income Tax Act, the burden of proof lies with the taxpayer to demonstrate that the transfer pricing policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's-length standard.

Furthermore, as per the Zambian draft Practice Note, the ZRA considers that as a step towards discharging the burden of proof, it is in the taxpayer's best interests to:

- a. develop and apply an appropriate transfer pricing policy
- b. determine the arm's-length conditions as required by section 97A of the Zambian Income Tax Act
- c. Maintain contemporaneous documentation to support the policy and the arm's-length conditions in (a) and (b) above, and
- d. voluntarily produce the documentation when asked.

Tax audit procedures

As per the Zambian draft Practice Note, the ZRA has adopted the arm's-length principle and refers to the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in conducting a transfer pricing investigation. All multinational enterprises are potential targets. The ZRA follows no specific procedure when conducting a tax audit; generally, the company is notified and requested to provide supporting documentation. The ZRA prefers that the company under enquiry also provide the comparables. The ZRA then looks at the information provided and the comparables and negotiates accordingly.

Resources available to the tax authorities

The Domestic Taxes Department within the ZRA is responsible for conducting corporate tax enquiries. There has been no move yet towards the establishment of a specialist unit for conducting transfer pricing audits. However, investment has been made in developing specialist expertise within the ZRA through training locally and abroad (i.e. in the United Kingdom, Australia and South Africa).

Use and availability of comparable information

Use

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Therefore (within the context of the OECD Guidelines), any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

Africa Regional

Note, however, that the ZRA does prefer comparable information to be in respect of Zambian companies with the view that inter alia the companies will be operating under the same economic circumstances.

Availability

Information on the performance of public companies in Zambia is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available publicly. Consequently, a search for comparables in Zambia is more often than not a futile exercise.

As per the Zambian draft Practice Note, the ZRA accepts the use of foreign comparables, such as data from the United Kingdom, the United States and Australian markets. However, taxpayers using this approach are required to adjust for the expected effect on the price due to geographic and other differences in the Zambian market.

The South African Revenue Services uses the Orbis database (previously Amadeus) to conduct comparable studies, relying largely on European companies for comparability. It is envisaged that the Commissioner General of the ZRA will also follow this approach.

The ZRA does not have access to the Amadeus or Orbis database nor does it have access to any similar database. The ZRA prefers for the company under enquiry to provide comparables and, if possible, those comparables should be with other similar companies in Zambia.

Risk transactions or industries

There is no indication at present that certain types of transactions or that multinationals operating in particular industries are at higher risk of investigation than others. All multinationals are considered to be at a high risk of investigation.

Note that the particular transactions that the ZRA may examine are management and technical assistance fees, royalties and purchases of trading goods.

Competent authority

Lack of experience coupled with potentially difficult administrations in wider Africa means that competent authority claims or reliance on MAP to resolve disputes is problematic.

Advance pricing agreements

As per the Zambian draft Practice Note, the ZRA does not currently intend to adopt an advance pricing agreement procedure, but will keep this decision under review as taxpayers and the ZRA gain transfer pricing experience.

Anticipated developments in law and practice

It is not foreseen that significant further laws or amendments will be introduced to transfer pricing legislation in the near future. It is however important to note that in terms of the Zambian draft Practice Note, Zambia fully adopts the principles laid in the OECD Guidelines. Consequently, any changes to the OECD Guidelines will be relevant to and adopted in Zambia.

Liaison with other authorities

As the ZRA applies the OECD Guidelines on transfer pricing as the basis for determining acceptable transfer pricing methodology, it is envisaged that the ZRA will work closely with the OECD. When conducting an investigation, the ZRA may liaise with the foreign revenue authority of the foreign company involved in the related party transaction. The ZRA may further seek advice and guidance from the revenue authorities in the United Kingdom and Australia.

OECD issues

Zambia is not a member of the OECD, but enjoys observer status and does follow the OECD Guidelines and models.

Joint investigations

It is possible for the ZRA to join with the authorities of South Africa or any other country to jointly investigate a multinational group.

Thin capitalisation

Thin capitalisation is dealt with primarily by section 97A and 97AA of the Zambian Income Tax Act. Guidance on thin capitalisation and the charging of excessive interest is provided in the Zambian draft Practice Note.

Thin capitalisation commonly arises where a company is funded by another company in the same group or by a third party, such as a bank, but with guarantees or other forms of comfort provided to the lender by another group company or companies (typically the foreign parent company).

The ZRA seeks to establish the terms and conditions that a third-party lender would have required if it had been asked to lend funds to the borrower. This involves the consideration of, for example, the type of business; the purpose of the loan; the debt-to-equity ratio of the borrower; the income cover, profits cover or cash-flow cover; and any additional security available. This list is not exhaustive; the governing factor is what would have been considered arm's length.

If the borrowing under consideration would not have been made at arm's length on the terms that were actually applied, the ZRA may seek to adjust those terms to those that would have been applied at arm's length. This may involve the adjustment of the rate of interest payable, the amount of the loan and any other terms of the loan that would not be found in an arm's-length borrowing. Furthermore, the ZRA may limit the interest deduction on interest actually incurred to that which a Zambian borrower would have incurred at arm's length.

Section 97AA of the Zambian Income Tax Act makes provision for determining the arm's-length conditions when the actual conditions include the issue of a security.

12.

Argentina

Introduction

Argentine transfer pricing regulations have existed, in some form, since 1932. Prior to 1998, the rules focused on the export and import of goods through application of the wholesale price method, comparing the price of imports and exports with the wholesale price of comparable products in the markets of origin or destination. This methodology was applied unless the parties to the transaction could demonstrate that they were not related parties (Article 8 of the Income Tax Law).

Article 14 of the Income Tax Law reflected the need for all transactions to comply with the arm's-length standard:

“Transactions between a local enterprise of foreign capital and the individual or legal entity domiciled abroad that either directly or indirectly control such enterprise shall, for all purposes, be deemed to have been entered into by independent parties, provided that the terms and conditions of such transactions are consistent with normal market practices between independent entities, with limits to loans and technical assistance.”

However, the rules did not include any methodologies for supporting inter-company transactions or outline any documentation requirements.

On 30 December 1998, pursuant to Law 25,063, Argentina adopted general guidelines and standards set forth by the Organisation for Economic Co-operation and Development (OECD), including the arm's-length standard, and applied it to tax years ending on or after 31 December 1998. With the adoption of the OECD standards, the computation of a taxpayer's income tax liability, including provisions governing the selection of appropriate transfer pricing methodologies for transactions between related parties, could be impacted.

On 31 December 1999, Law 25,063 was updated with Law 25,239, which introduced the special tax return and documentation requirements in relation to inter-company transactions. Under the transfer pricing reform process, the old wholesale price method was only applicable to transactions involving imports or exports of goods between unrelated parties.

On 22 October 2003, Law 25,784 introduced certain amendments to the Income Tax Law that affected transfer pricing regulations. One of the amendments related to one of the points of an anti-evasion programme, with one of its objectives being to control evasion and avoidance in international operations resulting from globalisation. On the one hand, Law 25,784 replaces regulations on the import and export of goods with related and unrelated parties (replacement of Article 8 of the Income Tax Law), eliminating the concept of wholesale price at the point of destination or origin as

a parameter for comparison. Now, in the case of imports or exports of goods with international prices known through commonly traded markets, stock exchanges, or similar markets, the new parameter establishes that those prices will be used to determine net income. On the other hand, a new transfer pricing method is introduced for the analysis of exports of commodities (amendments to Article 15 of the Income Tax Law).

Taxpayers currently have two important transfer pricing-related obligations: to prepare, maintain and file transfer pricing documentation; and to file an information return (special tax return) on transactions with non-resident-related parties. In addition, taxpayers are required to maintain some documentation on import or export of goods between unrelated parties.

On 14 November 2003, Law 25,795 was published in the Official Gazette (modifying Procedural Law 11,683), establishing significant penalties for failure to comply with transfer pricing requirements.

It is important to note that tax authorities are currently conducting an aggressive audit programme, including a number of transfer pricing audits that are under way.

Statutory rules

Effective 31 December 1998, Argentine taxpayers must be able to demonstrate that their transactions with related parties outside of Argentina are conducted at arm's length. Transfer pricing rules are applicable to all types of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions, and licensing of intangible property). Under Argentine legislation, there is no materiality factor applicable, and all transactions must be supported and documented.

Transfer pricing rules apply to:

- taxpayers who carry out transactions with related parties organised, domiciled, located, or placed abroad and who are encompassed by the provisions of Article 69 of the Income Tax Law, 1997 revised text, as amended (mainly local corporations and local branches, other types of companies, associations or partnership) or the addendum to Clause D of Article 49 of the Income Tax Law (trusts or similar entities)
- taxpayers who carry out transactions with individuals or legal entities domiciled, organised, or located in countries with low or no taxation, whether related or not
- taxpayers resident in Argentina, who carry out transactions with permanent establishments abroad that they own, and
- taxpayers resident in Argentina who are owners of permanent establishments located abroad, for transactions carried out by the latter with related parties domiciled, organised, or located abroad, under the provisions of Articles 129 and 130 of the Income Tax Law.

Related parties

The definition of related party under Argentine transfer pricing rules is rather broad. The following forms of economic relationship are covered:

- One party that owns all or a majority of the capital of another.

Argentina

- Two or more parties that share: (a) one common party that possesses all or a majority of the capital of each, (b) one common party that possesses all or a majority of the capital of one or more parties and possesses significant influence over the other or others, and (c) one common party that possesses significant influence over the other parties.
- One party that possesses the votes necessary to control another.
- One or more parties that maintain common directors, officers, or managers/administrators.
- One party that enjoys exclusivity as agent, distributor, or licensee with respect to the purchase and sale of goods, services, and intangible rights of another.
- One party that provides the technological/intangible property or technical know-how that constitutes the primary basis of another party's business.
- One party that participates with another in associations without a separate legal existence pursuant to which such party maintains significant influence over the determination of prices.
- One party that agrees to preferential contractual terms with another that differs from those that would have been agreed to between third parties in similar circumstances, including (but not limited to) volume discounts, financing terms, and consignment delivery.
- One party that participates significantly in the establishment of the policies of another relating to general business activities, raw materials acquisition, and production/marketing of products.
- One party that develops an activity of importance solely in relationship to another party, or the existence of which is justified solely in relationship to such other party (e.g. sole supplier or customer).
- One party that provides a substantial portion of the financing necessary for the development of the commercial activities of another, including the granting of guarantees of whatever type in the case of third party financing.
- One party that assumes responsibility for the losses or expenses of another.
- The directors, officers, or managers/administrators of one party who receive instructions from or act in the interest of another party.
- The management of a company is granted to a subject (via contract, circumstances, or situations) who maintains a minority interest in the capital of such company.

Methodology

For the export and import of goods between unrelated parties, the international price is applicable. In the event the international price cannot be determined or is not available, the taxpayer (the exporter or importer of the goods) must provide the tax authorities with any information available to confirm whether such transactions between unrelated entities have been carried out applying reasonable market prices (Article 8 of the Income Tax Law).

For related party transactions, both transactional and profit-based methods are acceptable in Argentina. Article 15 of the Income Tax Law specifies five transfer pricing methods. An additional method has been established dealing with specific transactions.

- Comparable uncontrolled price method (CUP).
- Resale price method (RPM).
- Cost plus method (CP).
- Profit split method (PSM).
- Transactional net margin method (TNMM).

- Specific method for export transactions involving grain, oilseed, and other crops, petroleum and their derivatives and, in general, goods with a known price in transparent markets.

This last method will only be applied when: (1) the export is made to a related party, (2) the goods are publicly quoted on transparent markets, and (3) there is participation by an international intermediary that is not the actual receiver of the goods being sold.

It should be noted that this method will not be applicable when the international intermediary complies with all the following conditions:

- Actual existence in the place of domicile (possessing a commercial establishment where its business is administered, complying with legal requirements for incorporation and registration, as well as for the filing of financial statements).
- Its main activity should not consist of the obtaining of passive incomes or acting as an intermediary in the sale of goods to and from Argentina or other members of its economic group.
- Its foreign trade transactions with other members of the group must not exceed 30% of the annual total of its international trading transactions.

The method consists of the application of the market price for the goods being exported on the date the goods are loaded. This applies regardless of the type of transport used for the transaction and the price that may have been agreed with the intermediary, unless the price agreed with the latter were to be higher than that determined to be the known price for the good on the date of loading. In such a case, the higher of the two prices should be used to determine the profit of Argentine source.

Under the above-mentioned circumstances, the Argentine tax authorities disregard the date of transaction for these types of operations and consider the date of loading, assuming the date of the transactions could be manipulated by the related parties. In addition, they apply the same methodology even when the foreign intermediary was an unrelated party.

Best method rule

There is no specific priority of methods. Instead, each transaction or group of transactions must be analysed separately to ascertain the most appropriate of the five methods to be applied (i.e. the best method must be selected in each case). The transfer pricing regulations provide that in determining the best method to apply in a given circumstance, consideration will be given to:

- the method that is most compatible with the business and commercial structure of the taxpayer
- the method that relies upon the best quality/quantity of information available
- the method that relies upon the highest level of comparability between related and unrelated party transactions, and
- the method that requires the least level of adjustments in order to eliminate differences existing between the transaction at issue and comparable transactions.

Tested party

The regulations established by the tax authority have stated that the analysis of the comparability and justification of prices – when applying the methods of Article 15 – must be made based on the situation of the local taxpayer.

Argentina

Documentation requirements

The Argentine income tax law requires that the *Administración Federal de Ingresos Públicos* (AFIP) promulgate regulations requiring the documentation of the arm's-length nature of transactions entered into with related parties outside of Argentina. In this regard, the transfer pricing regulations require that taxpayers prepare and file a special tax return detailing their transactions with related parties. These returns must be filed along with the taxpayer's corporate income tax return.

In addition to filing the special tax return, the Argentine transfer pricing regulations require that taxpayers maintain certain contemporaneous supporting documentation (i.e., such documentation must exist as of the filing date of the special tax return). This requirement was applicable to fiscal years 1999 up to fiscal year ended on 30 November 2000.

However, on 31 October 2001, the AFIP issued new regulations regarding information and documentation requirements. This required certain contemporaneous documentation be filed and submitted together with the special tax return. This applies to periods ending on or after 31 December 2000.

Other regulations

Information returns

Import and export transactions between unrelated parties:

- Requirements have been established for information and documentation regarding import and export of goods between unrelated parties (Article 8 of the Income Tax Law) covering international prices known through commonly traded markets, stock exchanges or similar markets, which will be used to determine the net income. A semi-annual tax return must be filed in each half of the fiscal year (Form 741).
- In the case of import and export transactions of goods between unrelated parties for which there is no known internationally quoted price, the tax authorities shall be able to request the information held in relation to cost allocation, profit margins, and other similar data to enable them to control such transactions, if they, altogether and for the fiscal year under analysis, exceed the amount of ARS 1 million. A yearly tax return must be filed for those import and export of goods between unrelated parties for which there is no known internationally quoted price (Form 867).
- In cases of transactions with parties located in countries with low or no taxation, the methods established in Article 15 of the law must be used, and it will be necessary to comply with the documentation requirements described for the transactions covered by transfer pricing rules. The obligation to document and preserve the vouchers and elements that justify the prices agreed with independent parties is laid down, and minimum documentation requirements are established.

Compliance requirements for related party transactions:

- Six-month tax return, for the first half of each fiscal period (Form 742).
- Complementary annual tax return covering the entire fiscal year (Form 743). The return and any appendices must be signed by the taxpayer and by an independent public accountant whose signature must be authenticated by the corresponding professional body. This tax return must be accompanied by both:

- a report containing the information detailed below
- a copy of the financial statements of the taxpayer for the fiscal year being reported.

Additionally, financial statements for the previous two years must be attached to the first tax return presentation.

Contents of the report

- Activities and functions performed by the taxpayer.
- Risks borne and assets used by the taxpayer in carrying out such activities and functions.
- Detail of elements, documentation, circumstances, and events taken into account for the analysis or transfer price study.
- Detail and quantification of transactions performed and covered by this general resolution.
- Identification of the foreign parties with which the transactions being declared are carried out.
- Method used to justify transfer prices, indicating the reasons and grounds for considering them to be the best method for the transaction involved.
- Identification of each of the comparables selected for the justification of the transfer prices.
- Identification of the sources of information used to obtain such comparables.
- Detail of the comparables selected that were discarded, with an indication of the reasons considered.
- Detail, quantification, and methodology used for any necessary adjustments to the selected comparables.
- Determination of the median and the interquartile range.
- Transcription of the income statement of the comparable parties corresponding to the fiscal years necessary for the comparability analysis, with an indication as to the source of the information.
- Description of the business activity and features of the business of comparable companies.
- Conclusions reached.

On 15 June 2011, the Official Gazette published General Resolution No. 3132, amending General Resolution No. 1122/01. This new resolution establishes the obligation for taxpayers to submit a new complementary tax return (F. 969) that includes detailed information about international transactions performed during the fiscal year with related companies located abroad or in countries of low or no taxation. This obligation applies to the companies' fiscal year endings from 31 December 2010.

The due date for the submission of F. 969 will operate 15 days immediately after the due date for filing the income tax return.

General due dates		
Form	Period	Due date
741	First six months of fiscal year	Fifth month following the end of the half-year
741	Second six months of fiscal year	General due date for filing income tax return
867	Full fiscal year	Seventh month following the end of the fiscal year
742	First six months of fiscal year	Fifth month following the end of the half-year

Argentina

General due dates

Form	Period	Due date
743	Full fiscal year	Eighth month following the end of the fiscal year
969	Full fiscal year	Fifteen days immediately after the due date for filing the income tax return

Legal cases

Since the tax reform introduced in 1998, several cases have been and are currently being discussed before the courts. It is expected that the tax courts will address several issues related to transfer pricing in the coming years. Following are summaries of some of the transfer pricing court cases.

S.A. SIA

The Supreme Court applied Article 8 for the first time in the S.A. SIA, decided on 6 September 1967. The taxpayer, a corporation resident in Argentina, had exported horses to Peru, Venezuela, and the United States. It was stated in the corporation's tax return that these transactions had generated losses because the selling price had been lower than the costs. The tax authority decided to monitor such transactions under the export and import clause, that is according to the wholesale price at the place of destination. The tax authority concluded that, contrary to what had been argued by the taxpayer, such transactions should generate profits. It based this statement on foreign magazines on the horse business, which explicitly referred to the horses of the taxpayer and the transactions involved in this case.

The Supreme Court maintained that because the evidence on which the tax authority based its argument was not disproved by the taxpayer, it had to be deemed that they correctly reflected the wholesale price of the horses. As a result, the adjustment was considered valid.

Eduardo Loussinian S.A.

Loussinian S.A. was a company resident in Argentina that was engaged in importing and distributing rubber and latex. It concluded a supply contract with a non-resident subsidiary of a foreign multinational. Under this contract, the parent of the multinational group, ACLI International Incorporated (ACLI), would provide Loussinian such goods from early January 1974 up to the end of 1975.

After the contract was agreed, the international market price of rubber and latex fell substantially. However, Loussinian kept importing the goods from ACLI despite the losses. The tax authority argued that there was overcharging under the contract and that Article 8 should be applied in this case. As a result, it considered that the difference between the wholesale price of the goods at the place of origin and the price agreed on the contract was income sourced in Argentina that Loussinian should have withheld when it made the payments to ACLI. Both the tax court and the court of appeals upheld the tax authority decision.

The Supreme Court said that despite the fact that the purchasing price was higher than the wholesale price, the latter could not be applied to this case to determine the income sourced in Argentina. This was because it considered that Loussinian had rebutted the presumption under which both parties had to be deemed associated due to this gap between prices.

Laboratorios Bagó S.A.

On 16 November 2006, the members of Panel B of the National Fiscal Court (NFC) issued a ruling in the case *Laboratorios Bagó S.A. on appeal – Income Tax*. The matter under appeal was the taxpayer's position to an official assessment of the income tax for the fiscal years 1997 and 1998.

Even though the current transfer pricing legislation was not in force during those periods (wholesale price method was applicable in 1997 and 1998), the case was closely related to that legislation. Specifically, the ruling addressed issues such as (1) comparability of selected companies, (2) the use of secret comparables (non-public information) for the assessment of the taxpayer's obligation, and (3) the supporting evidence prepared by the tax authorities.

Laboratorios Bagó S.A., a pharmaceutical company based in Argentina, exported finished and semi-finished manufactured products to foreign subsidiaries. The tax audit was focused on the differences in prices between the markets involved, both international and domestic.

In this case, the taxpayer argued that, with regard to its export transactions, it only performed 'contract manufacturer' activities, focusing its efforts only on manufacturing. Foreign affiliates performed research and development, advertising, sales and marketing activities, among others.

The tax authorities first confirmed the lack of publicly known wholesale prices in the country of destination. Afterwards, they conducted a survey of other similar companies in Argentina, requesting segmented financial information on export transactions. The main purpose of that request was to obtain the profitability achieved by independent companies in the same industry.

Because the taxpayer's results were below the profitability average of independent companies, the tax authority adjusted the taxable basis for income tax purposes.

The ruling focused on four specific issues:

- Validity of the information obtained by the tax authority.
- Use of the so-called secret comparables.
- Nature of the adjustment performed by the tax authority.
- Evidence presented by the parties.

Matters such as comparability adjustments, the application of statistical measures like the interquartile range, and especially the definition of functions, assets, and risks, were mentioned in the ruling but were not material to the decision.

The analysis conducted by the tax authority contained conceptual mistakes that affected the comparability of the transactions (e.g. differences in volume of net sales as well as of export sales, verification of economic relationship or otherwise between the selected companies and their importers, unification of criterion for the different selected companies' allocation of financial information, among others).

It is also remarkable that in this case, the tax court accepted the use of secret comparables, being understood as information obtained by the tax authority through audits or other information gathering procedures.

Argentina

The taxpayer presented several scenarios and other related evidence that supported its current position.

Eventually, it was the evidence presented by the parties that allowed for the ruling in this case to be favourable to the taxpayer. Specifically, the tax court held in this case that under domestic law, the tax authority has a significant burden of proof when adjusting transfer prices. Because the tax authority did not offer enough evidence to support its position, the tax court ruled in favour to the taxpayer.

DaimlerChrysler Argentina

The case dealt with export transactions for the fiscal period 1998 (i.e. under the old transfer pricing methodology). The members of the Argentine tax court unanimously decided that Section 11 of the regulatory decree establishes a ‘different’ presumption where ‘once the business relationship has been proved’, the tax authorities may apply the wholesale price of the country of seller. However, the tax court clearly stated that it is not entitled to issue an opinion on the constitutionality of laws unless the Argentine Supreme Court of Justice had already issued an opinion. Additionally, from the decision of the tax court, we understand that there are elements to consider that the comparability standard is not the most appropriate standard for this case.

Based on that interpretation, the crucial element to be determined is whether the business relationship criteria applies to transactions between Mercedes Benz do Brasil, Mercedes Benz Argentina, and Daimler Benz AG. Quoting traditional case law, and considering the economic reality principle, the tax court ruled that wholesale prices effective in Argentina should be applied.

In terms of the price used in the assessment by the tax authorities, the discounts and rebates granted to local car dealers were important elements. The court adopted a formal approach in this case because it stated that the regulatory decree sets forth that the tax authorities can apply the wholesale price without taking into consideration the impact of the domestic market expenses. Thus, the tax court has not considered that prices in the domestic and foreign market can only be compared if an adjustment is made on the differences in the contractual terms, the business circumstances, functions, and assets and risks in either case. In this situation, the tax court has applied a price to a substantially different operation (and therefore non-comparable).

Volkswagen Argentina SA (Fiscal Year 1998)

The case was conceptually similar to DaimlerChrysler Argentina, with the exception that an independent third party acquired products of the local company (VWA), then sold them, once imported, to Volkswagen do Brasil (VWB).

The court’s analysis is based on the export contract executed between VWA and the third party. The court considered that certain clauses evidence the control that VWA and VWB exerted on the third party (i.e. purchase commitments, audit of the costs and expenses of the intermediary, assistance in the import process, among others). As such, the tax court concluded that the operations should be considered as having been conducted between related parties, even when the relationship was not economic, based on the principle of economic reality, according to which substance prevails over form.

The tax court believes that the administrative court ignored Article 8 and applied Section 11 of the regulatory decree without giving any reason for not applying the

wholesale prices in the country of destination (Brazil) and applying that of the country of seller (Argentina). The procedure followed by the tax authorities would have been appropriate if it had proved why prices informed by the Brazilian tax authorities were not valid or if it had applied the provisions of Article 8 (i.e. the determination of the factors of results obtained by third parties conducting activities similar or identical to those of the taxpayer).

Volkswagen Argentina (Fiscal Year 1999) / Aventis Pharma (Fiscal Year 2000)

Even when the companies belong to different industries, there is a common issue related to the burden of proof when discussing transfer pricing issues. The National Tax Courts stated that both parties (taxpayer and the tax authorities) shall support their statements on the process and that the quality of the proof is relevant to both parties. The court considers that the Tax Authority has not proved its own position, which basically consists of discrediting comparability adjustments carried out by the taxpayers in the transfer pricing study.

For example, in case of a selected comparable company with operating losses, the impugnation made by the tax authority is rejected due to lack of a systematic investigation work, so that disqualification has something to be based on.

As a conclusion, the decision points out the importance of preparing and submitting the transfer pricing study because once the taxpayer has met the documentation requirements, the tax authorities shall demonstrate that the analysis performed by the taxpayer is incorrect.

Nobleza Piccardo

In this case, local tax authorities applied the CUP method to analyse the exports of manufactured products using what the tax authorities considered internal comparables (local sales to unrelated customers in a free trade zone). The taxpayer considered that those transactions were not comparable and applied a TNMM.

Again in this case, the National Tax Court considered that proof was a fundamental element to the final decision because the majority of the judges decided that no comparability was observed in the transactions used by the tax authorities as internal comparables.

Alfred C. Toepfer Internacional

This decision, favourable to the tax authorities, remarks the importance of the 'certain date' of the transactions when dealing with products with publicly known prices (commodities). In this case, as the taxpayer was not able to prove the certain date of the transaction, the tax authorities disregarded the prices applied by the taxpayer and compared the price of the exported products with the price at the moment of shipping the goods. It is important to mention that the Income Tax Law was modified in 2003 to include the position adopted by the tax authorities, but the transactions under discussions referred to fiscal year before the law amendment.

Burden of proof

The general rule is that the taxpayer has the burden of proof, as it is obligated to file a report with certain information related to transfer pricing regulations together with the income tax return. If the taxpayer has submitted proper documentation, the

Argentina

AFIP must demonstrate why the taxpayer's transfer prices are not arm's length and propose an amount of transfer pricing adjustment in order to challenge the transfer prices of a taxpayer. Once the AFIP has proposed an alternative transfer pricing method and adjustment, it is up to the taxpayer to defend the arm's-length nature of its transfer prices.

Tax audit procedures

Selection of companies for audit

The AFIP has a specialised group that performs transfer pricing examinations. This group is part of the *División de Grandes Contribuyentes*, a division of the AFIP that deals with the largest taxpayers. At present, the Argentine tax authorities investigate transfer pricing issues under four main categories:

- In the course of a normal tax audit.
- Companies that undertake transactions with companies located in tax havens.
- Companies that registered any technical assistance agreement or trademark or brand name licence agreement with the National Industrial Property Institute.
- Specific industrial sectors such as the automotive, grain traders, oil and pharmaceutical industries.

Controversial issues include, among others, the use of multiple-year averages for comparables or, for the tested party, the application of extraordinary economic adjustments according to the particular situation of the country (e.g. extraordinary excess capacity, extraordinary discounts, and accounting recognition of extraordinary bad debts).

The audit procedure

The audit procedure must follow the general tax procedure governed by Law 11,683. Transfer pricing may be reviewed or investigated using regular procedures such as on-site examination or written requests. Written requests are the most likely form of audit.

During the examination, the tax authorities may request information and must be allowed access to the company's accounting records. All findings must be documented in writing, and witnesses might be required. In the course of the examination, the taxpayer is entitled to request information, and the audit may not be completed without providing the taxpayer a written statement of findings. Upon receipt of this document, the taxpayer is entitled to furnish proof and reasoning that must be taken into account for the final determination.

Reassessments and the appeals procedure

Additional assessments or penalties applied by the *Dirección General Impositiva* (DGI) may be appealed by the taxpayer within 15 working days of receipt of the notification of assessment. The appeal may be made to either the DGI or the tax tribunal. An unsuccessful appeal before one of these bodies cannot be followed by an appeal before the other, but an appeal before the competent courts of justice may be filed against the findings of either.

If appeal is made before the DGI or the tax tribunal, neither the amount of tax nor the penalty appealed against need be paid unless and until an adverse award is given. For an appeal to be made before the courts of justice, the amount of tax must first be paid (although not the penalties under appeal).

Overpayments of tax through mistakes of fact or law in regular tax returns filed by the taxpayer may be reclaimed through submission of a corrected return within five years of the year in which the original return was due. If repayment is contested by the DGI, the taxpayer may seek redress through either the tax tribunal or the courts of justice, but not both. Overpayments of tax arising from assessments determined by the DGI may be reclaimed only by action before the tax tribunal or the courts of justice. Upon claim for overpayments of tax, interest is accrued from the time when the claim is filed.

Additional tax and penalties

Law 25,795 increases existing penalties and introduces new penalties covering non-compliance by taxpayers in relation to international transactions, as follows:

- Omitted filing of informative tax returns regarding international import and export operations on an arm's-length basis will be penalised with a fine amounting to 1,500 Argentine pesos (ARS) (390 United States dollars [USD]) or ARS 10,000 (USD 2,590) in the case of entities owned by foreign persons. Failure to file returns for the remaining operations will be penalised with a fine of ARS 10,000 (USD 2,590) or ARS 20,000 (USD 5,180) in the case of entities belonging to foreign persons.
- A fine ranging between ARS 150 (USD 40) and ARS 45,000 (USD 11,700) will be set in the event of failure to file data required by AFIP for control of international operations and lack of supporting documentation for prices agreed in international operations.
- A fine ranging between ARS 500 (USD 130) and ARS 45,000 (USD 11,700) has been established for non-compliance with the requirements of AFIP on filing of informative returns corresponding to international operations and information regimes for owner or third party operations. Taxpayers earning gross annual income equal to or higher than ARS 10 million (USD 2.6 million) not observing the third requirements on control of international operations will be fined up to ARS 450,000 (USD 117,000), ten times the maximum fine.
- A fine on tax omission has been established between one and four times the tax not paid or withheld in connection with international operations. In addition, the taxpayer will be liable for interest, currently 2% per month of the additional tax due.

If the tax authorities consider that a taxpayer has manipulated its results intentionally, the fine can climb to 10 times the tax amount evaded, in addition to the penalties established by the Penal Tax Law 24,769. The tax authorities have the discretion to analyse the transfer pricing arrangement(s) by consideration of any relevant facts and application of any methodology they deem suitable.

Use and availability of comparable information

Availability of comparables

Comparable information is required to determine arm's-length prices and should be included in the taxpayer's transfer pricing documentation. Argentine companies are required to make their annual accounts publicly available by filing a copy with the local authority (e.g. *Inspección General de Justicia in Buenos Aires*). However, the accounts would not necessarily provide much information on potentially comparable transactions or operations because they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign comparables.

Argentina

The tax authorities have the power to use third parties' confidential information.

Use of comparables

To date, there have been several cases where the tax authorities have attempted to reject a taxpayer's selection or use of comparables. Any discussion in this context is focused on the comparability of independent companies, or its condition as independent. In this connection, the tax authority has requested additional information related to the final set of comparables.

Limitation of double taxation and competent authority procedure

Most of the tax treaties for the avoidance of double taxation concluded by Argentina include provisions for a mutual agreement procedure. In Argentina, a request to initiate the mutual agreement procedure should be filed with the Argentine Ministry of Economy. There are no specific provisions on the method or format for such a request.

No information is available on the number of requests made to the Ministry of Economy. It is understood that the competent authority procedure is not well used in Argentina, as there is no certainty for the taxpayer that the relevant authorities will reach an agreement.

Advance pricing agreements (APAs)

There are no provisions enabling taxpayers to agree on APAs with the tax authorities.

Anticipated developments in law and practice

Law

New transfer pricing rules are not expected in the near future.

Practice

The tax authorities are expected to become more aggressive and more skilled in the area of transfer pricing. Transfer pricing knowledge of the 'average' tax inspector is expected to increase significantly, as training improves and inspectors gain experience in transfer pricing audits.

As the number of audits increases, some of the main areas being examined include intercompany debt, technical services fees, commission payments, royalty payments, transfers of intangible property, and management fees.

Liaison with customs authorities

The DGI and the customs authority (*Dirección General de Aduanas*, or DGA) are both within the authority of the AFIP. Recent experience suggests that exchange of information between DGI and DGA does occur. Nevertheless, there is no prescribed approach for the use of certain information of one area in another area (e.g. transfer pricing analysis for customs purposes).

Recently, there has been a change in the customs legislation, and the information that must be provided to the DGA, in relation with foreign trade, is now required in an electronic form. As a result, DGI could have better and easier access to that information.

OECD issues

Argentina is not a member of the OECD. The tax authorities have generally adopted the arm's-length principle and use as guidance the methodologies endorsed by the OECD Guidelines for transfer pricing that give effect to the arm's-length standard.

Joint investigations

Even though there have been some requests for information from other tax authorities (e.g. Brazil) for specific transactions or companies, there is no regular procedure for joint investigations.

Thin capitalisation

The thin capitalisation rules are primarily focused on interest stemming from loans granted by foreign-related parties (entities having any type of direct or indirect control of the borrower). Interest will be deductible considering, at the year-end closing date, the total amount of the liability generating the interest (excluding any liability corresponding to interest whose deductibility is not conditioned) may not exceed two times the amount of the net worth at that date.

In such a circumstance, any excess interest that cannot be deducted will be treated as a dividend.

13.

Australia

Introduction

Australia's transfer pricing legislation was introduced with effect from 27 May 1981. Since this time, the Australian Taxation Office (ATO) has issued a series of major rulings and publications providing guidance in applying the legislation. The Australian Government commenced a review of Australia's transfer pricing legislation in 2011. The first stage of changes was enacted in September 2012, and further changes are expected to be introduced shortly.

The ATO is vigilant in policing taxpayers' compliance with Australia's transfer pricing rules and continues to work closely with tax authorities in other jurisdictions and international bodies (such as the Organisation for Economic Co-operation and Development [OECD]) to reduce double taxation, resolve transfer pricing disputes and share information. The views of the ATO are largely consistent with the views expressed by the OECD.

Statutory rules

Division 13 – Transfer pricing legislation

Division 13 of Part III of the Income Tax Assessment Act 1936 (ITAA 1936) (SS136AA to 136AF) contains Australia's domestic law dealing with transfer pricing. It is an anti-avoidance division aimed at countering international profit-shifting techniques. The division operates only at the discretion of the Commissioner of Taxation (the Commissioner) and only to increase the tax liability of a taxpayer.

Section 136AD deals with circumstances in which a taxpayer has 'supplied' or 'acquired' 'property' (all of these terms are widely defined in Section 136AA[1]) under an 'international agreement', as defined in Section 136AC. Section 136AD does not require that the parties to an international agreement be related. Section 136AD contains four subsections:

- Supplies of property for less than arm's-length consideration.
- Supplies of property for no consideration.
- Acquisition of property for excessive consideration.
- Determination of the arm's-length consideration in circumstances in which it is neither possible nor practicable to ascertain.

Section 136AE addresses international dealings between different parts of the same entity (e.g. dealings between a permanent establishment [branch office] and its head office, or between two permanent establishments of the same entity). The Commissioner is authorised to reallocate income and expenditure between the parties and thereby determine the source of income and the allocation of related expenses.

The ITAA does not impose a time limit for the Commissioner to make transfer pricing adjustments. Therefore, adjustments are technically possible commencing from 27 May 1981, being the date of effect of Division 13; although this would be highly unlikely in practice.

Double-tax agreements

The domestic legislation is supplemented by the provisions in Australia's double-tax agreements (DTAs), which appear as schedules to the Income Tax (International Agreements) Act 1953. The DTAs contain specific provisions which deal with profit-shifting arrangements, namely the Associated Enterprises and Business Profits Articles. These Articles are broadly similar to Division 13 in that they are based on the arm's-length principle. In the event that Division 13 and the DTA are inconsistent, the provisions of the DTA will prevail.

The ATO holds the view that the Associated Enterprises and Business Profits Articles of Australia's DTAs provide the Commissioner a separate power to make transfer pricing assessments independently of Division 13. While obiter dicta comments in the recent SNF case provide some support for this position, it remains untested as to whether the relevant Articles of Australia's DTAs provide a separate power to assess. However, with the recent introduction of retrospective legislation that inserts language consistent with the Associated Enterprises article within Australia's domestic legislation (Subdivision 815-A; *see below*), and the likely introduction of similar language in new prospective transfer pricing legislation, this particular debate may well become redundant in the context of transfer pricing assessments within Australia.

Subdivision 815-A

Subdivision 815-A of the Income Tax Assessment Act 1997 (ITAA 1997) was enacted in September 2012 with retrospective application to income years beginning on or after 1 July 2004. Subdivision 815-A applies to dealings between Australian taxpayers and related parties in countries with which Australia has a DTA in place. Subdivision 815-A was introduced to remove doubt over whether the Commissioner can make transfer pricing assessments based on the Associated Enterprises and Business Profits Articles of Australia's DTAs (*see above*), by introducing 'treaty-equivalent' transfer pricing rules into the domestic legislation. Subdivision 815-A applies to dealings between Australian resident taxpayers and related parties in DTA countries and to Australian permanent establishments of foreign residents of DTA countries.

The Commissioner can make a determination under Subdivision 815-A when an Australian taxpayer has received a 'transfer pricing benefit' in relation to dealings with a related party in a DTA country. A 'transfer pricing benefit' is defined by reference to the relevant Associated Enterprises or Business Profits DTA Article. These Articles typically refer to the profits that have accrued to the parties, so a 'transfer pricing benefit' for the purposes of Subdivision 815-A will arise where the Australian taxpayer's actual profits are less than the profits it would have accrued if it had been dealing wholly independently with its related party. The Commissioner must have regard to relevant OECD guidance (including the Transfer Pricing Guidelines and Model Tax Convention) when assessing whether a transfer pricing benefit has arisen.

Subdivision 815-A also contains specific rules on the interaction of Australia's transfer pricing and thin capitalisation rules, which give legislative effect to the position taken by the Commissioner in a Taxation Ruling issued on this topic (TR 2010/7; *see Thin capitalisation section below*).

Australia

Minerals Resource Rent Tax

The Australian Federal Government has introduced a profits-based tax on the economic rents from the extraction of coal and iron ore in Australia. A key component of the Minerals Resource Rent Tax (MRRT) requires the application of generally accepted transfer pricing principles, albeit in a domestic context, to identify the value of the mineral at the MRRT taxing point. The MRRT regime commenced from 1 July 2012.

Other regulations

Taxation rulings

In addition to the statutory rules referred to above, the ATO has issued various public rulings concerning transfer pricing. These both interpret the application of the statutory rules and provide guidance on other issues not specifically covered by statute.

The taxation rulings issued to date, of relevance to transfer pricing, include:

- Loan arrangements and credit balances – Taxation Ruling TR 92/11.
- Basic concepts underlying the operation of Division 13 – Taxation Ruling TR 94/14.
- Arm's-length transfer pricing methodologies – Taxation Ruling TR 97/20.
- Documentation and practical issues associated with setting and reviewing transfer pricing – Taxation Ruling TR 98/11.
- Penalty tax guidelines – Taxation Ruling TR 98/16.
- Intra-group services – Taxation Ruling TR 1999/1.
- Transfer pricing and profit reallocation adjustments, relief from double taxation and Mutual Agreement Procedure – Taxation Ruling TR 2000/16 and Taxation Ruling TR 2000/16A.
- Operation of Australia's permanent establishment attribution rules – Taxation Ruling TR 2001/11.
- Interpreting Australia's DTAs – TR 2001/13.
- Meaning of 'arm's length' for the purpose of dividend deeming provisions – Taxation Ruling TR 2002/2.
- Thin capitalisation, applying the arm's-length debt test – Taxation Ruling TR 2003/1.
- Cost contribution arrangements – Taxation Ruling TR 2004/1.
- Branch funding for multinational banks – Taxation Ruling TR 2005/11.
- Effects of determinations made under Division 13, including consequential adjustments – Taxation Ruling TR 2007/1 (replaces Taxation Ruling TR 1999/8).
- Interaction of the thin capitalisation provisions and the transfer pricing provisions – Taxation Ruling TR 2010/7.
- Application of the transfer pricing provisions to business restructuring – Taxation Ruling TR 2011/1.

Taxation determinations

In addition to taxation rulings, the ATO also releases taxation determinations. While also a type of public ruling, determinations are generally shorter than rulings and deal with one specific issue rather than a comprehensive analysis of the overall operation of taxation provisions. For example, Tax Determination TD 2008/20 provides specific guidance in relation to the interaction of Australia's transfer pricing and debt/equity provisions.

Final taxation determinations may be relied upon by taxpayers.

Law administration practice statements

The ATO provides instructions to ATO staff on the approaches to be taken in performing their duties. These instructions may outline, for example, procedures for identifying and resolving significant issues, and work practices to be followed in the practical application and administration of the tax laws.

The instructions, known as a Law Administration Practice Statement (LAPS), do not express a precedential ATO view. Taxpayers who rely on a LAPS will remain liable for any tax shortfall (but not interest and penalties) in the event the LAPS is incorrect and the taxpayer makes a mistake as a result.

The LAPS that are directly applicable to transfer pricing include:

- Making a determination under Division 13 and applying the relevant Articles of Australia's DTAs – PS LA 2003/5.
- The transfer pricing review panel – PS LA 2004/13.
- Transfer pricing review work – PS LA 2005/14.
- Treatment of non-resident captive insurance arrangements – PS LA 2007/8.
- ATO's Advance Pricing Arrangement program – PS LA 2011/1.

ATO transfer pricing publications

The ATO has issued a suite of publications about international transfer pricing. They include:

- *International transfer pricing: introduction to concepts and risk assessment.*
- *International transfer pricing: applying the arm's-length principle.*
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses.*
- *International transfer pricing: marketing intangibles.*
- *International transfer pricing: attributing profits to a dependent agent permanent establishment.*

The ATO has indicated that these guides do not replace, alter or affect in any way the ATO interpretation of the relevant law as discussed in the various taxation rulings; however, they do provide insights into the ATO view on various matters.

Other transfer pricing publications

Australia is a member of the OECD. The ATO generally has followed the OECD Guidelines in relation to transfer pricing, the principles of which are reflected in Australia's tax rulings, but is under no obligation to follow them when applying Division 13. The ATO must follow the OECD Guidelines when applying Subdivision 815-A, i.e. when considering arrangements between Australian taxpayers and international related parties located in treaty jurisdictions.

Australia is also a member of the Leeds Castle group, which superseded the Pacific Association of Tax Administrators (PATA) in 2006. While the PATA no longer exists, we understand that the ATO will continue to apply the principles in PATA publications which deal with bilateral transfer pricing issues with Canada, Japan and the United States.

Australia

Legal cases

There have been few cases relating to transfer pricing brought before an Australian court or tribunal. Most of these cases have involved an administrative law challenge to the Commissioner's processes in issuing transfer pricing-based assessments. Only two cases have involved the substantive operation of Australian transfer pricing rules.

The Australian transfer pricing cases include:

- *San Remo Macaroni Company Pty Ltd v Commissioner of Taxation* (1999) – allegations that the Commissioner had made transfer pricing assessments in bad faith.
- *Daihatsu Australia Pty Ltd v Commissioner of Taxation* (2001) – challenging transfer pricing adjustments on the basis that the Commissioner did not exercise his power on a bona fide basis.
- *Syngenta Crop Protection Pty Ltd v Commissioner of Taxation* (2005) – request for the Commissioner to provide details of the transfer pricing assessments.
- *WR Carpenter Holdings Pty Ltd v Commissioner of Taxation* (2008) – request for the Commissioner to provide particulars of matters taken into account in making transfer pricing determinations.
- *Roche Products Pty Ltd v Commissioner of Taxation* (2008) – an Administrative Appeals Tribunal (AAT) case, which represents the first transfer pricing case involving the application of Division 13.
- *Commissioner of Taxation v SNF (Australia) Pty Ltd* (2011) – the second substantive transfer pricing matter to face an Australian court or tribunal after the Roche case.

The recent cases are discussed in more detail below.

WR Carpenter Holdings Pty Ltd

In July 2007 the Full Court of the Federal Court of Australia upheld an earlier decision to deny the taxpayer the right to request particulars of how the ATO arrived at its transfer pricing determination. Affirming the precedent set in the case of *Syngenta Crop Protection*, the court found that Division 13 does not make the Commissioner's reasoning process in making a transfer pricing determination a relevant consideration. Therefore, the court declined to give the taxpayer an opportunity to view and challenge these reasons, removing a potential avenue by which the taxpayer could challenge the ATO's transfer pricing adjustment.

The taxpayer was granted leave to appeal to the High Court of Australia. In July 2008, the High Court of Australia unanimously dismissed the appeal.

Roche Products Pty Ltd

This case, handed down in July 2008, was the first Australian judgment on substantive transfer pricing issues. The case concerned the transfer price of goods acquired by Roche Products (an Australian company) from its Swiss parent. The AAT found that the transfer prices paid by the Australian taxpayer for ethical pharmaceutical products were excessive and made adjustments accordingly. No adjustments were made to the transfer prices of the other product lines.

In its judgment, the AAT made a number of comments that have potential implications for all Australian taxpayers with transfer pricing issues. They include:

- The operation of DTAs – Although the AAT was not required to decide on this issue, the AAT commented that there is a lot to be said for the proposition that Australia's DTAs do not give the ATO the ability to impose tax and that Division 13 must form the base that supports any assessment.
- Transfer pricing methodologies – Although the ruling acknowledges the difficulty in finding available comparable data, and uses a uniform gross margin to price the transfers of all pharmaceutical products, the AAT expressed a preference for transactional methods over profit methods, such as the profit-based TNMM.
- Loss-making companies – In noting the weaknesses of profit methods, the AAT pointed out their tendency to attribute any losses to incorrect transfer pricing. The AAT rejected this inference. The ruling accepted the taxpayer's commercial reasons for the losses, despite their occurring over a number of years, and did not order a transfer pricing adjustment.
- Division 13 test – The ruling clearly stated that the provisions of Division 13 require that arm's-length prices be determined for each separate year under consideration, rather than a multiple-year average.

In January 2009 the ATO released its Decision Impact Statement in relation to the case. The Statement expresses the ATO's view that the decision in Roche is confined 'to the facts of the case' and that 'all things considered [Roche] is seen as having limited significance for the administration of transfer pricing laws generally'. The ATO's message is that the status quo prevailed. As a result, taxpayers were not provided with any guidance by the ATO to that which was already in the public domain. However, in our view, aspects of the AAT decision should not be ignored by taxpayers.

SNF (Australia) Pty Ltd

A judgment in only the second substantive transfer pricing matter to face an Australian court or tribunal (after Roche) was handed down by the Federal Court of Australia in June 2010. The Federal Court found in favour of the taxpayer. The Commissioner subsequently appealed this decision in the Full Federal Court in 2011. The Full Federal Court upheld the original decision.

The proceedings concerned an Australian distributor (SNF Australia) purchasing from offshore related parties. For 13 years SNF Australia had no income tax liability and made trading losses in all years bar two. The Commissioner argued that an arm's-length purchaser would never agree to the prices paid, given the sustained period of losses. In a significant win for the taxpayer, the Federal Court and the Full Federal Court both held that SNF Australia had successfully discharged its burden to satisfy the court that the price paid to offshore related parties did not exceed the arm's-length price. SNF Australia did this through the application of a comparable uncontrolled price (CUP) method.

The transfer pricing issues emerging from SNF Australia's win in the Full Federal Court were similar to those addressed by the AAT in Roche. These issues include:

- The operation of DTAs – Although the operation of the DTAs was not at issue, obiter dicta comments in the June 2010 Federal Court decision suggest that Australia's DTAs may provide a standalone taxing power. These obiter dicta comments, however, have reduced precedential value to taxpayers as the Commissioner elected not to pursue the issue. Therefore, the question of whether or not the DTAs provide the Commissioner a legal basis for raising transfer pricing assessments independently of Division 13 remains untested; although this now appears

Australia

irrelevant (for post-2004 transactions) following the introduction of Subdivision 815-A.

- Transfer pricing methodologies (CUP method) – The courts found that the CUP method is the most appropriate methodology where direct transactional data is available, but noted that Division 13 does not require the same ‘exactness’ of comparability as suggested by the ATO. The Full Federal Court observed that the ATO’s current approach was impractical and would set the bar ‘at an unattainable height’ for taxpayers to ever be able to apply the CUP method.
- Relevance of OECD Guidelines. The Full Federal Court found that the Commissioner did not provide sufficient evidence to establish that the OECD Guidelines were relevant for the interpretation of Division 13 or the DTAs. The Government has addressed this in Subdivision 815-A by explicitly requiring the OECD Guidelines to be taken into account when applying the treaty-equivalent transfer pricing rules. It is likely that the new prospective transfer pricing rules will include a similar requirement that will apply to all dealings subject to the transfer pricing rules.
- Loss-making companies – The judgment in SNF indicates that the existence of losses, even over a lengthy period, will not necessarily mean that the price paid for products is not arm’s length.
- Division 13 test – According to the courts, the test under Division 13 is not to determine what consideration an arm’s-length party ‘in the position of the taxpayer’ would have given for the products. Rather, the essential task is to determine the arm’s-length consideration in respect of the acquisition of the goods. This meant that the financial position of the taxpayer (such as a history of sustained losses) was not relevant to the determination of an arm’s-length price in this case. The ATO acknowledged in its Decision Impact Statement that a loss does not automatically mean that a transfer price was not arm’s length, but it also indicated that there are some types of transactions where it is necessary to consider the taxpayer’s circumstances to identify an arm’s-length consideration (such as a loan). The ATO’s Decision Impact Statement on the SNF case raised a possible alternative argument that the Commissioner could have put forward: that an arm’s-length party in the taxpayer’s position ‘would have sought separate compensation’ for representing the SNF group in the Australian market. In other words, the ATO believes it could have argued that SNF was implicitly providing a service to its parent company. Since there was no actual service transaction between the taxpayer and its parent company, this would have required the ATO to deem a new transaction to exist. It is questionable whether the ATO would be able to successfully ‘reconstruct’ transactions under Division 13, but it may take the view that Subdivision 815-A would support this approach due to comments in the OECD Guidelines that suggest reconstruction of transactions may be appropriate in exceptional circumstances. It is unlikely that a clear position on this will be known until a case is tested in the courts.

Burden of proof

The burden of proof to satisfy the ATO and the courts that transfer prices are arm’s length lies with the taxpayer.

The weight of this burden has been affirmed by the judicial decisions in Syngenta and WR Carpenter Holdings. In these judgments, the court declined to allow taxpayers to examine and challenge the Commissioner’s reasons underlying transfer pricing determinations on the grounds that this was not a relevant consideration to the case.

The court found that the provisions of Division 13 do not require the ATO to establish the validity of its transfer pricing assessments. Rather, the burden rests entirely on the taxpayer to establish that its prices were arm's length or that the Commissioner's assessments were excessive. The SNF appeal decision clarified that the taxpayer's burden does not require it to demonstrate a single arm's-length price; rather, the taxpayer is only required to demonstrate that (in the case of an acquisition from a related party) the prices paid did not exceed an arm's-length amount.

Tax audit procedures

Tax return

Australia has a self-assessment system. Taxpayers are responsible for correctly assessing and reporting their tax obligations. Taxpayers are expected to take reasonable care in preparing and documenting their income tax returns.

Every taxpayer that engages in international transactions with connected parties with an aggregate amount greater than Australian dollar (AUD) 2 million is required to submit an International Dealings Schedule (IDS) with their income tax return, detailing the nature and value of these transactions. For permanent establishments, the responses in the IDS should be provided on a notional basis that a permanent establishment is a separate but related entity. The ATO uses information from the IDS to assess a taxpayer's transfer pricing risk and select taxpayers for review.

The IDS became mandatory for all taxpayers in 2012 after a trial in 2010 and 2011 for certain financial services entities. The IDS has replaced the Schedule 25A and the Thin Capitalisation Schedule. The disclosures required in the transfer pricing section of the IDS (Section A) are significantly more detailed than the disclosures that were required in the Schedule 25A. Details must be provided regarding the nature and dollar value of transactions, the locations of counterparties, the extent to which each type of transaction is covered by transfer pricing documentation, details of any cross-border business restructures involving related parties, and various other questions.

In addition to the above schedules, the ATO has introduced a Reportable Tax Position (RTP) Schedule, which requires certain taxpayers to disclose information about reportable tax positions (i.e. uncertain or contestable positions) in an attachment to their income tax return. The RTP Schedule was introduced for certain large business taxpayers for 2012, and may be rolled out to other taxpayers in future years. Transfer pricing involves inherent uncertainty, which means that taxpayers with international related party transactions could potentially have reportable tax positions.

The public officer's duties in relation to the income tax return also apply in respect of the schedules to be lodged with the income tax return. The public officer is required to sign the declaration on the company's income tax return, certifying disclosures in the company income tax return and supporting schedules to be true and correct.

Recent ATO activity

The ATO releases an annual compliance program which sets out the tax compliance risks of most concern to the ATO and the ATO's mitigation strategies to address these risks. The 2012/13 compliance program continued to highlight transfer pricing as a key compliance risk for both large business (turnover of AUD 250 million or more) and small to medium enterprises (SMEs) (turnover of between AUD 2 million and AUD 250 million).

Australia

In June 2010 the ATO released a new edition of the Large Business and Tax Compliance booklet, previously released in 2006. The booklet contains essential information on the ATO's expectations around good corporate tax governance, sets out how the ATO identifies tax risk and details how large corporate taxpayers can work with the ATO to manage their tax risks. The ATO is also preparing a Compliance Booklet for SMEs. This was released in draft in March 2012.

Large business

The ATO's compliance activities for large businesses are focused on increasing the level of 'real time' information gathering and interactions with taxpayers. The ATO has developed a range of initiatives that it is using to achieve this objective, including Annual Compliance Arrangements (a voluntary arrangement between the taxpayer and ATO similar to a unilateral-APA [Advance Pricing Agreement] but covering a wider range of tax issues), Pre-lodgement Compliance Reviews, risk workshops, and the RTP Schedule. There is also a trend of increased information sharing with other tax authorities around the world.

Particular focus areas of the ATO's compliance activities for large businesses in 2012-13 include:

- Related party debt arrangements, particularly where taxpayers have relied upon asset revaluations to fall within the thin capitalisation safe harbour.
- Corporate restructures, including those involving complex or novel arrangements.
- Research and development claims.
- MRRT implementation reviews.

Understanding taxpayers' tax risk management and governance policies and procedures is also a key theme of the ATO's compliance activities in the large business segment.

Small to medium enterprises

The ATO's focus areas for SMEs in 2012-13 include:

- Ensuring that taxpayers are aware of their IDS lodgement obligations.
- Business losses.
- Dealings with low tax jurisdictions.
- Promotion of the 'simplified' APA product.

The audit procedure

Risk differentiation framework

The ATO uses a Risk Differentiation Framework (RDF) to assess tax risk and determine an appropriate risk management response. In using this framework, the ATO considers the likelihood of non-compliance (i.e. having a tax outcome that the ATO doesn't agree with) and the consequences of that non-compliance (e.g. in terms of dollars, precedent). If the likelihood and consequences of non-compliance are considered to be high, the ATO will target the taxpayer for a review or audit. Conversely, if the risk assessment by the ATO is determined to be low, the taxpayer will be monitored periodically.

Risk review

The ATO typically uses an approach known as a Client Risk Review (CRR) when undertaking a risk assessment of potential material tax issues, including transfer pricing. The ATO will examine information such as the taxpayer's IDS, compliance history, latest collections, news or media articles and other publicly available information. A CRR is a review of one or more historical income years for which a tax return has been lodged. As noted above, the ATO is increasingly conducting real time reviews of taxpayers to gather information prior to lodgement of the income tax return.

When transfer pricing is identified as a significant risk, the CRR may proceed to a formal Transfer Pricing Record Review (TPRR). As part of a TPRR, and in deciding whether to proceed beyond a TPRR to a transfer pricing audit, the ATO considers:

- the quality of a taxpayer's processes and documentation, and
- whether the taxpayer's results are commercially realistic.

The quality of a taxpayer's processes and documentation is generally assessed as falling into broad categories ranging from 'low quality' to 'high quality'. The taxpayer's financial results will be assessed as either 'commercially realistic', 'less than commercially realistic' or 'consistently returns losses'.

Taxpayers will receive a risk rating at the completion of the risk review. A higher risk rating does not necessarily mean that the company will be selected for audit, but with such a risk rating, the taxpayer is likely, at a minimum, to be placed on a watching brief.

Audit

An ATO audit is more comprehensive than a risk review. When a taxpayer is selected for audit, the audit process usually commences with the ATO requesting a meeting with the taxpayer. At this meeting the ATO will carry out an inspection of the taxpayer's premises and interview key operational personnel. The ATO's approach broadly follows the first three steps of the four- step process set out in Taxation Ruling TR 98/11 as follows:

- Step 1: Characterise the international dealings with related parties in the context of the taxpayer's business.
- Step 2: Select the most appropriate transfer pricing methodology.
- Step 3: Apply the most appropriate methodology and determine the arm's-length outcome.

At the completion of this process, the ATO would consider all information gathered (including a review of the taxpayer's transfer pricing documentation) and issue a position paper outlining its findings and proposed adjustments to taxable income over the review period.

While verbal communications between the ATO and the taxpayer generally will continue throughout the process, the taxpayer is offered an opportunity to respond in writing to the ATO's position paper, which would involve correcting any factual errors made by the ATO and, where available, to provide additional information and arguments to counter the ATO's position. After a review of the taxpayer's response, the ATO will issue its final position paper followed by determinations and notices of assessment or amended assessments giving effect to the determinations. The notices of

Australia

assessment or amended assessment will state when any tax, interest and penalties are 'due and payable'. Usually the due date for payment will be 21 days from the notice, but the Commissioner has the discretion to defer or bring forward the payment time. Any delay in paying the assessments incurs additional interest costs.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The record-keeping provisions of the ITAA do not require taxpayers to create specific records demonstrating that international related party dealings comply with the arm's-length principle. However, according to Taxation Ruling TR 98/11, taxpayers are well advised to prepare such documentation contemporaneously (the ATO considers documentation to be 'contemporaneous' if it is completed at or before the date of filing the income tax return for the relevant year).

There are four key reasons why taxpayers should create and maintain 'contemporaneous' documentation:

- There is a statutory requirement to retain documents. A taxpayer must retain documents that are relevant for the purposes of ascertaining the taxpayer's income and expenditure, etc., for at least five years (calculated from the date the records were prepared or obtained, or from the date the transactions or acts to which the records relate were completed, whichever is later).
- The burden of proof rests with the taxpayer in the event of an ATO dispute. Taxpayers will be better placed to discharge their burden of proof if contemporaneous documentation exists.
- It may be easier to demonstrate a reasonably arguable position if contemporaneous documentation exists. This is relevant to determining whether penalties should be remitted in the event of a transfer pricing adjustment.
- Contemporaneous documentation mitigates the risk of an ATO audit and helps the taxpayer communicate its position.

The Commissioner, or any duly authorised taxation officer, has the right of full and free access to all buildings, places, books, documents and other papers for the purposes of the ITAA. The Commissioner might also require any person to attend and give evidence or produce any documents or other evidence relating to a taxpayer's assessment. The provisions of the ITAA also empower the Commissioner to require a person to produce documents held outside Australia. Compliance with this latter requirement is not mandatory, but where a taxpayer fails to comply with such a requirement, the taxpayer may not rely on those documents in the event it wishes to challenge the Commissioner's assessment.

Revised assessments and the appeals procedure

Australia has a comprehensive objection and appeals procedure for disputing an amended assessment raised by the Commissioner. Under these provisions, the taxpayer may object to an amended assessment issued by the Commissioner to give effect to a Division 13 determination. A taxpayer who is dissatisfied with such an assessment has the later of four years from the date of the original assessment (which is shortly after filing the relevant income tax return) or 60 days from receiving the notice of amended assessment to lodge an objection in writing, setting out the grounds relied upon in support of the claim.

In practice, most transfer pricing audits are not completed until more than four years after the original assessment, i.e. the date at which the taxpayer lodges its tax return under a self assessment regime, so in most cases taxpayers are required to object within 60 days of receiving an amended assessment. The Commissioner is required to consider the objection and may either allow it in full, or in part, or disallow it. The Commissioner is then required to give notice to the taxpayer of the decision on the objection. A taxpayer dissatisfied with such a decision may either refer it to the AAT for review or refer the matter to the Federal Court of Australia.

Where the notice of assessment includes additional tax for incorrect returns, it is generally prudent to remit the matter to the AAT, which has the discretion to reconsider the level of additional tax imposed and may substitute its own decision for that of the Commissioner. In contrast, on appeal to the Federal Court, that court can only decide whether the Commissioner has made an error in law in imposing the additional tax. If no error of law has occurred, then the penalties will remain unadjusted. Decisions of the AAT may be appealed to the Federal Court, but only on a question of law.

Additional tax and penalties

Penalties for 1992/93 onwards

Penalty rates applying to transfer pricing adjustments are outlined in Taxation Ruling TR 98/16.

The penalties generally range from 10% of the additional tax where the taxpayer has documented a reasonably arguable position and had no purpose of avoiding Australian tax, to 50% where there was an intention to avoid Australian tax and a reasonably arguable position had not been documented. Broadly speaking, a position will be considered 'reasonably arguable' if it is 'about as likely as not' to be correct. In order to demonstrate that a position is reasonably arguable, the taxpayer must retain documentation to support arm's-length pricing.

The ATO has the discretion to remit penalties in full if special circumstances exist.

Penalties may be increased by 20% where:

- a taxpayer takes steps to prevent or hinder the ATO from discovering that a transfer pricing provision should be applied. It is noteworthy that unreasonable time delays in responding to ATO enquiries or failure to notify the ATO of errors within a reasonable time could amount to 'hindrance'
- a taxpayer has been penalised under a scheme section in a prior year of income.

Penalties may be reduced:

- by 20% if the taxpayer makes a voluntary disclosure to the ATO after it has been informed of an impending audit
- by 80% if the taxpayer makes a voluntary disclosure to the ATO before it has been informed of an impending audit.

In addition to penalties, the taxpayer is liable to pay a shortfall interest charge (SIC) on the value of any increase in the tax assessment arising from an ATO adjustment. The SIC annual rate was 6.66% for the quarter July-September 2012.

Australia

Penalties for 1991/92 and prior years

Prior to the introduction of the self-assessment regime there was a two-tier structure for penalties – 200% for schemes designed to avoid tax and 25% per annum in other cases. Where voluntary disclosures are made, the penalty may be restricted to 10% per annum, subject to a maximum of 50% of the tax avoided in any year.

Resources available to the tax authorities

The ATO's new Jurisdictional Income Practice deals with transfer pricing, thin capitalisation, withholding tax and other international tax issues. The move to combine transfer pricing with other international tax issues within a single team recognises that the examination of these issues is often interrelated and of key importance to the ATO's ongoing compliance initiatives.

In addition to the above, there are various specialist teams within the ATO that deal with transfer pricing. For example, the Transfer Pricing Operations Group oversees the implementation of strategies to manage transfer pricing risks and is responsible for allocating and overseeing active compliance case work, identifying transfer pricing risks, selecting cases for active compliance and capability development initiatives. The Economist Practice provides economic advice on transaction/business characterisation, transfer pricing methods and benchmarking.

On occasion, normally in the most complex cases, the ATO seeks advice from external economists.

Use and availability of comparable information

Availability of comparable information

Public companies and large private companies must lodge financial statements with the Australian Securities and Investments Commission (ASIC). This information is publicly available. However, despite the information being lodged with ASIC, reliable comparable data is difficult to locate in the Australian market.

Databases are available (for example IBISWorld, Company 360, OSIRIS) to identify organisations on an industry and activity basis; however, the particularly small Australian market makes identification of reliable comparables difficult. In addition, some Australian entities are exempt from lodging full financial statements with ASIC, and many Australian companies are members of multinational groups and consequently themselves are engaged in controlled transactions such that reliable comparisons often cannot be made.

Given the limitations of Australian data, the ATO (and taxpayers) may turn to overseas markets to identify comparables. It is also of note that the ATO has a strong preference for use of public companies (over private companies) in comparability analyses; however this is yet to be tested in court.

Australian Bureau of Statistics data

In conducting TPRRs, the ATO sometimes uses publicly available data from the Australian Bureau of Statistics (ABS) in order to form an opinion on the commercial realism of a taxpayer's financial performance, relative to the performance of a market segment as a whole. The ATO's use of ABS data is limited to this situation and not used in comparability analyses because the data includes details of companies engaged in

controlled transactions, and the categories may be wide enough to include companies that might be functionally dissimilar.

Use of controlled data

A contentious aspect of Taxation Ruling TR 97/20 is the ATO's intention to use controlled data in circumstances for which there is insufficient publicly available information on which to base a comparison. In practice, the ATO's use of controlled data has softened and where possible it endeavours to work with methodologies put forward by the taxpayer and publicly available information.

Anticipated developments in law and practice

Division 13

After the Commissioner suffered an adverse decision in the SNF appeal in the Full Federal Court, the Government initiated a review and rewrite of the Australian transfer pricing rules. The first stage of changes involved the introduction of Subdivision 815-A (with retrospective effect) to dealings between Australian taxpayers and related parties in treaty countries. The second stage of changes will involve a comprehensive rewrite of Division 13 which will apply prospectively to all non-arm's-length international dealings regardless of the location of the counterparty.

The new transfer pricing rules are expected to include the following features:

- Similar to the existing Division 13, the rules are expected to apply to non-arm's-length dealings even in situations where the parties are not related by common ownership or control.
- The OECD Guidelines are likely to be given formal recognition. This would confirm that all methods recognised by the OECD (including profit based methods) are able to be applied.
- Documentation is likely to become mandatory (possibly subject to certain thresholds).
- A statute of limitations on transfer pricing adjustments is expected to be introduced.
- The discretionary power held by the Commissioner under s136AD(4) is expected to be removed; although it is likely that some form of discretionary power will continue to exist which will allow the Commissioner to deem an arm's-length outcome and/or reconstruct transactions in certain circumstances.

Risk transactions or industries

It is possible that the ATO may review all types of international dealings, situations or industries in the context of a transfer pricing review. Each year the ATO releases a compliance program which sets out the tax compliance risks of most concern to the ATO and the ATO's strategies to address these risks. The ATO annually adjusts its compliance program to address new and emerging transfer pricing issues.

Limitation of double taxation and competent authority proceedings

In the event that a transfer pricing audit results in an adjustment, a taxpayer may suffer double taxation. There are, however, mechanisms available to taxpayers which may be able to limit the double taxation.

Australia

Resident taxpayers

An Australian taxpayer may obtain relief from double taxation; however, the mechanism available depends on whether or not there is a DTA.

Where there is a DTA

A resident taxpayer may present his case to the Australian competent authority. The Mutual Agreement Procedure (MAP) Article in each of Australia's DTAs enables competent authorities of the relevant countries to meet and consult with each other with a view to seeking to resolve potential double-taxation issues. The MAP does not compel an agreement to be reached and does not relieve the Australian taxpayers from penalties or interest charged by the ATO. Taxation Ruling TR 2000/16 and TR 2000/16A outline the procedures for seeking relief from double tax.

Where there is no DTA

If a foreign tax authority makes a transfer pricing adjustment and Australia does not have a DTA with that country, there is generally no mechanism to obtain relief from double taxation. However, the resident taxpayer may pursue domestic relief through the Australian appeals process.

Non-resident taxpayers

A non-resident party to certain transactions may be able to obtain relief from double taxation under Australia's domestic legislation.

Division 13 allows for consequential adjustments to be made to the income or deductions of the non-resident party to a transaction, where a transfer pricing adjustment has been made in relation to that non-resident taxpayer. For example, where withholding tax has been paid on interest, the provision prevents double taxation by allowing the withholding tax to be recalculated based on the adjusted interest (i.e. as revised for the transfer pricing agreement). Taxation Ruling TR 2007/1 explains the effects on taxpayers of a determination made under the provisions of Division 13, including consequential adjustments.

Advance pricing arrangements

A formal APA process is available in Australia. APAs represent an agreement between a taxpayer and the tax authority to establish the transfer pricing methodology to be used in ensuring arm's-length transfer prices are achieved for tax purposes. The APA programme is well-established within the ATO, with more than 150 APAs completed or renewed since its inception.

In March 2011, the ATO released detailed guidance on Australia's APA program. The guidance is contained in Law Administration Practice Statement PS LA 2011/1 (replaces Taxation Ruling TR 95/23, which has now been withdrawn).

PS LA 2011/1 outlines a number of major initiatives, including:

- The development of a differentiated framework for simplified, standard and complex APAs.
- Improved ATO procedures and processes, including the introduction of an ATO Case Leader role, and the implementation of a more detailed project management framework for all APAs.
- The establishment of a circuit breaker mechanism in some cases.

- Alternative risk assessment products.

Differentiated framework

PS LA 2011/1 outlines a differentiated APA program, with three different types of APAs: simplified, standard and complex.

The simplified APA product aims to be a shorter, less costly and less time-consuming process, and as such, it is designed for low-value, low-risk dealings. It is available only for unilateral APAs. The standard APA product can be undertaken on a unilateral or bilateral APA, and may also include collateral issues – that is, taxation issues unrelated to transfer pricing. The complex APA product is suitable for high-risk, complex international related party dealings with limited comparables and a significant amount of tax at stake. It is available on a unilateral or bilateral basis.

ATO procedures and processes

PS LA 2011/1 outlines a more rigorous framework in relation to project management procedures, and to both the ATO's and taxpayers' obligations with respect of the process. For example, the introduction of an APA case leader role aims to ensure a single point of responsibility within the ATO, with accountability for delivery, including meeting agreed timing milestones and facilitating the resolution of technical issues.

The LAPS also outlines the reporting requirements for the taxpayer. Specifically, an Annual Compliance Report is required and must include information and computations necessary to the transfer pricing methodology, and information pertaining to the specific related party dealings covered in the APA. The ATO may request further information, and may cancel the APA where records are not in order.

Circuit breaker/review mechanism

Importantly, the LAPS introduces a 'circuit breaker' option which can be requested by the taxpayer. This process allows the taxpayer to seek an internal review when the ATO does not accept the APA, cannot reach an agreement with the taxpayer, withdraws the APA, or where there is a 'standstill' in proceedings.

Alternative risk assessment tools

There are products available to both SME and large business taxpayers who require a level of assurance as to the ATO view of their international related party dealings without the cost and time associated with undertaking an APA. These products include the ATO Risk Assessment Product (for taxpayers wishing to obtain some degree of assurance from the ATO as to its views on the arm's-length nature of their dealings based on their transfer pricing documentation) and the Self Assessment Risk Product (for taxpayers to evaluate their own transfer pricing risk).

Liaison with customs authorities

The Australian Customs and Border Protection Service (Customs) and the ATO have an agreement to share information relating to transfer pricing issues. This arrangement includes reciprocal exchange rights to their systems, particularly with respect to product and company pricing data.

In July 2009, Customs released a Practice Statement that addressed the impact of transfer pricing arrangements on the Customs value of imported goods. Companies importing into Australia from related parties should always review any customs

Australia

implications of their transfer pricing adjustments, particularly with respect to overpaid or underpaid duties. This applies to all transfer pricing adjustments, whether they are self-assessed adjustments, adjustments resulting from an audit or compensating adjustments arising under an audit adjustment.

OECD issues

Australia is an OECD member and has a representative on the OECD Transfer Pricing Task Force. The ATO is an active participant in OECD working parties for emerging areas of transfer pricing.

The ATO generally has followed the OECD Guidelines in relation to transfer pricing, the principles of which are reflected in Australia's tax rulings, but is under no obligation to follow them.

Joint investigations

Australia is supporting the OECD and others in various initiatives to promote greater transparency in the tax field. For example, the OECD is looking at improving and expanding exchange-of-information activities between tax authorities under a multilateral framework known as the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Joint International Tax Shelter Information Centre is another example where several countries (including Australia) work together to promote tax compliance through the exchange of information on complex cross-border cases.

Australia has a number of taxation information exchange agreements with non-OECD offshore financial centre jurisdictions (most of which are tax havens) in order to improve transparency and information exchange.

In addition, the OECD's Forum on Tax Administration is promoting joint cross-jurisdictional audits as a way to enforce tax compliance across multinational corporations (MNCs). Transfer pricing audits have traditionally been challenging for MNCs given the breadth and depth of the revenue authorities' enquiries and the time and resources taken up in managing the audit. It is likely that joint audits will present new challenges for MNCs, given the need to manage two or more tax authorities examining both sides of a transaction simultaneously.

Thin capitalisation

Substantial changes to Australia's thin capitalisation regime became effective in 2001. The legislation is lengthy and complex.

The legislation has introduced a 'safe harbour' debt amount. An alternative test is the 'arm's-length' debt amount, which potentially can increase the permissible interest deduction. Taxation Ruling TR 2003/1 deals with the application of the arm's-length debt test in the thin capitalisation regime.

Taxation Ruling TR 2010/7 provides guidance on the interaction of Australia's thin capitalisation provisions (Division 820 of the ITAA 1997) and the transfer pricing provisions. The ruling confirms the ATO's view that Division 13 applies independently of Division 820 in determining the allowable deduction for a taxpayer's related party debt. The transfer pricing provisions are to be applied first to determine an arm's-length interest rate. The arm's-length rate is then applied to the actual amount of the

loan. The ruling provides four examples to demonstrate possible scenarios involving the interaction of Division 13 and Division 820 to a taxpayer's related party debt.

The ruling also sets out the ATO's approach for determining an arm's-length consideration on inbound related party loans under Australia's transfer pricing rules. The Commissioner confirms that his views on transfer pricing methods in relation to related party debt arrangements are contained in Taxation Ruling TR 92/11 and Taxation Ruling TR 97/20. However, a number of important observations are made in TR 2010/7. Firstly, the ruling confirms the ATO's view that in setting an interest rate on a related party loan, it must 'produce an outcome that makes commercial sense' for both the borrower and the lender in all of the circumstances. Secondly, the ruling confirms the ATO's view that it is important to take into account parental affiliation in determining the credit standing of the borrower.

The position taken by the Commissioner in TR 2010/7 has been given legislative effect for loan arrangements with related parties in DTA countries under Subdivision 815-A.

Management services and other services

Taxation Ruling TR 1999/1 sets out the ATO's position on whether prices for services, or dealings between associated enterprises in relation to the provision of services, conform to the arm's-length principle.

According to the ruling, whether a service has been, or will be, provided by the performance of an activity, and whether a charge should be levied depends upon whether the activity has conferred, or is expected to confer, a benefit to a related party.

The ruling introduces administrative practices or a safe harbour, which allow for a 7.5% mark-up on 'non-core' services provided or received where service revenue/expenses are not more than 15% of the Australian group's total revenue/expenses. A mark-up of between 5% and 10% may be permitted if the services are provided to, or received from, another country that requires a different mark-up. Taxpayers relying on the administrative concession must apply a consistent mark-up for the relevant services globally. Examples of 'non-core' services include administration and human resource matters, but specifically exclude technical and marketing services.

The ruling also allows for smaller companies that receive or provide services worth not more than AUD 500,000 per annum, to apply the administrative practices to all services (i.e. core and non-core). The adoption of a safe harbour mark-up does not remove the requirement for taxpayers to document their intragroup services transactions. The safe harbour mark-up will only remove the necessity for taxpayers to include benchmarking analysis of their intragroup services mark-ups within their documentation.

Marketing and other intangibles

The ATO's position on the application of Australia's transfer pricing rules to marketing services provided by an Australian enterprise that uses trademarks and names it does not own is outlined in an ATO publication titled International transfer pricing: Marketing intangibles. This publication is intended to be consistent with previous ATO rulings and with the OECD Guidelines.

Australia

In determining whether an arrangement for the provision of marketing services is consistent with the arm's-length principle, the ATO considers the following issues relevant:

- The nature of the contractual arrangements.
- The extent to which the activities are expected to benefit the trade name owner and/or the marketer.
- Whether the level of marketing activities performed by the marketer exceeds that of comparable independent enterprises.
- Whether the marketer is properly compensated by a normal return on its activities or should receive an additional return on the trade name.

The ATO is likely to challenge an arrangement in which a distributor pays a royalty yet receives no rights to use a trade name other than to distribute a branded product. Furthermore, if the ATO perceives that a distributor is performing a greater level of marketing than comparable independent distributors, it will expect the taxpayer to earn a higher level of profit than that of a 'routine' distributor.

In addition to marketing intangibles, the ATO also focuses on transfers of intellectual property (IP) to international related parties.

R&D tax incentive program

The research and development (R&D) tax incentive provides a tax offset for eligible R&D activities and is targeted toward R&D that benefits Australia. Specifically, the new R&D tax program, which came into effect from 1 July 2011, provides a 40% non-refundable tax credit for eligible R&D activities conducted in Australia, regardless of where the resulting IP is held. The 40% tax credit equates to a cash benefit of 10 cents in the dollar of eligible R&D expenditure. Additional benefits will be available to small companies with group turnover of less than AUD 20 million. Companies undertaking R&D activities in Australia should consider their R&D tax position to ensure they take advantage of all R&D tax benefits.

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Introduction

As member of the Organisation for Economic Co-operation and Development (OECD), Austria subscribes to the principles contained in the OECD Guidelines on transfer pricing. In addition, the Austrian Ministry of Finance published Transfer Pricing Guidelines (*Verrechnungspreisrichtlinien 2010*, VPR 2010) in November 2010 with the intention to facilitate the implementation of the OECD Guidelines in Austria. The publication of VPR 2010 was widely anticipated since they harmonise the tax authorities' approach regarding the assessment of transfer pricing cases. Transfer pricing is becoming increasingly important, and this is reflected by the increasing number of tax inspectors specialising in international transactions.

Statutory rules

Austria has general statutory rules which are aimed at dealing with transfer pricing. Consequently, the statutory authority for addressing transfer pricing issues is found in the application of general legal concepts, such as substance over form and anti-avoidance regulations, as well as the application of other regulations to deal with issues such as fictitious transactions, hidden capital contributions and constructive dividends. The requirements to apply the arm's-length principle on inter-company dealings and for adequate documentation of transfer prices are constituted in Article 6 Item 6 Income Tax Act and Articles 124, 131 and 138 Federal Fiscal Code, respectively.

Other regulations

The OECD Guidelines were published in Austria as administrative decrees. Although an administrative decree does not have the force of law, this is nevertheless an important indication of the acceptance of the principles contained in the OECD Guidelines and the approach to transfer pricing that the Austrian authorities are likely to adopt.

The Austrian VPR 2010 have been published for the general public, however, they primarily aim at providing guidance to tax inspectors on how to handle transfer pricing cases by interpretation of the OECD Guidelines. As a result, VPR 2010 do not represent comprehensive guidelines on the determination and documentation of transfer prices, but refer back in many aspects to formerly published opinions of the Ministry of Finance in connection with specific questions of international tax issues, the so called Express Answer Services (EAS).

No other binding regulations concerning transfer pricing have been published. If, however, guidance is required on a particular transfer pricing problem, then a taxpayer may submit the facts of that problem to the Austrian Ministry of Finance to obtain comment on its legal aspects (an EAS inquiry and EAS reply, respectively). It should be

Austria

noted that, although the reply of the ministry is not legally binding, these replies are published in professional journals and are referred to in practice.

Legal cases

Information on legal cases and the legal aspects of transfer pricing issues is set out as follows:

Administrative High Court decisions

Any decisions of this court are published without specific details that could identify the parties involved. Though court decisions on transfer pricing cases are scarce, some decisions are worth mentioning:

- The court ruled that a precise and detailed description of services rendered by a foreign group company to a domestic recipient is required for the service or licence fees to be tax-deductible. Thereby, the more incomprehensible the services performed are, the more detailed the documentation has to be. Specifically, consulting services, the transfer of know-how and the procurement of business contacts require a very detailed description as well as documentation for the related expenses to be deductible for tax purposes.
- The court ruled again that a precise and detailed description of the nature and market value of all inter-company services rendered to a domestic recipient is required for the fee paid for those services to be tax-deductible. A simple submission of a large set of files consisting of several (standalone or incoherent) documents cannot be accepted as sufficient. The documents have to satisfactorily demonstrate and to clearly represent in a comprehensible way the content and the market price of each service received.
- The court emphasised that inter-company service payments are tax-deductible only if a willing-to-pay test is passed. If the services could have been obtained at lower cost from third-party service providers, the willing-to-pay test is deemed to be failed.
- A German company engaged in the sales and support of software failed to allocate profits to its Austrian permanent establishment (PE). The Austrian tax authorities stated that the PE acts as a service provider and determined the arm's-length compensation for this function based on estimations applying the cost-plus method. The Administrative High Court of Austria decided that such adjustments, especially the determination of the mark-up, made by the tax authorities cannot be based solely on vague assumptions and experience. The court stated that the tax authorities have to prove the accuracy of their assumptions and must grant access to the information on how such adjustments were computed, including the requirement to provide detailed information on the comparables used to determine the arm's-length transfer price.

Tax Appeals Board decisions

In one of its recent decisions, the Tax Appeals Board did not accept a flat rate remuneration for several services (marketing, financing, personnel, etc.) determined as a percentage of the Austrian service recipient's turnover. Although the board acknowledged that the Austrian company needed the services for its operation, the actual provision of these services was not proved credibly by the taxpayer. In addition, the Austrian service recipient should be in the position to provide evidence on the actual provision of services by the group companies and the benefit arising thereof.

Replies from the Austrian Ministry of Finance (Express Answer Service replies)

EAS replies are also published without company-specific data but with a short summary of the relevant facts. Recently, several EAS replies have been significant, details of which are as follows:

- In the context of the reorganisation of an Austrian distribution company into a commission agent or commissionaire, the Ministry of Finance issued a letter ruling that deals with goodwill aspects. The Ministry stated that if the subsidiary being transformed does not receive any compensation for investments with respect to customers, this might be deemed to deprive the subsidiary of the customer base it has created throughout the past, as a result, constituting an infringement of the arm's-length principle. This is the view conveyed by some OECD member countries in the course of an OECD working group on commissionaire arrangements. As long as these OECD working papers are not final, the Austrian Ministry of Finance, however, will not publish further general guidance on goodwill issues, but explicitly refers such cases to the local tax office.
- In connection with the reorganisation of an Austrian distribution company into a commissionaire, the Austrian Ministry of Finance stated that the Austrian distribution company downsized to a commissionaire constitutes a PE of the French parent company. Under the Austria–France Double Tax Agreement (DTA), a French production entity has a PE in Austria when it sells its products through a dependent agent that has binding authority for sales contracts. According to the ministry, the dependent status is substantiated by the fact that the Austrian subsidiary performs the sales activity for the French parent company only and it has to follow the French producer's instructions with regard to the product sales.
- As part of a new group strategy, a Germany-based parent company closed its manufacturing subsidiary in Austria and transferred the production activity to Poland. According to the Austrian Ministry of Finance, the Austrian company should be compensated for the estimated future profit potential lost through the restructuring. To calculate the arm's-length remuneration, it needs to be analysed which assets, tangibles as well as intangibles, were transferred to the Polish company. Furthermore, it has to be defined which entity receives the economic benefit out of the restructuring to be able to determine by whom (i.e. the German parent company, the Polish company or both jointly) the compensation has to be borne.
- In a recent EAS reply the Austrian Ministry of Finance also deals with downsizing. As a consequence of a group wide reorganisation, an Austrian sales entity will purchase the products not from its existing supplier in the group but from a Swiss principal. In addition the local marketing functions are transferred to the Swiss principal. According to the Ministry, the significant increase of the Austrian sales entity's purchase price cannot be regarded as at arm's length under the new structure since only the marketing functions and no other valuable functions, assets or risks are transferred. The Austrian sales entity should compensate the Swiss principal for the marketing functions to the extent of its marketing cost savings resulting from the restructuring.
- A group company acts as an intermediary reseller between an Austrian manufacturer and a processing company in Luxembourg. The reseller has the same address as the processing company and does not have any personnel. The Austrian Ministry of Finance challenged the arm's-length nature of the profit allocated to the reseller in an EAS reply. The fact that the price paid by the reseller matches the price the processing company negotiated with third parties does not justify the

Austria

application of CUP method. In case of the CUP method the comparison has to be conducted with third parties, however the Austrian manufacturer sold its products to related parties.

- In general, services (e.g. accounting or administrative services) rendered by a group company engaged in the insurance branch to its affiliates should be charged with a mark-up. Only if the service constitutes a mere ancillary service of the service provider a mark-up is not required. Apart from that, charging the services at cost is only possible if a cost sharing agreement is in place. The main requirement, however, is that the services are rendered in the interest and for the benefit of all pool members.
- A parent company located in the Czech Republic seconded one of its managing directors to its subsidiary in Austria, where he spends 50% of his working hours. The legal opinion of the VPR 2010 (Rz 164) concerning the lease of personnel is that the assigning parent company renders a passive service and does not create a permanent establishment in Austria. According to the Austrian Ministry this opinion applies also when a company seconded its managing director. Furthermore, the charging of secondments of managing directors is possible without any mark-up on the current costs if the secondment can be regarded as an ancillary service of the assigning party to the Austrian subsidiary.
- When an Austrian enterprise carries on its business through a PE in Saudi Arabia the attribution of profits to the latter should be based on the separate entity approach. Therefore, business relations between the head office and the PE have to be at arm's length and an appropriate transfer pricing methodology has to be applied. The separate entity approach is applied with certain restrictions. Instead of using transfer pricing methodology a mere cost allocation method can be employed if the head office has incurred payments for the PE (e.g. according to such cost allocation concept, salary paid by head office to employees working for the permanent establishment are deducted in computing the profits of the permanent establishment). Additionally, executive and general administrative expenses incurred for the PE have to be allocated on an appropriated pro rata to the PE. As the cost allocation concept does not require payments between the two parts of the single enterprise it cannot entail a withholding of tax at source.
- Since the update 2010 of the OECD MTT the cost allocation concept has been abolished, this means that the arm's-length principle prevails. This requires the establishment of accounts for internal transfer pricing receivable and transfer pricing payable which at some point in time have to be settled through real payments. However, the separate entity approach is only a fiction and cannot disregard the fact that the PE and the head office are only two parts of one single taxpayer, which is why a single entity cannot conclude real contracts with itself. Therefore, source taxation on purely internal flows of payments from one part of the enterprise to another is not permitted.
- With reference to financial activities VPR 2010 states: 'In accordance with the general principles for determining transfer prices the comparable uncontrolled price method (CUP method) is also to be preferred to other transfer pricing methods in case of inter-company financing transactions if comparables of third parties can be found on the money or capital market. If the CUP method is applied and if independent commercial banks are referred to for this purpose, it needs to be ensured that the conditions of these financing structures are comparable or that at least adjustments for any differences are quantifiable (2.7/ 2.14 rev no. 2 OECD TPG)'.

However, a comparison without restrictions of inter-company financing transactions to those of commercial banks might generally not be possible as their goals deviate. While a commercial bank strives for investing the money received from their customers at the highest return, a group aims at identifying liquid funds and forwarding them depending on the requirements of the group so that the individual group companies achieve their goals. Banks therefore aim to generate profit by granting loans whereas group financing companies strive to secure liquidity as well as to optimise its funding and interest outcome.

As a result the credit interest rate of independent commercial banks can only be used as an upper limit of an arm's-length interest rate. Whether this limit provides for a comparable of the deductible interest expenses depends on the individual circumstances of the case, which must be assessed in the light of all relevant conditions by the responsible tax office. Moreover, the evaluation needs to take into account factors such as currency, term, creditworthiness of borrower, inevitable currency risk, third party refinancing costs. It needs to be acknowledged that the ultimate parent company is able to directly influence the capital structure of the group companies, thus influences the creditworthiness of them. The provision of securities for loans is under the control of the ultimate parent company, too. As a consequence, according to a German Court decision only the interest rates for secured loans provide for an upper limit (BFH of 21.12.1994, I R 65/94).

If the group financing company has sufficient own liquidity, the deposit interest rate shall be used as benchmark (BFH of 28.2.1990, I R 83/87, BStBl. II 1990,649 and BFH of 19.1.1994, I R 93/93, BStBl. II 1994,725). In such a case it cannot be justified that the foreign related creditor earns more by investing its excess liquidity in an associated enterprise than in a bank.

In order to determine the arm's-length range (1.45/3.55 rev OECD TPG) of interest rates a comprehensive functional analysis is necessary which also encompasses the foreign group financing company's capital structure. However, the range between the upper limit of the credit interest rate and the lower limit of the deposit interest rate is not comparable to the range of acceptable transfer prices in terms of the OECD TPG. The range of acceptable transfer prices in terms of the OECD TPG is either in the direction to the lower or upper limit depending on the individual functional circumstances. In order to determine if the yield resulting from the difference between credit and deposit interest rate is attributable to creditor or debtor, the risk allocation within the group has to be taken into account. In case of doubt the German judiciary can be followed, according to which the creditor and debtor share the range between the credit and deposit interest rate (BFH of 19.1.1994, I R 93/93, BStBl. II 1994, 725).

The above mentioned considerations apply to both group financing companies which are located within the territory of a tax haven and outside the territory of a tax haven. However, in case a tax haven is involved in financing transactions a suspicion of an impermissible profit shift would be more relevant compared to other financing structures. As a result, if a tax haven is involved, it needs to be ensured that the relationship is transparent and properly documented right from the beginning (VwGH of 25.05.93, 93/14/0019).

If a local group company receives funds from a foreign group financing company which is located in a tax haven and the suspicion of an impermissible profit shift cannot be disproved, the remuneration shall be based on the proven costs. For this purpose

Austria

the proven and tax deductible refinancing costs are to be compensated as well as remuneration for the service rendered is to be made. In case of tax evasion the legal consequences according to Article 22 Paragraph 2 Federal Fiscal Code will be triggered.

If the loan is provided in a foreign currency, the interest rates of this foreign currency are to be referred to if third parties in comparable circumstances would have agreed on a loan in this foreign currency. If the foreign currency loan could have been taken out at a cheaper interest rate on another capital market, then this interest rate shall be applied to determine the arm's-length interest rate.

If an Austrian parent company issues an interest-free loan to its foreign subsidiary and this is not qualified as a hidden capital contribution in neither of these countries, then according to the arm's-length principle it is expected that interest is charged from the parent company to the subsidiary. If this does not happen and cannot be justified through extraordinary circumstances, Article 9 of the DTA provides for a profit adjustment in Austria and a corresponding foreign adjustment.

- According to VPR 2010 cash management is the daily transfer of current accounts' balances of the individual group companies to a pool account of a group company which is responsible for the cash management. As a result, only the resulting balance needs to be financed (or is available for investments) for the group. The group therefore saves paying credit interest on the individual group companies' accounts while other group companies earn low deposit interest. These synergies must be allocated to all participating group companies after appropriate costs were charged. The service rendered by the cash-management-provider can be remunerated based on the cost plus method (CP method). If the cash-management-provider has to bear actual risks (e.g. due to a constant and substantial refinancing obligation at an independent third party) this needs to be remunerated adequately.
- Regarding framework agreements for inter-company transactions, transfer prices dictated by the parent company may be considered to be at arm's length, provided this is properly documented. This documentation has to contain details concerning the comparability with third party arrangements. The Austrian provisions imply that a proper documentation of the transactions should be prepared at the latest when the tax returns are filed. The Ministry recommends further that a provision obliging the parent company to assist in providing information requested during a tax audit should be included in the framework agreement.
- With respect to the method selection, sales companies engaging in comparable transactions with third parties in their home markets may use the gross or net profit margin of these transactions as internal comparables. In case a local company only pursues inter-company buying and selling in foreign markets, internal comparables obtained from the home market may be used if necessary adjustments are feasible. If the distribution chain involves several group companies with routine functions, the resale price method may also be used for the whole chain. The CP method, however, is not regarded as adequate in such situations.
- Sarbanes Oxley (SOX)-related costs arising in connection with the implementation of an internal control system in a US-based group are deemed not to be deductible with the Austrian subsidiary. The Austrian Ministry of Finance stated that SOX-related costs have to be seen in connection with the control function of the US parent company. Such costs can be borne by the Austrian subsidiary only if (and to that extent) it benefits from the internal control system. Such benefits have to be specifically measurable.

- The Austrian Ministry of Finance has interpreted a similar view in relation to costs incurred through the implementation of a new software system within the whole group. These costs are not a priori tax-deductible in Austria. The company has to prove that changing its software system is needed and directly benefits from the company. Incidental benefits of the group-wide implementation such as an increasing efficiency or synergy effects do not constitute such direct benefits. As already described previously, the benefits of the Austrian group entity have to be specifically measurable.
- The Austrian Ministry of Finance recently commented on the EU-Masterfile approach, which is generally accepted for transfer pricing documentation purposes in Austria. Specifically, the Ministry referred to the fact that the Austrian local file should be prepared in German. However, the tax authorities could have already asked for a certified German translation before this EAS reply was issued due to a provision in the Federal Fiscal Code. In practice such requests are rarely the case and English local files are generally accepted.

Burden of proof

As a matter of principle, the tax authorities carry the burden of proof. If the tax authorities challenge a tax return, the taxpayer does not have to prove the accuracy of the return; rather, the tax authorities would have to prove the contrary. However, based on the fact that tax authorities are entitled to ask for the documentation of transfer pricing, if an accurate documentation is not provided, the burden of proof switches to the taxpayer. In addition, in international tax cases, the taxpayer bears a special liability of cooperation (see Tax audit procedures).

Tax audit procedures

In Austria, it is not usual for the tax authorities to carry out an audit specifically in respect of transfer prices alone. However, recent experience shows that already at the beginning of a tax audit, inspectors request a description of the transfer pricing system in place. Typically, transfer prices represent one part of a tax audit. If transfer pricing or benchmarking studies exist, they have to be provided to the tax auditors. The tax authorities have special experts who are retracing and reviewing the correctness and comparability of such studies.

Selection of companies for audit

The tax authorities aim at auditing companies exceeding certain size thresholds on a three- to five-year basis.

For smaller companies, there are three possible ways for a company to be selected for a tax audit:

1. Time – Those companies that have not been audited for an extended period are likely to be selected.
2. Industry group selection – Tax authorities might focus on certain industries from time to time.
3. Individual selection – Some companies are selected individually, based on ‘professional judgement’ or exceptional fluctuations in key ratios.

Austria

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The taxpayer has a general duty to cooperate with the tax authorities, although decisions of the Administrative Court indicate that there is a limit to this duty insofar as the tax authorities cannot demand impossible, unreasonable or unnecessary information from the taxpayer.

There is an increased duty to cooperate where transactions with foreign countries are involved. Under this increased duty to cooperate, the taxpayer has a duty to obtain evidence and submit this to the tax authorities. The possibility of administrative assistance from other (foreign) tax authorities does not suspend the duty of the taxpayer to cooperate with the Austrian authorities.

The audit procedure

There is no special procedure for transfer pricing investigations, which are seen as part of a normal tax audit. In this procedure, the tax auditors visit the company's premises, interview the relevant company personnel and inspect the company's books and records. As far as transfer pricing is concerned, tax inspectors increasingly request a summary of the transfer pricing system applied, and ask for the transfer pricing documentation.

It should be noted that the conduct of the taxpayer during the tax audit can significantly affect both the outcome of the inquiry and the amount of any adjustment. If the taxpayer is able to maintain an objective approach and can provide good documentary evidence to support the transfer pricing scheme in place, he or she will have a much better chance of defending it against any adjustments proposed by the tax authorities.

Revised assessments and the appeals procedure

After the end of a tax audit, the tax inspector usually issues a 'list of findings', which is discussed with the company and/or the tax adviser. If the company agrees to the findings, the list forms the basis for the revised assessments covering the audited years. If, however, agreement could not be reached on any particular issues, then the tax office would still issue revised assessments in accordance with the inspector's findings but the company could file an appeal against the assessments.

If an appeal is filed by the company, it will be heard by the Tax Appeals Board (*Unabhängiger Finanzsenat*). The company may file a further appeal against a decision of the Tax Appeals Board with the Administrative High Court (*Verwaltungsgerichtshof*).

Additional tax and penalties

Despite the focus on structures aiming at tax evasion, there are no specific transfer pricing penalties stipulated in VPR 2010. However, transfer pricing adjustments have a direct effect on the corporate income tax base and late payment interest may also be assessed if corporate taxes are not paid by the statutory deadline. If, however, the tax liability relating to past years is increased as a result of a tax audit, interest will be charged on the difference between the tax paid and the final tax assessed. The period for which interest is levied starts from October following the assessment year and lasts for 48 months at a maximum. The interest rate amounts to 2% above the base interest rate. If tax is paid late, a late payment surcharge will be imposed, amounting to 2% of the unpaid amount. An additional surcharge of 1% would be levied if tax is not paid

within three months as of the date it has become due and an additional 1% in case of late payment of the second surcharge. This surcharge is not tax-deductible, and no supplementary interest will be charged.

In addition, with the amendment of the Act on Tax Offences 2010, the regulations for infringement of tax law covering fines and imprisonment have been tightened. According to the Act of Tax Offences 2010 fines and imprisonment charges may be assessed in cases of tax evasion and tax fraud. Moreover, fines are assessed on negligent and minor tax offences. Further, a tax offence is not only committed by the perpetrator, but also by anyone who incites another person to commit an offence.

Resources available to the tax authorities

Within the tax audit department, there are units that specialise in international transactions including transfer pricing. The staff in these units receives special training, which includes participating in audits and training courses in other countries. Indeed, the number of these specialised auditors has been constantly increasing in recent years: In a recent reorganisation within the tax audit department, a specialist division consisting of 17 experts has been formed, whereof seven persons are responsible for international transactions, including transfer pricing. Inquiries are normally undertaken by tax inspectors from the tax audit department without the assistance of lawyers, economists or other kinds of experts. The tax authorities have access to the Orbis/Amadeus database. Mutual agreement procedures are conducted by the Ministry of Finance.

Use and availability of comparable information

Use

According to the VPR 2010 the taxpayer has to prepare reasoned documentary evidence of the issues that were considered when determining the transfer prices. This documentation should be prepared before any transactions occur using those transfer prices.

The Austrian tax authorities have gained much experience lately by increasing the number of transfer pricing audits. They have recently formed a strict view on what constitutes a reasonably reliable process for using databases to provide comparable data on arm's-length margins or profits. Critical elements of the search strategy are independence criterion (25% preferred), start-ups, loss-makers, geographic region (EU (27) plus Switzerland, Norway and Island are generally accepted), size, consolidated data and intangibles. In line with the increased focus on comparability in the OECD Guidelines' updated chapters I-III, VPR 2010 stipulate that each of the five comparability factors needs to be considered in detail. Although the VPR 2010 do not refer to the nine-step process introduced in the update of the OECD Guidelines, this process is generally considered required for preparing benchmarking studies from 2010 on.

Similarly to the revised OECD Guidelines, VPR 2010 state that the application of interquartile ranges to narrow the range of transfer prices is an internationally accepted approach. By contrast, however, VPR 2010 provide for an adjustment to the median if a taxpayer's transfer prices deviate from the acceptable range of transfer prices.

Austria

Availability

If a company is legally obliged to publish its financial statements (such a requirement exists for all companies other than very small partnerships and individual enterprises), then there is access to the financial information contained therein; otherwise, access to such information is not normally publicly available.

If the transfer pricing policy of a company were being investigated by the tax authorities, it would be possible for advisers to use information on comparable companies in defence of the policy of the investigated company. Such information is, however, extremely difficult to obtain. Furthermore, tax advisers are bound to keep confidential any information obtained on other clients in the course of their work. Tax authorities certainly have access to more information than advisers, and this would be obtained through investigations into other taxpayers' transfer pricing policies; however, the tax authorities are bound to keep this information confidential.

Risk transactions or industries

There are no particular transactions that run a higher risk of being attacked than any other transactions. However, it can be stated that transactions with group companies based in low-tax jurisdictions, cross-border transfer of functions, assets or risks, financing transactions as well as inter-company services and licensing are regularly examined.

Limitation of double taxation and competent authority proceedings

If a DTA exists that contains provisions for mutual agreement procedures, it is very likely that these procedures would be used to avoid double taxation. According to information obtained from the Ministry of Finance, there are only a few cases where such an agreement between the tax authorities involved could not be reached. In such cases or where there is no DTA, settlement could be achieved under the Arbitration Convention (the convention re-entered into force retroactively as of 1 January 2000). Currently the convention is applicable between Austria and the 14 other pre-2004 European Union Member States except Greece. Otherwise, Article 48 of the Austrian Fiscal Code and a decree of the Ministry of Finance provide unilateral measures to avoid double taxation where no DTA is applicable. Taxpayers subject to taxation on Austrian-sourced income may file an application for a double taxation relief to the Ministry of Finance, and it may be granted at the Ministry's discretion.

The competent authority procedure may be initiated by the taxpayer, too. In case no competent authority procedure clause is given under the respective DTA, double taxation may be avoided by administrative assistance proceedings (EC Administrative Assistance Directive and EC Administrative Assistance Act) carried out by the tax audit authorities.

Advance pricing agreements

There has been a formal procedure for obtaining unilateral advance pricing agreements (APAs) in Austria since 1 January 2011. The Austrian Ministry of Finance published the decree to the new advance ruling regulation on the 2 May 2011. The Ministry issued a law that enables taxpayers to ask for binding APAs regarding certain issues in taxation such as transfer pricing. These regulations allow taxpayers for the first time to apply for binding, unilateral APAs in Austria. Bilateral agreements remain possible under the mutual agreement procedure clause of the applicable DTA. Besides

applying for binding rulings regarding transfer prices, such applications are also possible for reorganisations and group taxation. Taxpayers wanting to have a binding ruling must submit a written application which includes the relevant facts, the critical assumptions as well as a legal assessment of the facts. Administrative fees between Euro (EUR) 1,500 and EUR 20,000 will be charged for the processing of the application of such APAs depending on the company's size.

Anticipated developments in law and practice

No significant changes in law are expected in the near future. In practice, due to VPR 2010 and the formal APA legislation, the increasing importance of transfer pricing issues with the tax authorities is noticeable.

Liaison with customs authorities

Tax authorities and customs authorities may exchange information. Experience suggests, however, that different authorities do not in fact deal very closely with each other where transfer prices are concerned.

Transfer pricing adjustments for direct tax purposes are not normally reflected in declarations and assessments, respectively, for customs or any other indirect taxes. The VPR 2010 state that in case of transfer pricing adjustments, the respective VAT and input VAT also have to be adjusted. However, they may remain undone if they have no effect on the national tax revenue.

OECD issues

Austria is a member of the OECD. In our experience, the Austrian Ministry of Finance is very inclined to follow the positions of the OECD as expressed in the Model Commentary and the various OECD reports (e.g. partnership report, report on the attribution of profits to a PE). The new VPR 2010's stated objective is to facilitate and ensure the application of the OECD Guidelines and to allow for a dynamic interpretation, that is, to consider further developments by the OECD.

Joint investigations

A joint investigation by Austria and other countries' tax authority is possible on a bilateral basis by referring to a clause in an applicable DTA as well as on a bi- or multilateral basis through multilateral controls. The latter possibility is available through Austria's participation in the EU's Fiscalis 2013 programme. This programme aims at improving the functioning of the tax system in the EU by strengthening cooperation between participating countries, their administrations and any other bodies. Multilateral controls have become standard procedures in Austria and take on average one and a half years. The legal basis for multilateral controls varies depending on the type of tax involved and can include one or more of the following sources:

- Regulation 1798/2003 for VAT (Art 12-13).
- Council Directive 77/799/EEC for direct taxes.
- Council Directive 92/12/EEC and Regulation 2073/2004 for excise taxes.
- DTAs and OECD Convention on Mutual Administrative Assistance in Tax Matters.
- Decision No. 2235/2002/EC.

Austria

Thin capitalisation

There are no statutory rules on permissible debt equity ratios. As a rule of thumb, debt to equity ratios of 3:1 would in principle not be challenged by tax authorities, provided the terms of the debt are otherwise at arm's length. A recent decision of the Tax Appeals Board indicates that even a much higher debt to equity ratio could be permissible provided that the ability of the company to pay the interest rates and to repay the loan principal at maturity date are supported by a business plan that is based on realistic assumptions. However, it is not clear whether the Administrative High Court will confirm this position. Where, e.g. the interest rate is higher than an arm's-length rate, the consequences are that a deduction would be denied for the excessive interest, that corresponding amount would be qualified as a constructive dividend and withholding tax would also be payable (there is normally no withholding tax on interest payments to foreign lenders, whether related or unrelated, unless the loan is secured by real estate).

Management services

Where the amount of a management charge has been calculated on an arm's-length basis, the management fee would normally be tax-deductible. The following issues should, however, also be considered where management services agreements are being concluded:

- A detailed contract should be drawn up.
- The terms of the agreement should not be retroactive.
- Documentary evidence to substantiate the provision of services and its benefits to the recipient should be maintained.

Further, the VPR 2010 includes a list of intragroup activities that are regarded as shareholder activities, and are therefore non-deductible. These comprise e.g. costs of the management board, costs that concern the legal organisation of the affiliated group, incidental benefits. In contrast, the VPR 2010 also state a number of management services that generally may be charged, as e.g. consulting services concerning the economic and legal affairs of the group company, training and education of the personnel on behalf of the group company, costs for a continuous audit as long as these release the subsidiary from its audit expenses.

15.

Azerbaijan

A

Introduction

The transfer pricing concept is relatively new to Azeri tax law, although in the pre-tax code legislation there were some limited transfer pricing regulations focused principally on circumstances where goods, work, or services were sold at or below cost or bartered/transferred without charge.

The current transfer pricing rules were introduced in the current tax code effective from 1 January 2001, and have been amended several times since then. These rules mainly focus on the determination of prices on the sale of goods, work, or services and establish the principle of arm's-length pricing for transactions between related parties and, in certain instances, the approach for making adjustments to transfer prices.

In practice, the tax authorities have limited experience in dealing with transfer pricing, mainly making adjustments to taxpayers' profits by disallowing certain deductible costs or challenging interest rates or the mark-up on services that were not, in their opinion, incurred or charged on an arm's-length basis.

Statutory rules

Scope

Under the tax code, 'market price' is defined as the price for goods, works, or services, based on the relationship of demand and supply. A contractual price should be deemed the market price between counterparties for tax purposes, unless the contract or transaction falls under one of the exceptions below.

Under the tax code, the tax authorities may apply market price adjustments in the following cases:

- Barter transactions.
- Import and export operations.
- Transactions between related persons.
- Transactions in which the prices within 30 days deviate by more than 30% either way from the prices set by the taxpayer for identical or homogeneous goods, works, or services.
- A property of an entity was insured for the amount exceeding net book value of such property.

Azerbaijan

Related parties

Persons are considered 'related' in the following cases:

- If one person holds, directly or indirectly, 20% or more of the value or number of shares or voting rights in the other entity, or in an entity that actually controls both entities.
- If one individual is subordinate to the other with regard to official position.
- If persons are under the direct or indirect control of a third person.
- If persons have a direct or indirect control over a third person.

Pricing methods

The tax code lists the following methods for determining the 'market price':

- Comparable uncontrolled price (CUP) method.
- Resale price method.
- Cost-plus method.

The tax code establishes the priority of pricing methods to be used by the tax authorities to determine market prices, according to which the CUP method should be used first before all other methods.

If the determination of the market price is not possible under any of the methods above, the market price should be determined by an 'expert'.

Comparability factors

In determining the market price, the tax authorities are required to take into account usual discounts from, or mark-ups to, prices. In particular, the tax code gives specific circumstances of how the discounts or mark-ups can be caused, such as deterioration of the quality of goods or the expiry of a product's life.

In addition, the tax code sets out the commonly accepted principle that, for the purposes of determining the market price, only transactions carried out under comparable conditions should be taken into account. In particular, the following factors should be evaluated:

- Quantity (volume) of supply.
- Quality level of goods and other consumption indicators.
- Period within which liabilities should be fulfilled.
- Terms of payment.
- Change of demand for goods (works, services) and supply (including seasonal fluctuations of consumer demand).
- Country of origin of goods and place of purchase or procurement.

In the Profits Tax section of the tax code, there is a separate list of comparability factors that should be looked at to identify borrowings that can be treated as taking place under comparable circumstances. In particular, borrowings should take place in the same currency and be under the same terms and conditions.

Documentation requirements

There is no statutory requirement in Azeri law that requires transfer pricing documentation to be prepared, apart from a general requirement for taxpayers to maintain and retain accounting and tax records and documents. It is, however, clear that taxpayers that do not take steps to prepare documentation for their transfer pricing systems, in general or for specific transactions, will face an increased risk of being subject to an in-depth transfer pricing audit.

Other regulations

Currently, besides linked provisions stipulated in the tax code, there are no other specific regulations in Azerbaijan relating to transfer pricing.

Legal cases

Very few court cases have been related to transfer pricing in Azerbaijan.

Burden of proof

Under the tax code, the burden of proof rests with the tax authorities to demonstrate that the price charged by a taxpayer significantly fluctuates from the market price. Unless otherwise proved, prices set by taxpayers are deemed to be the market prices. However, if the documentation requested by the tax authorities is inappropriate or unavailable, then the tax authorities can determine the adequate pricing levels, whereby the burden of proof would be shifted to the taxpayer.

Tax audit procedures

Currently, the tax authorities do not have specific procedures in the tax code for conducting separate transfer pricing audits. Control over prices is primarily made in the course of tax audits.

Revised assessments and the appeals procedure

Taxpayers have the right to appeal to higher level tax authorities or to court.

Additional tax and penalties

There is no separate penalty regime for the violation of transfer pricing rules; however, transfer pricing adjustments made by the tax authority in the course of a tax audit that would increase the taxable revenue of the taxpayer (e.g. by disallowing the deduction of the costs in relation to excessive pricing levels), may lead to the underpayment of tax.

In case of a successful challenge by the authorities, a penalty of 50% of the underestimated tax may be imposed on the taxpayer. In addition, an interest payment of 0.1% per day also would accrue until the tax is paid in full.

Resources available to the tax authorities

Although the arm's-length principle has existed in the tax legislation since 2001, the enforcement of this principle is not common practice. Absence of statistical information for benchmarking purposes and the lack of modern information systems hamper the effective application of transfer pricing regulations in Azerbaijan.

Azerbaijan

Use and availability of comparable information

The tax code provides that comparables for the determination of market prices are to be taken only from 'official and open' information sources. The tax code does not define or specify what sources are considered official and open, but gives examples of such possible sources – databases of authorities in the specific market, information submitted by taxpayers to tax authorities, or advertisements.

In practice, in the majority of tax audits where transfer pricing issues have been raised, the tax authorities have relied on information they collect from other similar taxpayers, or directly from alternative producers or sellers of similar goods in the local market (primarily, state-owned concerns). Information published by the State Statistics Committee has not been commonly used.

Occasionally, the Azeri tax authorities undertake extensive data-gathering involving comparables to obtain an in-depth knowledge of specific industry practices and pricing policies. The data obtained from comparables have been used in some cases to make transfer pricing adjustments on a single-transaction basis without regard to overall company profitability or multiple-year data. In that situation, taxpayers have been faced with considerable difficulty in challenging the position, as no specific data is provided on the comparables to allow verification and submission of counter-arguments.

Risk transactions or industries

The types of transactions typically scrutinised by the Azeri tax authorities in tax audits include:

- Sale/purchase of goods, where the supplier is an overseas entity, even unrelated to the taxpayer.
- Provision of centralised head-office services, and technical/management fees.
- Import transactions and recovery of related input value added tax (VAT).
- Interest rates on inter-company loans.

All industries are subject to the transfer pricing regulations in Azerbaijan.

Limitation of double taxation and competent authority proceedings

Currently, there are 40 effective double tax treaties with Azerbaijan. However, there is no experience with the application of the transfer pricing provision in those treaties.

Advance pricing agreements (APAs)

Currently, there are no procedures in Azerbaijan for obtaining an APA. However, it is possible to obtain a written opinion from the tax authorities on transfer pricing issues. Such opinions are not binding.

Anticipated developments in law and practice

The Ministry of Taxes has started consultations with the Organisation for Economic Co-operation and Development (OECD) on adopting new, more detailed transfer pricing regulations. The general expectation is that the OECD-type guidelines and models will be adopted in Azerbaijan at some point in the future, but the government has not yet indicated a target date.

Liaison with customs authorities

The tax and customs authorities communicate with each other on various transfer pricing issues and have access to each other's respective databases.

OECD issues

Azerbaijan is not a member of the OECD. However, as mentioned, the general expectation is that the OECD-type guidelines and models are expected to be adopted in Azerbaijan.

Joint investigations

Usually, transfer pricing investigations are conducted by the tax authorities only. However, in some audits the tax authorities have engaged experts from other governmental bodies (e.g. the Ministry of Justice, the State Customs Committee), scientific research institutes and others.

Thin capitalisation

There are no thin capitalisation rules in Azerbaijan.

Management services

Currently, there are no specific rules or unified practice with regard to the application of the transfer pricing rules to management service charges in Azerbaijan.

16.

Belgium

Introduction

The Belgian tax authorities turned their attention towards transfer pricing in the early 1990s. Belgium has become more aggressive in the field of transfer pricing as it has become increasingly aware of the active interest adopted (typically) in the surrounding countries and the risk of seeing Belgium's taxable basis eroded. This focus on transfer pricing resulted in the issuing of a Dutch/French translation of the 1995 Organisation for Economic Co-operation and Development (OECD) Guidelines (and the 1996, 1997 and 1998 additions thereto) and of a revenue document that comments on the 1995 OECD Guidelines and serves as an instruction to tax auditors. As of 1 January 2003, the Belgian government also introduced a new broadened ruling practice aimed at providing foreign investors upfront certainty regarding their ultimate tax bill. In 2004, further changes to the ruling procedure were made to enhance a flexible cooperation between taxpayers and the Ruling Commission. A specialist transfer pricing team has been established and, in 2006, the Belgian tax authorities also installed a special transfer pricing investigation squad. Finally, during 2006, the Belgian government issued a second transfer pricing practice note endorsing the EU Code of Conduct on transfer pricing documentation.

Statutory rules

The Belgian Income Tax Code (ITC) did not provide specific rules on inter-company pricing until mid-2004, with the formal introduction of the arm's-length principle in a second paragraph to Article 185 of the ITC.

In addition, the authorities can make use of other more general provisions in the ITC to challenge transfer prices. For example, in some cases where the Belgian tax authorities raise the issue of transfer pricing, the general rules on the deductibility of business expenses are invoked. Furthermore, the ITC contains provisions that tackle artificial inbound or outbound profit shifting. These are the so-called provisions on abnormal or gratuitous benefits.

Arm's-length principle

In 2004, Article 185 of the ITC was expanded to include the arm's-length principle in Belgian tax law for the first time. Article 185, paragraph 2 of the ITC allows for a unilateral adjustment to the Belgian tax basis, similar to the corresponding adjustment of Article 9 of the OECD Model Tax Convention. The underlying assumption is that, in case of downward adjustment, the 'excess profit' forms part of the profits of the foreign-related-party. The Ruling Commission has to agree which part of the profit is deemed to be derived from the related party dealings and how the 'part of the profits of the foreign related party' condition should be interpreted. Various rulings on this topic have been issued in the meantime.

Deductibility of expenses

General rules

The general rule concerning the deductibility of expenses is contained in Article 49 of the ITC. This article stipulates that a tax deduction is allowed only if an expense is incurred for the benefit of the taxpayer and is connected with the taxpayer's business activity. This connection must be demonstrated by the taxpayer. The expense itself must be real and necessary; incurred to obtain and retain taxable income; and be paid, accrued or booked as a definite and fixed liability during the taxable period.

Excessive expenses

As a matter of principle, the tax authorities and courts may not test whether a business decision was expedient. Although the company bears the burden of proof that expenses are necessarily linked with its operations or functions, the authorities have no right to question whether the expenses are useful or appropriate. However, Article 53 of the ITC provides that relief may be denied for any excessive expenses incurred, and this will be the case if the expense is not reasonable in light of the activities carried out. No case law exists on the application of this article in the context of transfer pricing.

Interest payments

Article 55 of the ITC provides that interest paid is a tax-deductible business expense, provided that the rate of interest does not exceed normal rates after taking into account the specific risks of the operation. (*See also section on Thin capitalisation*)

Abnormal or gratuitous benefits

Article 26 of the ITC provides authority for the taxable profits of enterprises in Belgium to be increased where the authorities can demonstrate that any profit transfers were 'abnormal or gratuitous benefits' granted to individuals or companies established in Belgium or abroad. This does not apply if the benefits transferred are subject to (Belgian) tax in the hands of the recipient(s). Although this article seems to have become obsolete because of the formal introduction of the arm's-length principle in Belgian tax law by Article 185, paragraph 2 of the ITC, this is not true for situations where the latter article does not apply. This may, for example, be the case for pure Belgian transactions where the recipient of the benefit is not subject to taxation on said advantage.

The Belgian ITC does not define 'abnormal or gratuitous benefits' and, consequently, the issue has been subject to review in the courts. Case law suggests that 'abnormal' refers to 'that which is not consistent with common practice', while 'gratuitous' refers to the fact that a benefit is not granted in the course of the execution of a contractual obligation, but is granted where there is none or insufficient consideration (Court of Cassation, 31 October 1979, NV Regents Park Co Belgium, Bull. Bel. 590).

The Belgian legislature inserted in Article 26 paragraph 1 of the ITC the following wording: 'notwithstanding the application of Article 49'. This means that the application of Article 26 of the ITC does not exclude the application of Article 49 of the ITC. In other words, even if the abnormal or gratuitous benefit is taken into account for determining the taxable basis of the beneficiary, the tax deductibility of the related expenses can still be denied in the hands of the grantor. This could result in economic double taxation. This provision has come into play as of tax year 2008.

Belgium

Article 207 of the ITC provides that a Belgian company that receives (directly or indirectly) abnormal or gratuitous benefits from a company upon which it is directly or indirectly dependent may not use any current year losses or losses carried forward, nor may it apply the participation exemption, investment deduction or notional interest deduction (NID) against the taxable income arising from the benefit. In an answer to a parliamentary question (L. Van Campenhout, 2 April 2004), the Belgian Minister of Finance has given a very broad interpretation to this provision by declaring that in the case of received abnormal or gratuitous benefits, the minimum taxable basis of the receiving company equals at least the amount of the benefit. The previous administrative tolerance under which abnormal or gratuitous benefits received from abroad were not tackled has been abolished as of tax year 2004.

Anti-abuse regulation

Under the Programme Act of 29 March 2012, a new general anti-abuse provision was introduced in Belgian tax law applicable as of tax year 2013 – income year 2012 (with some exceptions). The revised Article 344, §1, of the ITC contains this general anti-avoidance rule. Under the previously applicable general anti-abuse provision, the Belgian tax authorities could reclassify a legal deed (transaction) into a different transaction provided that both transactions had the same/similar legal consequences. Due to the latter condition, the old rule in most cases proved to be inadequate to recharacterise transactions on the basis that they did not make commercial sense (commercially rational).

The new wording of article 344 §1 ITC now clearly provides that a transaction (in other words a legal action [or a chain of legal actions]) is not opposable towards the tax authorities if the tax authorities can demonstrate that there is tax abuse.

For the purpose of the anti-abuse rule, ‘tax abuse’ is defined as:

- a transaction in which the taxpayer places himself – in violation with the purpose of a provision of the ITC – outside the scope of this provision of the ITC
- a transaction that gives rise to a tax advantage provided by a provision of the ITC whereby getting this tax advantage would be in violation with the purpose of this provision of the ITC, and whereby getting the tax advantage is the essential goal of the transaction.

In case the tax authorities uphold that a transaction can be considered as tax abuse, it is up to the taxpayer to refute that the choice for the legal action or the whole of legal actions is motivated by other reasons than tax avoidance (reversal of burden of proof). In case the taxpayer cannot refute this, the administration can reclassify the transaction or the whole of transactions into another transaction. The transaction will be subject to taxation in line with the purpose of the ITC, as if the abuse did not take place.

Please note that the extent of this new anti-abuse rule is still uncertain. Notwithstanding the fact that the Belgian tax authorities published administrative commentaries on May 4, 2012 (Circular letter Ci.RH.81/616.207) on the new anti-abuse rule, no clear examples have been given in this respect. However, in the parliamentary works (DOC 53 2081/016) with respect to the new anti-abuse rule, the Belgian Minister of Finance stated that taxpayers will still be free to choose the structure with the lowest tax burden provided that there is no tax abuse.

Notional interest deduction

On 22 June 2005, the Belgian tax law on the notional interest deduction was passed.

These rules are intended first to ensure equal treatment of debt and equity funding, and, second, to provide a successor to the Belgian coordination centres regime.

Companies liable to Belgian corporation tax (including Belgian branches of foreign companies) are granted a notional interest deduction equal to the 10-year state bond rate on the equity shown in the company's individual Belgian financial statement. The equity requires slight alteration (e.g. holdings in subsidiary companies [inter alia] are to be trimmed off in assessing the relevant equity figure).

To the extent that the interest deduction does not have a direct tax effect (e.g. in loss situations), the interest deduction can be carried forward for the next seven years. The measure thus allows obtaining tax relief for what is deemed an arm's-length interest rate calculated on the adjusted equity for which no charge is reported in the profit and loss statement.

However, on 20 July 2012, the council of ministers approved the limitation of the carry forward of excess NID. This Bill (draft law) was sent over to the Chamber. Currently, the bill is not yet published and not yet approved by the Chamber. Although the limitation of the carry forward of excess NID is currently not yet final law, it is expected that it will become final law. According to the Bill, carrying forward excess NID is no longer possible. Whereas excess NID could be carried forward for seven years (as explained above), the Bill proposes to abolish the carry forward of excess NID generated as of tax year 2013 (financial years closing between 31 December 2012 and 30 December 2013, both dates inclusive).

Although the Bill introduces this strict limitation, it also introduces a Grandfather clause for the current existing 'stock' of excess NID. This is in relation to the excess NID existing in the hands of a Belgian company or branch at the end of tax year 2012 (financial years closing between 31 December 2011 and 30 December 2012, both dates inclusive). For the application of this Grandfather clause three conditions must be met, this includes (i) the existing stock of excess NID can only be offset against the profit that remains after all other tax deductions have been applied (dividends received deductions, patent income deductions, current year NID, carry forward tax losses, and investment deductions), (ii) the existing stock of excess NID can be deducted from the first tranche of euro (EUR) 1 million of the taxable profit remaining after the deductions listed in first condition have been applied. If the taxable profit exceeds EUR 1 million, an additional amount of stock of excess NID can be offset, corresponding to 60% of the taxable profit that remains after the first tranche of EUR 1 million has been used, and (iii) the existing stock of excess NID can be carried forward as provided in the current rules, i.e. for a maximum seven years. However, the portion of excess NID that cannot be used due to the 60% limitation – i.e. 40% of the taxable profit remaining after all other tax deductions and after deductions of the first tranche of EUR 1 million of the excess NID – can be carried forward indefinitely.

For budgetary reasons, the notional interest deduction rate for tax years 2012 (3,425%) and 2013 (i.e. financial years ending between 31 December 2012 and 30 December 2013, both dates inclusive) has been capped at 3% (3.5% for small and medium-sized companies).

Belgium

Small and medium-sized companies, as defined for Belgian company law purposes, are allowed to raise the reference interest rate by 0.5%. However, they have to make the choice between the current system of an investment reserve and the notional interest deduction. They are not allowed to apply both incentives.

Patent income deduction

On 27 April 2007, the Belgian parliament approved the law introducing a tax deduction for new patent income (PID) amounting to 80% of the income, thereby resulting in effective taxation of the income at the maximum rate of 6.8%.

To benefit from the PID, the Belgian company or branch can exploit the patents owned by it, or licensed to it, in different ways.

A first option available to the Belgian company or branch is to licence the patents or extended patent certificates to related and unrelated parties.

Alternatively, the Belgian company or branch can exploit the patents by manufacturing, or having manufactured by a contract manufacturer, products in which the patents are used and supply the products to related or unrelated customers. It may also use the patents in the rendering of services.

For patents licensed by the Belgian company or branch to any related or unrelated party, the PID amounts to 80% of the gross licence income derived from the patents and patent certificates, to the extent the gross income does not exceed an arm's-length income. The PID applies to variable and fixed patent licence fees as well as other patent income, such as milestone payments.

For patents used by the Belgian company or branch for the manufacture of patented products – manufactured by itself or by a contract manufacturer on its behalf – the PID amounts to 80% of the patent remuneration embedded in the sales price of patented products. In the case of services, the PID amounts to 80% of the patent remuneration embedded in the service fees.

The new tax measure is aimed at encouraging Belgian companies and establishments to play an active role in patent research and development, as well as patent ownership. The tax deduction is to apply to new patent income and has come into force as of financial years ending on or after 31 December 2007.

Administrative guidelines

Initial guidelines

On 28 June 1999, administrative guidelines were issued relating to transfer pricing. The guidelines are broadly based on the OECD Guidelines. The reason for issuing the guidelines is of a purely 'offensive' nature. The guidelines stipulate that Belgium risks being forced to make corresponding downward profit adjustments if no adequate measures are taken to counterattack aggressive revenue action in other countries.

Although no specific penalty rules are imposed, the guidelines urge tax inspectors to carry out in-depth transfer pricing audits where the taxpayer fails to show 'documentary evidence' that efforts have been made to fix arm's-length inter-company prices. Consequently, taxpayers may benefit from preparing a defence file upfront, substantiating their transfer pricing methodology. In addition, the guidelines

underscore the importance of conducting a proper functional analysis and refer to a list of generic functional analysis questions.

Guidelines on Arbitration Convention

On 7 July 2000, the Belgian tax authorities issued administrative guidelines on the technicalities of applying the Arbitration Convention. The guidelines offer guidance to taxation officers and tax practitioners into how the tax authorities will apply the Convention. It is also an acknowledgement by the Belgian tax authorities of the need to develop an efficient practice to resolve issues of international double taxation.

Guidelines on transfer pricing audits and documentation

Introduction

The Belgian tax authorities published, in November 2006, administrative guidelines on transfer pricing audits and documentation.

In light of certain developments, such as the formal set-up of a specialist transfer pricing investigation squad and the approved EU Code of Conduct on transfer pricing documentation, the need had obviously arisen in Belgium for an update of the previous transfer pricing administrative guidelines and for new guidance, particularly on transfer pricing audits and documentation requirements. The 2006 administrative guidelines fill this need and, at the same time, confirm the integration in Belgian tax practice of the EU Code of Conduct. The Code of Conduct is added as an appendix to the administrative guidelines.

Cases with a higher risk of prompting an audit

The administrative guidelines contain a list of cases (which is not exhaustive) where ‘it may be advisable’ to check the transfer pricing practices. Among the situations listed in the administrative guidelines are transactions with tax havens and low-tax jurisdictions, back-to-back operations, and so-called guidelines/conduit structures, as well as situations that are much more frequent (i.e. entities that suffer structural losses, business reorganisations or migrations and the charge-out of management fees).

Pre-audit meeting

The administrative guidelines acknowledge the fact that an investigation into the transfer pricing dealings of a business and the related documentation form a complex whole and are significantly affected by widely diverse company-specific factors. To this end, the administrative guidelines suggest the possibility of holding a ‘pre-audit meeting’ before issuing any transfer pricing questionnaire. The purpose of this pre-audit meeting is to explore, in consultation with the taxpayer, what should be the appropriate scope of the tax audit, what documentation is relevant to the transfer pricing investigation, if there is any readily available documentation, etc.

Concept of ‘prudent business manager’

As to the question of what proactive effort is required when putting together transfer pricing documentation, the administrative guidelines refer to the concept of a ‘prudent business manager’ (i.e. given the nature of the transactions that take place between related companies, it is only normal, as a ‘prudent business manager’, to maintain written documentation that underpins the arm’s-length character of the transfer pricing applied).

The administrative guidelines list the information that can be prepared to this end.

Belgium

Flexibility as to the language of the documentation

The administrative guidelines acknowledge the reality that a large part of the transfer pricing documentation may not be available in one of the official languages of Belgium (i.e. Dutch, French or German). Reasons for this include the multinational character of business, the growing tendency of organising transfer pricing studies at a pan-European or global level, or the need to ask a foreign-related company for information.

Inspectors are urged to apply the flexibility they feel 'in conscience' to be necessary when they evaluate the reasons given by the taxpayer for submitting documentation in a foreign language. This applies particularly to pan-European or worldwide transfer pricing studies, group transfer pricing policies and contracts with foreign entities.

Code of conduct on transfer pricing

The administrative guidelines ratify the standardised and partly centralised approach to transfer pricing documentation that is recommended in the Code of Conduct. This also means that concepts such as the 'master-file' and 'country-specific documentation' are now officially introduced into a Belgian context. The resolution of the EU Council on this Code of Conduct is added to the administrative guidelines as an appendix.

Pan-European benchmarks

The administrative guidelines confirm the current practice whereby the use of pan-European data cannot per se be rejected in the context of a benchmark analysis.

The use of pan-European analyses finds its justification not only in the often-existing lack of sufficient points of reference on the Belgian market, but also in the fact that many multinational businesses prefer to spread the cost of investing in a benchmark analysis over various countries.

Treatment of tax havens

As of 1 January 2010, Belgian companies and Belgian permanent establishments of foreign companies are required to report in their annual tax returns all payments, direct and indirect, to tax havens totalling EUR 100,000 or more.

Within the context of this new provision, tax havens are considered to be:

- countries that have been identified by the OECD as not sufficiently cooperative in the domain of international exchange of information
- countries that appear on a list of countries with no or low (less than 10%) taxes.

Payments made, directly or indirectly, to such tax havens and which have not been reported accordingly are not accepted as deductible business expenses. The same applies for payments that have been appropriately reported, but for which the taxpayer concerned has not provided sufficient proof that the payments have been made in the context of real and sincere transactions with persons other than artificial constructions. The latter proof can be provided by all means of evidence as defined in the Belgian Income Tax Code.

Accounting guidelines

The Belgian Commission for Accounting Standards has caused some discussion in the accounting and tax field by issuing advice that deviates from current accounting practice. As Belgian tax law, in principle, follows accounting law (unless it explicitly deviates hereof), these evolutions may also impact the transfer pricing field. Broadly

speaking, the discussion relates to the acquisition of assets for free or below-market value.

Until now, Belgian accounting law basically referred to the historical cost to determine the acquisition value of assets, provided the principle of fair image of the balance sheet is not impaired.

If the acquisition price is below fair value, the accounting standard stipulates that the difference between fair value and historical cost is treated as an exceptional profit at the level of the acquiring company.

In 2009, a new Royal Decree introduced additional reporting requirements in statutory and consolidated accounts made under Belgian GAAP. The additional reporting requirements cover (1) information on non-arm's-length inter-company transactions and (2) information on the off-balance-sheet operations that could have an impact on the balance sheet. By ratifying this Royal Decree, the Belgian legislature complied with the content of the European Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006. These new accounting rules introduce a new burden of proof on the arm's-length character of inter-company transactions. More specifically, since the board of directors and the statutory auditor have to approve and sign these accounts, sufficient evidence should be available to draw conclusions on the arm's-length nature of inter-company transactions. Henceforth, for transactions covered by these new accounting rules, transfer pricing documentation may prove to be extremely useful or even required to comply with accounting law and to manage directors' liability.

Legal cases

Belgian authorities did not significantly turn their attention to transfer pricing until the beginning of the 1990s. Consequently, relatively few important transfer pricing cases have taken place in Belgium.

In 1995, the Supreme Court decided that the benefit of losses carried forward in a loss-making company is denied where there has been an abnormal transfer of profit from a profitable company to that loss-making entity (Supreme Court, 23 February 1995).

On 21 May 1997, the Liege Court of Appeal rendered a favourable decision recognising the acceptability of a set-off between advantages of transactions of related parties. In the case at hand, a Belgian distribution entity acquired the contractual rights (from a group affiliate) to distribute certain high-value branded products in the Benelux countries. However, this was subject to the Belgian entity contracting out the distribution of certain dutiable brands to a Swiss affiliate. The Belgian authorities stipulated that the Belgian-Swiss transaction granted abnormal or gratuitous benefits to the Swiss entity. However, it was demonstrated that the transfer of profit potential to a foreign-related-party subsequently generated an inbound transfer of profit from another foreign-related-party. The court based its decision on the economic reality in a group context, and the fact that different companies were involved (and thus an indirect set-off was made) did not jeopardise the possibility to net the advantages against each other. The Ghent Court of Appeal has also confirmed the acceptance of some form of economic solidarity in April 1999. In this case, the court ruled in favour of a Belgian company that had granted quality discounts to its UK affiliates to secure the going concern of the latter, as this was done for its own commercial interest (contra

Belgium

Brussels Court of Appeal 12 April 2000). Also, the Ruling Commission (*see below*) confirms the view of the Belgian courts by granting rulings over the acceptability of certain benefits being granted between related entities because of particular intragroup reasons.

The Ghent Court of Appeal ruled in November 2002 in a high-profile tax case that an advantage received by a Belgian company pursuant to the acquisition of shares at book value, which was lower than market value, may create a Belgian tax liability on the basis of Article 24 of the ITC.

The Bergen Court of Appeal ruled in favour of analysing in detail why certain related party transactions take place under terms and conditions that might at first glance breach the arm's-length standard. In the case at hand, the Court accepted the granting of interest-free loans, as otherwise the group might have faced adverse financial circumstances.

Moreover, in the case of SGI vs. the Belgian State, the European Court of Justice (ECJ) delivered a judgment dated January 2010 that clarifies the position of transfer pricing rules within the framework of European law. The relevant provisions of the Belgian income tax law (Article 26) allow for adjustments in the cases of 'abnormal or gratuitous benefits' granted to a foreign affiliate, but not in a domestic context.

The ECJ found that (a) there was in principle a breach of the EU freedom of establishment, but (b) the Belgian legislation was justified as being within the public interest, provided (c) it was proportional.

Proportionality in this context means that (1) the expenses disallowed (or income imputed) are limited to the excess (shortfall) over the arm's-length amount; and (2) there is a defence of commercial justification.

The court remitted the case back to the Belgian courts to consider whether the way in which the national legislation was applied met the two tests of proportionality.

Furthermore, on 22 December 2010 the Constitutional Court of Belgium (*Arbitragehof/Court d'Arbitrage*) published a preliminary ruling based on the request from the Ghent Court of Appeal of 5 October 2010 in the case of NV Vergo Technics v Belgian State (No. 5042), which confirmed that the current version of the corporate income tax code that may in some situations still trigger double taxation does not breach the equality principle laid down in the constitution

The 'substance over form' approach also has been addressed by a number of Belgian courts. For instance, on 27 October 2010 the Antwerp Court of First Instance confirmed the priority of the substance principle. In this case, the court reconfirmed the rejection of deduction of certain business expenses related to a seat of management for lack of justification of personnel, offices, central bookkeeping or archives of the company.

On 10 June 2010 the Court of Cassation as well issued a decision where it stressed the importance of substance. In its decision, the court confirmed that the management fees paid to a company having neither tangible and intangible assets nor operational expenses to perform such management services were deemed to be paid to another company, i.e. the effective provider of the management services.

In a number of cases, different courts have accepted that the conditional waiver of a debt by a parent company to one of its subsidiaries does not constitute an abnormal or gratuitous advantage (after proving and fulfilling all the conditions and requirements). Moreover, it is also worthwhile mentioning that Belgium changed its legislation in 2009 with respect to waiver of debts to protect enterprises in financial distress (*see section on Debt waivers*).

However, on 31 January 2012, the Ghent Court of Appeal decided that the waiver of a debt by a Belgian parent company to its Italian subsidiary – despite the fact that is definitely not abnormal for a parent company to financially support its subsidiary under favourable conditions is to be considered a gratuitous advantage as it was not demonstrated that the Italian subsidiary was confronted with imminent bankruptcy at the time of the waiver. As such, according to the Court the waiver of debt by the Belgian company was not required or necessary.

Burden of proof

In theory, taxpayers must demonstrate that business expenses qualify as deductible expenses in accordance with Article 49 of the ITC, while the tax authorities must demonstrate that profit transfers to an affiliate are ‘abnormal or gratuitous benefits’. In practice, however, the tax authorities have actually requested on several occasions that taxpayers demonstrate that the transfer pricing methodology adopted is on an arm’s-length basis (*see below*).

Since 1997, the tax authorities have scrutinised the deductibility of management service fees in a more stringent way. The taxpayer is required to demonstrate that any services provided are both necessary to the business of the recipient and charged at market value.

Tax audit procedures

As noted above, Belgian tax authorities have issued administrative guidelines on transfer pricing audits and documentation. Although these guidelines are not legally binding, they play a pivotal role in current (and future) transfer pricing audits.

Selection of companies for audit

The administrative guidelines published in November 2006 contain a list of cases where it may be advisable to check the transfer pricing practices (*see section on Administrative guidelines*).

Transfer pricing enquiries may also arise in the course of a ‘routine’ tax audit.

The audit procedure

During the course of an audit, the inspector would normally visit the company’s premises. The 1999 administrative guidelines urge tax inspectors to interview as many people as possible, including staff with an operational responsibility, to get a fair idea of the functions, assets and risks involved.

The tax audit normally begins with a written request for information. The taxpayer must provide the data requested within (in principle) one month. However, the 2006 administrative guidelines preach flexibility as to this one-month period. Any documentary evidence considered relevant to the audit can be requested and reviewed by the authorities. As to the issue of obtaining information from foreign companies, the

Belgium

approach of the administrative guidelines seems to be more demanding than the OECD Guidelines. Indeed, the fact that a Belgian subsidiary argues that it did not receive any information from its foreign parent on its transfer pricing policy can be deemed to reflect a lack of cooperation.

The 2006 administrative guidelines stimulate companies to have a pre-audit meeting with the authorities to (1) discuss the transfer pricing policy carried out with the group, (2) discuss the level of transfer pricing documentation already available and (3) avoid having irrelevant questions raised which ask the taxpayer to prepare an unreasonable amount of documents. This focused approach should save a lot of time for the taxpayer as well as the tax authorities.

Revised assessments and the appeals procedure

Since assessment year 1999, new revised assessments and appeals procedures have been introduced. The main features can be summarised as follows:

Once the tax inspector has completed the analysis, any adjustment is proposed in a notification of amendment outlining the reasons for the proposed amendment. The company has 1Month to agree or to express disagreement. The tax inspector then makes an assessment for the amount of tax which he or she believes is due (taking into account any relevant comments of the company with which the inspector agrees). Thereafter the company has six months within which to lodge an appeal with the Regional Director of Taxes. The decision of the Regional Director of Taxes may be appealed and litigated. In a number of circumstances, the intervention of the courts can be sought prior to receiving the decision of the Regional Director of Taxes.

Additional tax and penalties

Tax increases in the range of 10% to 200% of the increased tax can be imposed.

In practice, discussion has arisen as to whether penalties or increases of tax can be levied in the context of abnormal or gratuitous benefits granted by a Belgian taxpayer. Although conflicting case law exists (e.g. Antwerp Court of Appeal, 17 January 1989), the Antwerp Court of Appeal ruled on 15 April 1993 that by its mere nature, abnormal and gratuitous benefits are always elements that are not spontaneously declared in the company's tax return and can therefore not give rise to an additional tax penalty.

It is unlikely that this reasoning can be upheld in cases where Article 185, Section 2 of the ITC is applicable.

Resources available to the tax authorities

Within the Central Tax Administration, several attempts have been made to improve the quality of transfer pricing audits and the search for comparable information. To this end, a specialist transfer pricing team (STPT) was established to ensure coherent application of the transfer pricing rules by the tax authorities, with a view to achieving consistency in the application of tax policies.

In short, the mission statement of the STPT is to:

- act as the central point of contact for all tax authorities facing transfer pricing matters

- maintain contacts with the private sector and governmental bodies in the area of transfer pricing
- formulate proposals and render advice with respect to transfer pricing
- take initiatives and collaborate in the area of learning and education, with a view to a better sharing of transfer pricing knowledge within the tax authorities, and
- take initiatives and collaborate with respect to publications that the tax authorities have to issue with respect to transfer pricing.

In addition to creating the STPT, in 2006, the Belgian tax authorities also installed an experienced special transfer pricing investigation squad (special TP team) with a twofold mission:

- Build up transfer pricing expertise to the benefit of all field tax inspectors and develop the appropriate procedure to conduct tax audits in this area according to the OECD Guidelines.
- Carry out transfer pricing audits of multinationals present in Belgium through a subsidiary or branch.

Use and availability of comparable information

Use

As indicated above, Belgium, in its capacity as an OECD member, has adopted the OECD Guidelines. Comparable information could, therefore, be used in defending a pricing policy in accordance with the terms of the OECD Guidelines.

On 22 July 2010, the OECD approved and published the final revision of Chapter I-III of the OECD Transfer Pricing Guidelines. One of the most significant changes in this respect is the removal of the hierarchy between traditional methods and profit-based methods in favour of the ‘most appropriate method’ rule. This means that in principle, all the authorised OECD methods now rank equally. In addition, higher standards of comparability are advocated. It is expected that the Belgian tax authorities will be using these new guidelines in evaluating taxpayers’ transactions upon tax audits.

Availability

The search for comparables relies primarily upon databases that provide financial data on the major Belgian companies. These databases provide comprehensive annual financial data, historical information and information on business activities, all of which is largely extracted and compiled from statutory accounts.

In addition, the Belgian National Bank maintains a database that contains all statutory accounts. Entries are classified according to NACE industry code (i.e. by type of economic activity in which the company is engaged).

Information on comparable financial instruments (such as cash-pooling, factoring, etc.) can be obtained from banks. This information (e.g. market interest rates) can then be used to support or defend a transfer pricing policy.

The 1999 administrative guidelines acknowledge that Belgium is a small country, so sufficient comparable Belgian data may be difficult to obtain. Consequently, the use of foreign comparables is accepted, provided proper explanation can be provided as to the validity of using surrogate markets. The 2006 administrative guidelines reconfirm that pan-European data cannot per se be rejected in the context of a benchmark analysis.

Belgium

Risk transactions or industries

Generally, there are no industry sectors which are more likely to be challenged than any other, and, since there are no excluded transactions, all transactions between related companies may be under scrutiny.

Furthermore, the authorities are more likely to question the price of services than the transfer of goods, and it is noticeable that some transactions are attracting increasing attention.

Debt waivers

According to Article 207 of the ITC, in some circumstances a Belgian company receiving abnormal or gratuitous benefits, whether directly or indirectly, is not allowed to offset amongst others current year losses or losses carried forward against these benefits. The circumstances in which this applies are those where the company receiving the benefits is directly or indirectly related to the company granting such benefits. This rule is being used stringently in cases where a loss-making company benefits from a debt waiver. In these circumstances, the waiver is treated as an abnormal or gratuitous benefit, although certain court cases (and also rulings) confirm the acceptability of intragroup debt waivers under particular circumstances.

In the beginning of 2009, however, the Belgian administration introduced a Continuity Act, which assists companies with judicial restructuring in a court of law. The act provides, among other things, a tax relief for a waiver of debt on both the creditor and debtor side. If a creditor waives debts according to the judicial restructuring procedure, the debtor's profit resulting from the debt reduction granted by the creditor should remain tax-exempt and the creditor's expenses resulting from waiving the debt will remain tax-deductible within Belgium. In this respect, the Act modified Section 48 of the ITC, which now explicitly states that, following approval by the court, expenses incurred due to a waiver of debt will qualify as tax-deductible. Similarly, (exceptional) profits are tax-exempt for the company receiving the waiver.

Permanent establishments – transactions with head office

The tax rules and administrative practices can be summarised as follows.

It is acceptable that, for tax purposes, a contractual relationship exists between a head office and its permanent establishment (PE). Hence, the arm's-length principle applies to most transactions between the head office and the PE, such as the sale of goods and the provision of services based on the separate entity approach. It is accepted that 'notional profits' can arise from internal transfers and that, in accordance with this treatment, these might be subject to taxation before any profit is actually realised by the enterprise as a whole.

Services

During a tax audit, particular attention would be paid to payments such as management fees or technical support fees to establish whether these payments should actually have taken the form of dividends.

Advance pricing agreements

Unilateral

As of 1 January 2003, the Belgian government introduced a new ruling practice that seeks to increase upfront legal certainty for investors, while taking into account national and international tax standards.

Under the new regime, a ruling is defined as an ‘upfront agreement’, which is a legal act by the Federal Public Service of Finance in conformity with the rules in force with respect to the application of law to a specific situation or operation that has not yet produced a tax effect.

Previously, a taxpayer could apply for a ruling only in a limited number of cases. Now, a taxpayer may apply for a ruling in all cases unless there is a specific exclusion. Although the Ministry of Finance acknowledges that it is impossible to provide a comprehensive list of all excluded topics, the new ruling practice nevertheless explicitly excludes some ruling categories to demonstrate the open nature of the new ruling system. To this end, a specific Royal Decree confirming the exclusions was published in January 2003.

A taxpayer may not apply for a ruling involving tax rates, computations, returns and audits; evidence, statutes of limitation and professional secrecy; matters governed by a specific approval procedure; issues requiring liaison between the Ministry of Finance and other authorities, whereby the former cannot rule unilaterally; matters governed by diplomatic rules; penalty provisions and tax increases; systems of notional taxation as for instance used in the agricultural sector; and tax exemptions.

In 2004, further changes to the ruling procedure were made to enhance a flexible cooperation between taxpayers and the Ruling Commission. At the same time, the ruling procedure itself has been rendered more efficient. These changes took effect 1 January 2005.

The provisions of double taxation treaties fall within the scope of the new ruling practice and, therefore, the Belgian competent authority is involved in the preparatory phase of making the ruling decision to ensure consistency of the decisions of the Ruling Commission in this respect.

Summaries of the rulings are published anonymously in the form of individual or collective summaries. The rulings are published at the government’s website, unless a foreign taxpayer is involved and the treaty partner has rules preventing publication. In such cases, approval to publish the ruling is requested.

Under the revised ruling practice, the use of pre-filing meetings is encouraged. A request for an advance ruling can be filed by (registered) mail, fax or email. The Ruling Commission must confirm receipt of a request within five working days. Subsequently, a meeting is organised allowing the Ruling Commission to raise questions and the applicant to support its request. Recent experiences have demonstrated the effectiveness of the Commission and its willingness to accommodate, within the borders of the national and international legal framework, the search by the taxpayer for upfront certainty. Although there is no legally binding term to issue a ruling, it is the Ruling Commission’s intention to issue its decision within three months (counting as of the submission of the formal ruling application). In most cases, this three-month period is adhered to.

Belgium

Bilateral/Multilateral

Under the new ruling practice, taxpayers may be invited to open multilateral discussions with other competent authorities. These issues are dealt with case by case according to the relevant competent authority provision as stipulated in the tax treaty.

Recent experience shows that the Belgian tax authorities are also promoting bilateral or multilateral agreements and that they take a cooperative position for realising such agreements.

Competent authorities

On 27 November 2006 the US and Belgium signed a new income tax treaty and protocol to replace the 1970 income tax treaty. This new treaty and protocol entered into force on 28 December 2007. The new treaty introduces an innovative binding arbitration procedure in the context of the mutual agreement procedure. Indeed, when the competent authorities are unable to reach an agreement, the case shall be resolved through arbitration within six months from referral. In this type of arbitration, each of the tax authorities proposes only one figure for settlement, and the arbitrator must select one of the figures ('baseball arbitration').

Anticipated developments in law and practice

Practice has shown a significant increase in transfer pricing audits in Belgium. This trend is expected to continue.

Within that framework, the importance of having available upfront transfer pricing documentation will only increase.

In terms of new laws, it may be expected that the government might seek additional budgetary measures. The intended changes towards the NID regime are the most likely example of such measures.

Liaison with customs authorities

Although it is possible for an exchange of information to take place between the income tax and customs authorities, this rarely happens in practice.

Joint investigations

A facility exists for the Belgian tax authorities to exchange information with the tax authorities of another country. According to Belgian law, such an exchange must be organised through the Central Tax Administration. A number of bilateral treaties have been concluded to facilitate this process.

The 1999 administrative guidelines also consider the possibility of conducting joint investigations with foreign tax authorities.

Belgium is currently involved in several of these multilateral audits.

Thin capitalisation

The arm's-length principle applies to financing arrangements between affiliated parties. Article 55 of the ITC provides that interest paid is a tax-deductible business expense, provided that the rate of interest does not exceed normal rates, taking into account the specific risks of the operation (e.g. the financial status of the debtor and the duration of the loan).

In addition, note that related party loans from shareholders or directors of a Belgian borrowing company are subject to specific restrictions.

In the past, Belgian tax law did not have a general thin-cap rule. A special thin-cap rule only existed for interest payments or attributions to (real) beneficiaries taxed at low rates on that interest. This was the so-called 7/1 debt-equity ratio.

The Programme Acts of 20 March and 22 June 2012 replace the 7/1 rule with a new rule introducing a (general) 5/1 debt-equity ratio. For the purposes of the thin-cap rule, equity is defined as the sum of the taxed reserves at the beginning of the taxable period and the paid-up capital at the end of the taxable period. For the purposes of this new rule, certain non-taxed reserves are deemed to be taxed reserves. It regards *inter alia* certain tax-free reserves created upon a merger/division (including as a result of merger goodwill).

For the purposes of the thin-cap rule, debt is defined as:

- all loans, whereby the beneficial owner is not subject to income taxes, or, with regard to the interest income, is subject to a tax regime that is substantially more advantageous than the Belgian tax regime, and
- all intra-group loans (whereby 'group' should be interpreted in accordance with section 11 of the Companies Code).

Bonds and other publicly issued securities are excluded, as are loans granted by financial institutions. The new thin-cap rule is not applicable to loans contracted by (movable) leasing companies (as defined by section 2 of Royal Decree no. 55 of 10 November 1967), to companies whose main activity consists of factoring or immovable leasing within the financial sector and to the extent the funds are effectively used for leasing and factoring activities and to loans contracted by companies primarily active in the field of public-private cooperation.

An anti-abuse rule was introduced stating that, if the loans are guaranteed by a third party or if loans are funded by a third party that partly or wholly bears the risk related to them, the third party is deemed to be the beneficial owner of the interest, if the guarantee or the funding has tax avoidance as its main purpose. Third party in this context would also mean group companies, even if the loan has formally been granted by a non-group member.

The new Programme Act of 22 June 2012 has made some amendments to the thin cap rule in order to safeguard companies that have a centralised treasury function in Belgium. The amendments introduce netting for thin-cap purposes for companies responsible for the centralised treasury management of the group. These companies are allowed to net all interest paid to group companies with all interest received from group companies insofar the interest is paid/received within the context of a framework agreement for centralised treasury management. In case where the 5/1 debt-equity ratio has been exceeded, only net interest payments (of the higher amount) will be regarded as non tax-deductible business expenses. Centralised treasury management is defined as management of daily treasury transactions or treasury management on a short-term basis (e.g. cash pools) or, exceptionally, longer-term treasury management. In addition, in order to qualify for the exemption, the treasury company should set up a framework agreement under which the group companies clarify the treasury activities and the financing model applicable to their group.

17.

Brazil

Introduction

From the outset, Brazil's transfer pricing rules, which took effect on 1 January 1997, have been very controversial. Contrary to the Organisation for Economic Co-operation and Development (OECD) Guidelines, US transfer pricing regulations, and the transfer pricing rules introduced by some of Brazil's key Latin American trading partners such as Mexico and Argentina, Brazil's transfer pricing rules do not adopt the internationally accepted arm's-length principle. Instead, Brazil's transfer pricing rules define maximum price ceilings for deductible expenses on inter-company import transactions and minimum gross income floors for inter-company export transactions.

The rules address imports and exports of products, services and rights charged between related parties. The rules also cover inter-company loans, and all import and export transactions between Brazilian residents (individual or legal entity) and residents in either low-tax jurisdictions (as defined in the Brazilian legislation) or jurisdictions with internal legislation that call for secrecy relating to corporate ownership, regardless of any relation.

Through the provision of safe harbours and exemptions, the rules were designed to facilitate the monitoring of inter-company transactions by the Brazilian tax authorities while they develop more profound technical skills and experience in the domain. Since the Brazilian rules do not adopt the arm's-length principle, multinational companies with Brazilian operations have had to evaluate their potential tax exposure and develop a special transfer pricing plan to defend and optimise their overall international tax burden. From the outset, planning to avoid potential double taxation has been especially important.

In view of the substantial double taxation and documentation burdens, several international chambers of commerce and multinational companies have lobbied for changes to the current regulatory framework, in order to align Brazil's transfer pricing rules with international standards, including the adoption of the arm's-length principle. This effort has so far been unsuccessful.

Statutory rules

The rules require that a Brazilian company substantiate its inter-company import and export prices on an annual basis by comparing the actual transfer price with a parameter price determined under any one of the Brazilian equivalents of the OECD's comparable uncontrolled price method (CUP method), resale price method (RPM) or cost plus method (CP method). Taxpayers are required to apply the same method, which they elect, for each product or type of transaction consistently throughout the respective fiscal year. However, taxpayers are not required to apply the same method for different products and services.

While incorporating these transaction-based methods, the drafters of the Brazilian transfer pricing rules excluded profit-based methods, such as the TNMM or PSM. This is contrary to the OECD Guidelines and the US transfer pricing regulations, as well as the transfer pricing regulations introduced in Mexico and Argentina.

Other material differences from internationally adopted transfer pricing regimes include the Brazilian transfer pricing legislation's exclusion of a best method or most appropriate method rule; accordingly, a taxpayer may choose the respective pricing method. In addition, the Brazilian transfer pricing rules explicitly exclude inter-company royalties and technical, scientific, administrative or similar assistance fees, which remain subject to previously established deductibility limits and other specific regulations.

Rules regarding imports of goods, services or rights

Deductible import prices relating to the acquisition of property, services and rights from foreign-related parties should be determined under one of the following Brazilian methods:

Comparable independent price method (PIC)

This Brazilian equivalent to the CUP method is defined as the weighted average price for the year of identical or similar property, services, or rights obtained either in Brazil or abroad in buy/sell transactions using similar payment terms. For this purpose, only buy/sell transactions conducted by unrelated parties may be used. The use of the taxpayer's own transactions with third parties for purposes of applying this method will be acceptable only to the extent the comparable transactions are equivalent to at least 5% of the tested transactions; if necessary, transactions carried out in the previous year can be considered to reach this percentage.

Resale price less profit method (PRL)

The Brazilian equivalent to the RPM is defined as the weighted average price for the year of the resale of property, services or rights minus unconditional discounts, taxes and contributions on sales, commissions and a gross profit margin determined in the tax legislation. As of 1 January 2013, a 20% gross profit margin is required for industries/sectors that are not specified in the legislation, calculated based on the percentage of the value imported over the final resale price. For the following industries/sectors a different mark-up is required:

Sectors where a 40% profit margin is required:

- Pharma chemicals and pharmaceutical products.
- Smoke products.
- Optical, photographic and cinematographic equipment and instruments.
- Machines, apparatus and equipment for dental, medical and hospital use.
- Extraction of oil and natural gas, and oil derivative products.

Sectors where a 30% profit margin is required:

- Chemical products.
- Glass and glass products.
- Pulp, paper and paper products.
- Metallurgy.

Brazil

These margins are applied in the same way for imports of products for resale or for inputs to be used in a manufacturing process. In applying the PRL, a Brazilian taxpayer may use their own prices (wholesale or retail), established with unrelated parties in the domestic market.

Until 31 December 2012 the PRL method was calculated considering a margin of 20% applicable to products for resale, and if value was added before resale, the profit margin was increased to 60%, calculated based on the percentage of the value imported over the final sales price. The changes introduced in the transfer pricing legislation to be effective as from the tax year 2013 may be adopted by taxpayers in the tax year 2012, under the conditions determined by the tax authorities.

Production cost plus profit method (CPL)

This Brazilian equivalent of the CP method is defined as the weighted average cost incurred for the year to produce identical or similar property, services, or rights in the country where they were originally produced, increased for taxes and duties imposed by that country on exportation plus a gross profit margin of 20%, and calculated based on the obtained cost.

Production costs for application of the CPL are limited to costs of goods, services, or rights sold. Operating expenses, such as R&D, selling and administrative expenses, may not be included in the production costs of goods sold to Brazil.

Quotation price on imports method (PCI)

This new Brazilian method, introduced by Law 12715/12, must be applied to test imports of commodities that have a quote in a commodities exchange, as of 2013. Based on this method taxpayers shall compare the transaction value with the average quote of the respective commodity involved, adjusted by an average market premium, in the date of the transaction. In the case of transactions involving commodities that do not have a quote in a commodities exchange, taxpayers may choose to test the prices in import transactions based on information obtained from independent sources, provided by internationally recognised institutes involved in researches of specific sectors.

In the event that more than one method is used, except when the use of the PCI method is mandatory, the method that provides the highest value for imported products will be considered by the Brazilian tax authorities as the appropriate import price. This is intended to provide taxpayers with the flexibility to choose the method most suitable to them. The Brazilian rules require that each import transaction be tested by the parameter price determined using one of the three methods, as applicable to the type of transaction (this also applies to export transactions).

If the import sales price of a specific inter-company transaction is equal to or less than the parameter price determined by one of the methods, no adjustment is required. Alternatively, if the import sales price exceeds the determined parameter price, the taxpayer is required to adjust the calculation basis of income tax and social contribution.

The aforementioned excess must be accounted for in the retained earnings account (debit) against the asset account or against the corresponding cost or expense if the good, service or right has already been charged to the income statement.

Until 2012 one of the most controversial issues raised with regard to import transactions was the treatment of freight and insurance costs, as well as Brazilian import duty costs for purposes of applying the Brazilian transfer pricing rules. Before the changes introduced for 2013 onwards, the transfer pricing law considered freight and insurance costs and the Brazilian import duty costs borne by the Brazilian taxpayer as an integral part of import costs (i.e. the tested import price). According to the regulatory norms published in November 2002, taxpayers could compare a parameter price calculated under the CPL or PIC methods with an actual transfer price that included or excluded freight and insurance costs as well as Brazilian import duty costs borne by the Brazilian taxpayer. Meanwhile, for testing under the PRL, freight and insurance costs and Brazilian import duty costs borne by the Brazilian taxpayer should be added to the actual transfer price.

As of 2013 taxpayers are no longer required to include customs duty in the tested price as well as freight and insurance contracted with third parties, provided such third parties are not located in low tax jurisdictions or benefit from privilege tax regimes. As mentioned, the changes introduced in the transfer pricing legislation to be effective as from the tax year 2013 may be adopted by taxpayers in the tax year 2012, under the conditions determined by the tax authorities.

Rules regarding exports of goods, services and rights

In the case of export sales, the regulations provide a safe harbour whereby a taxpayer will be deemed to have an appropriate transfer price with respect to export sales when the average export sales price is at least 90% of the average domestic sales price of the same property, services, or intangible rights in the Brazilian market during the same period under similar payment terms. When a company does not conduct sales transactions in the Brazilian market, the determination of the average price is based on data obtained from other companies that sell identical or similar property, services, or intangible rights in the Brazilian market. When it is determined that the export sales price is less than 90% of the average sales price in the Brazilian market, the Brazilian company is required to substantiate its export transfer prices based on the parameter obtained using one of the following Brazilian methods:

Export sales price method (PVE_x)

This Brazilian equivalent of the CUP method is defined as the weighted average of the export sales price charged by the company to other customers or other national exporters of identical or similar property, services, or rights during the same tax year using similar payment terms.

Resale price methods

The Brazilian versions of the RPM for export transactions are defined as the weighted average price of identical or similar property, services, or rights in the country of destination under similar payment terms reduced by the taxes included in the price imposed by that country and one of the following:

- A profit margin of 15%, calculated by reference to the wholesale price in the country of destination (wholesale price in country of destination less profit method, or PVA).
- A profit margin of 30%, calculated by reference to the retail price in the country of destination (retail price in country of destination less profit method, or PVV).

Brazil

Purchase or production cost-plus taxes and profit method (CAP)

This Brazilian equivalent of the CP method is defined as the weighted average cost of acquisition or production of exported property, services, or rights increased for taxes and duties imposed by Brazil, plus a profit margin of 15%, calculated based on the sum of the costs, taxes and duties.

Quotation Price on Exports method (PCEX)

This new Brazilian method, introduced by Law 12715/12, must be applied to test exports of commodities that have a quote in a commodities exchange, as of 2013. Based on this method taxpayers shall compare the transaction value with the average quote of the respective commodity involved, adjusted by an average market premium, in the date of the transaction. In the case of transactions involving commodities that do not have a quote in a commodities exchange, taxpayers may choose to test the prices in export transactions based on information obtained from independent sources, provided by internationally recognised institutes involved in researches of specific sectors as well as by Brazilian regulatory agencies. Taxpayers must apply this method to test commodities quoted in the exchange market, even if their average export sales price are at least 90% of the average domestic sales price of the same goods.

In the event that the export sales price of a specific inter-company transaction is equal to or more than the transfer price determined by one of these methods, no adjustment is required. On the other hand, if the export sales price of a specific inter-company export transaction is less than the determined transfer price, the taxpayer is required to make an adjustment to the calculation bases of income tax and social contribution.

Rules regarding interest on debt paid to a foreign-related person

Rules applicable until 31 December 2012

The statutory rules provide that interest on related party loans that are duly registered with the Brazilian Central Bank will not be subject to transfer pricing adjustments. However, interest paid on a loan issued to a related person that is not registered with the Brazilian Central Bank will be deductible only to the extent that the interest rate equals the LIBOR dollar rate for six-month loans plus 3% per year (adjusted to the contract period). The actual amount of the interest paid on the loan in excess of this limitation will not be deductible for income tax and social contribution purposes.

The rules do not provide a reallocation rule, which would treat the foreign lender as having received less interest income for withholding tax purposes. Because the foreign lender actually received the full amount of the interest in cash, the foreign lender will still be required to pay withholding tax at the rate of 15% on the full amount paid, including the excess interest.

Similarly, loans extended by a Brazilian company to a foreign-related-party that are not registered with the Brazilian Central Bank must charge interest at least equal to the LIBOR dollar rate for six-month loans plus 3%.

Rules applicable as of 1 January 2013

As of 1 January 2013 interest on related party loans, even if resulting from agreements duly registered with the Brazilian Central Bank, will be deductible only up to the amount that does not exceed the rate determined based on the following rules, plus a spread to be determined by the Ministry of Finance based on an average market spread:

- In case of transaction in US dollars subject to fixed interest rate: rate of Brazilian sovereign bonds issued in US dollars in foreign markets.
- In case of transaction in Brazilian reais subject to fixed interest rate: rate of Brazilian sovereign bonds issued in Brazilian reais in foreign markets.
- In all other cases: London Interbank Offered Rate – LIBOR for the period of six months.

In the case of transactions in Brazilian reais, subject to floating interest rate, the Ministry of Finance can determine a different base rate.

For transactions covered in item III above in currencies for which there is no specific Libor rate disclosed the LIBOR for US Dollar deposits must be considered.

The deductibility limit must be verified on the contract date, and it will apply during the full contract term. For this purpose, the renewal and the renegotiation of contracts will be treated as the signing of a new contract.

Rules regarding royalties and technical assistance

The statutory rules expressly exclude royalties and technical, scientific, administrative or similar assistance remittances from the scope of the transfer pricing legislation. Accordingly, provisions of the Brazilian income-tax law established before the Brazilian transfer pricing rules went into effect still regulate the remittances and deductibility of inter-company payments for royalties and technical assistance fees.

According to this preceding legislation, royalties for the use of patents, trademarks and know-how, as well as remuneration for technical, scientific, administrative or other assistance paid by a Brazilian entity to a foreign-related party are only deductible up to a fixed percentage limit set by the Brazilian Ministry of Finance. The percentage limit depends on the type of underlying royalty, product or industry involved (the maximum is 5% of related revenues, 1% in the case of trademarks).

Additionally, royalties and technical assistance fees are only deductible if the underlying contracts signed between the related parties have been approved by the National Institute of Industrial Property (INPI) and registered with the Brazilian Central Bank after 31 December 1991. Royalty payments that do not comply with these regulations and restrictions are not deductible for income tax.

Consequently, while royalty and technical assistance payments are not subject to transfer pricing rules, they are subject to rules that impose fixed parameters that are not in accordance with the arm's-length principle, except for royalties for the use of a copyright (e.g. software licences), which are not subject to the rate limitations mentioned above and, in most cases, are paid at much higher rates. Such remittances are subject to Brazil's transfer pricing rules for import transactions.

The Brazilian transfer pricing regulations make no mention of royalty and technical assistance payments received by a Brazilian taxpayer from a foreign-related party. Hence, such foreign-source revenues should be subject to Brazil's transfer pricing rules for export transactions.

Definition of related persons

Brazil's transfer pricing rules provide a much broader definition of related parties than do internationally accepted transfer pricing principles. As described in the following

Brazil

section, the regulations go so far as to characterise foreign persons as being related when both are located in low-tax jurisdictions, whether or not a relationship exists between them. The statutory list of related persons illustrates that the transfer pricing regulations clearly target foreign-related parties since none of the listed relationships would result in a Brazilian company being considered as related to another Brazilian company. Consequently, the transfer pricing rules do not apply to two Brazilian sister companies, leaving the possibility for multinationals to conduct inter-company transfers between their Brazilian subsidiaries on non-arm's-length terms. Inter-company transactions in a purely domestic context are covered by the disguised dividend distribution rules described below, which are less rigorous.

Under the statutory rules, a foreign company and a Brazilian company may be considered to be related if the foreign company owns as little as 10% of the Brazilian company, or when the same person owns at least 10% of the capital of each.

Additionally, regardless of any underlying relationship, the Brazilian definition of related parties considers a foreign person to be related to a Brazilian company if, in the case of export transactions, the foreign person operates as an exclusive agent of the Brazilian company or, in the case of import transactions, the Brazilian company operates as an exclusive agent of the foreign person. This broad definition was specifically designed to control potential price manipulations between third parties in an exclusive commercial relationship. For these purposes, exclusivity is evidenced by a formal written contract, or in the absence of one, by the practice of commercial operations relating to a specific product, service or right that are carried out exclusively between the two companies or exclusively via the intermediation of one of them. An exclusive distributor or dealer is considered to be the individual or legal entity with exclusive rights in one region or throughout the entire country.

Companies located in low-tax jurisdictions or beneficiaries of privileged tax regime

Under the regulations, the transfer pricing rules apply to transactions conducted with a foreign resident, even if unrelated, that is domiciled in a country that does not tax income or that taxes income at a rate of less than 20%, or in a jurisdiction with internal legislation allowing secrecy in regard to corporate ownership. For these purposes, the tax legislation of the referred country applicable to individuals or legal entities will be considered, depending on the nature of the party with which the operation was carried out. The transfer pricing provisions also apply to transactions performed in a privileged tax regime, between individuals or legal entities resident or domiciled in Brazil and any individuals or legal entities, even if not related, resident or domiciled abroad. These rules create some practical compliance issues because they require Brazilian companies to inform the tax authorities regarding transactions conducted with companies in tax havens even though the parties are completely unrelated and the transactions were contracted at arm's length.

In an effort to facilitate compliance by taxpayers, the Brazilian tax authorities have issued a list of jurisdictions that they consider to be tax havens or without disclosure of corporate ownership. This list currently includes the following jurisdictions: American Samoa, Andorra, Anguilla, Antigua and Barbuda, Dutch Antilles, Aruba, Ascension Islands, Bahamas, Bahrain, Barbados, Belize, Bermuda, Brunei, Campione D'Italia, Singapore, Cyprus, Costa Rica, Djibouti, Dominica, French Polynesia, Gibraltar, Granada, Cayman Islands, Cook Islands, Island of Madeira (Portugal), Isle of Man, Pitcairn Islands, Qeshm Island, Channel Islands (Jersey, Guernsey, Alderney, Sark),

Hong Kong, Kiribati, Marshall Islands, Samoa Islands, Solomon Islands, St Helena Island, Turks and Caicos Islands, British Virgin Islands, US Virgin Islands, Labuan, Lebanon, Liberia, Liechtenstein, Macau, Maldives, Mauritius, Monaco, Monserrat, Nauru, Niue, Norfolk, Oman, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Pierre and Miquelon, Saint Vincent and Grenadines, San Marino, Seychelles, Swaziland, Switzerland, Tonga, Tristan da Cunha, Vanuatu and United Arab Emirates. The list of privileged tax regimes includes: *Sociedad Anonima Financiera de Inversion* (SAFI) incorporated under Uruguayan law until December 2010, holding companies incorporated under Danish law and under Dutch law that do not have substantial economic activity, international trading companies (ITC) incorporated under Icelandic law, offshore (KFT) companies incorporated under Hungarian law, LLCs incorporated under US state law (in which the equity interest is held by non-residents and which are not subject to US federal income tax), *Entidad de Tenencia de Valores Extranjeros* (ETVEs) incorporated under Spanish law and ITCs and international holding companies (IHC) incorporated under Maltese law.

Currently, the inclusion of Switzerland, Dutch holding companies, and Spanish companies incorporated as '*Entidades de Valores Extranjeros*' or 'ETVEs' is suspended as a result of a request made to the Brazilian government by those countries, until their inclusion is further evaluated by the Brazilian authorities.

Other regulations

Contemporaneous documentation requirements

Many taxpayers initially failed to appreciate the complexities created by the Brazilian transfer pricing rules and their practical application to particular circumstances. The general impression held by many companies was that the fixed-income margins established by the Brazilian rules made it easier to comply with the rules and eliminated the need for detailed economic studies and supporting documentation. In practice, however, the application of the rules has shown that they are more complicated than they might appear. The amount of information necessary to comply with the rules was underestimated because the regulations did not provide any contemporaneous documentation requirements.

This changed in August 1999, when the Brazilian tax authorities issued information requirements concerning transfer pricing as part of the manual for filing the annual income-tax return (*Declaração de Informações Econômico-Fiscais da Pessoa Jurídica*, or DIPJ). These documentation requirements, which include five information forms (*Fichas*) in the tax return for disclosure of transactions conducted with foreign-related parties, greatly increased the transfer pricing compliance burden. These forms oblige taxpayers filing their annual tax returns to provide detailed disclosure regarding their inter-company import and export transactions, the method applied to test the inter-company price for the 49 largest import and export transactions, and the amount of any adjustments to income resulting from the application of the method to a specific transaction during the fiscal year in question.

For most companies, the elements needed to comply with the information requirements imposed by the information returns and a possible transfer pricing audit should be available through analytical information or the accounting system. However, many companies have yet to develop the systems that can provide the information needed to comply with these requirements as well as for purposes of determining the best transfer pricing methodology. Companies need to develop the necessary

Brazil

information-reporting systems and controls that can provide reliable accounting information regarding all transactions conducted with foreign parties to both facilitate compliance with the Brazilian transfer pricing rules and to properly defend on audit.

Divergence margin

For inter-company import and export transactions, even if the actually practised transfer price is above the determined transfer price (for import transactions) or below the determined transfer price (for export transactions), no adjustment will be required as long as the actual import transfer price does not exceed the determined transfer price by more than 5% (i.e. as long as the actual export transfer price is not below the calculated transfer price by more than 5%).

The divergence margin accepted between the parameter price obtained through the use of PCI and PCEX methods and the tested price is 3%.

Relief of proof rule for inter-company export transactions

In addition to the statutory 90% safe harbour rule for inter-company export transactions, there is a secondary compliance rule (herein referred to as the 'relief of proof rule') whereby a taxpayer may be relieved of the obligation to substantiate the export sales price to foreign-related persons using one of the statutory methods if it can demonstrate either of the following:

- Net income derived from inter-company export sales, taking into account the average for the calculation period and the two preceding years, excluding companies in low-tax jurisdictions and transactions for which the taxpayer is permitted to use different fixed margins, is at least 5% of the revenue from such sales. As of 2013 this relief of proof can be adopted only in case the net exports to related parties do not exceed 20% of the total net exports, and in case the net income from exports is at least 10% of the revenues from such sales.
- Net revenues from exports do not exceed 5% of the taxpayer's total net revenues in the corresponding fiscal year.

If a taxpayer can satisfy the relief of proof rule, the taxpayer may prove that the export sales prices charged to related foreign persons are adequate for Brazilian tax purposes using only the export documents related to those transactions.

The relief of proof rules does not apply to export transactions carried out with companies located in low-tax jurisdictions or beneficiaries of privileged tax regime, and they do not apply to exports subject to the mandatory adoption of the PCEX method.

Exchange adjustment

In an attempt to minimise the effect of the appreciation of local currency vis-à-vis the US dollar and the euro, the Brazilian authorities issued ordinances and normative instructions at the end of 2005, 2006, 2007, 2008, 2010 and 2011, which amended the Brazilian transfer pricing legislation for export transactions only. Per these amendments, Brazilian exporting companies were allowed to increase their export revenues for calendar years 2005, 2006, 2007, 2008, 2010 and 2011 (for transfer pricing calculation purposes only), using the ratio of 1.35, 1.29, 1.28, 1.20, 1.09 and 1.11, respectively. For 2009 and 2012, no exchange adjustment was allowed. This exceptional measure only applied for those years, and for the statutory 90% safe harbour, 5% net income relief of proof and CAP method.

Cost-contribution arrangements

No statutory or other regulations on cost-contribution arrangements have been enacted at this point. Accordingly, deductibility of expenses deriving from cost-contribution arrangements is subject to Brazil's general rules on deductibility, which require deductible expenses to be (1) actually incurred, (2) ordinary and necessary for the transactions or business activities of the Brazilian entity, and (3) properly documented.

Based on our experience, Brazilian tax authorities will assume that related charges merely represent an allocation of costs made by the foreign company. Consequently, they will disallow deductibility for income tax and social contribution on net income unless the Brazilian taxpayer can prove that it actually received an identifiable benefit from each of the charged services specified in any corresponding contracts. Sufficient support documentation is crucial to substantiate any claims that expenses are ordinary and necessary, especially in the case of international inter-company cost-contribution arrangements.

In past decisions, the Brazilian tax authorities and local courts have repeatedly ruled against the deductibility of expenses deriving from cost-contribution arrangements due to the lack of proof that services and related benefits had actually been received by the Brazilian entity. In addition, in past decisions Brazilian tax authorities have ruled against the deductibility of R&D expenses incurred by a foreign-related party and allocated as part of the production cost base in the calculation of the CPL for inter-company import transactions.

With the exception of cost-contribution arrangements involving technical and scientific assistance with a transfer of technology, which are treated the same as royalties (please see above), resulting inter-company charges will have to comply with Brazil's transfer pricing regulations, in order to be fully deductible. Due to the nature of the transaction, the CPL is the most commonly adopted method.

Back-to-back transactions

Back-to-back transactions are subject to TP rules. For this purpose, it should be considered as back-to-back transactions those in which the product is purchased from a foreign party and sold to another foreign party, and at least one of them is treated as a related party for Brazilian transfer pricing purposes, without the transit of goods in Brazil.

Legal cases

A significant issue under dispute between taxpayers and the tax authorities relates to the mechanics for calculating the PRL 60%. Normative Instruction (IN) 243 issued in 2002, which replaced IN 38, introduced significant changes to the calculation of the PRL method, creating a controversy regarding whether it expanded the scope beyond what the law intended. As a result of this controversy, most companies ignored the IN 243 provisions related to the PRL 60% calculation, which would yield much higher taxable income than the mechanics of IN 32. The Brazilian tax authorities have begun issuing large tax assessments based on IN 243.

The Taxpayers' Council decided in a few cases against the taxpayers, and recently there was a decision in favour of taxpayers. Also, a Federal Regional Court (that it is not yet a final instance of this legal dispute) decided against a taxpayer, in an overturn of

Brazil

the same Court's position from a few months back. In any event, the final decision on this dispute will only be known when it reaches the Superior Courts. As of 2013 the mechanics for calculating PRL 60% according to IN 243 provisions was included in Law 12,715, but with profit margins of 20%, 30% or 40% according to each industry/sector (please see comments above). This change in the tax law will end the dispute regarding this matter as of calendar year 2013.

Burden of proof

The taxpayer is obliged to satisfy the burden of proof that it has complied with the transfer pricing regulations as of the date the annual corporate income-tax return is filed. However, the fact that the Brazilian rules allow taxpayers to choose from several methods for each type of transaction provides properly prepared taxpayers an advantage over the tax authorities. Proper and timely preparation enables taxpayers to collect the necessary information and choose the most appropriate method in advance. The rules also state that the tax authorities can disregard information when considered unsuitable or inconsistent. Assuming the methodology is applied and documented correctly, taxpayers can satisfy the burden of proof and push the burden back to the tax authorities. This also applies when a taxpayer can satisfy the relief of proof rule for inter-company export transactions.

Tax audit procedures

Audits are the Brazilian tax authorities' main enforcement tool with regard to transfer pricing. Transfer pricing may be reviewed as part of a comprehensive tax audit or through a specific transfer pricing audit.

The audit procedure

The audit procedure occurs annually, except in some cases such as suspicion of fraud. As part of the audit process, the regulations require a Brazilian taxpayer to provide the transfer pricing calculation used to test inter-company transactions conducted with foreign-related parties, along with supporting documentation. Since the taxpayer is obliged to satisfy the burden of proof that it has complied with the transfer pricing regulations as of the date the tax return is filed, it is important for taxpayers to have their support and calculations prepared at that time. If the taxpayer fails to provide complete information regarding the methodologies and the supporting documentation, the regulations grant the tax inspector the authority to make a transfer pricing adjustment based on available financial information by applying one of the applicable methods. As from calendar year 2012, taxpayers can only change the method adopted before the start of the audit procedure, unless the tax authorities disqualify the existing documentation; in this case, taxpayers will have 30 days to present a new calculation based on another method and the corresponding support documentation.

As part of the audit process, the tax inspectors typically request that the methods used by the taxpayer be reconciled with the accounting books and records. The tax inspector also requests any significant accounting information used to independently confirm the calculations performed by the company. The information requested by the tax inspector may be quite burdensome and may require the company to provide confidential data regarding the production cost per product, the prices charged in the domestic market, and the prices charged to foreign-related and independent parties.

As previously mentioned, companies need to develop the necessary information-reporting systems and controls that can provide reliable accounting information

regarding all transactions conducted with foreign-related parties in advance to properly defend on audit.

Assessments and penalties

In making an assessment if taxpayers are not able to present a new calculation and its support documentation in 30 days after the first one has been disqualified, the tax inspector is not required to use the most favourable method available. Consequently, the inspector will most likely use the method that is most easily applied under the circumstances and assess income tax and social contribution at the maximum combined rate of 34%. The objective of an assessment would not necessarily result in the true arm's-length result but would be based on an objective price determined by the regulations.

In the case of exports, tax inspectors would most likely use the CAP, because they could rely on the Brazilian cost accounting information of the taxpayer. In the case of imports, the tax inspector may have independent data collected from customs authorities, using import prices set by other importers for comparable products, based on the customs valuation rules, or use the PRL.

If the Brazilian tax authorities were to conclude that there is a deficiency and make an income adjustment, penalties may be imposed at the rate of 75% of the assessed tax deficiency. The rate may be reduced by 50% of the penalty imposed if the taxpayer agrees to pay the assessed tax deficiency within 30 days without contesting the assessment. In some cases when the taxpayer fails to provide the required information, the penalty rate may be increased to 112.5% of the tax liability. In addition, interest would be imposed on the amount of the tax deficiency from the date the tax would have been due if it had been properly recognised. In this instance, the interest rate used is the federal rate established by the Brazilian Central Bank known as SELIC.

Resources available to the tax authorities

The Brazilian tax authorities have created a group of agents specialised in transfer pricing audits. In addition, all tax agencies have a special area dedicated to the investigation and development of audits that conduct studies and form databases that can be used to compare prices and profit margins across industries and to identify questionable companies for audit. The electronic contemporaneous documentation filing requirements (DIPJ) for transfer pricing purposes facilitate the creation of such comprehensive databases. Since taxpayers are required to report in the DIPJ the average annual transfer prices for the 49 largest inter-company import and export transactions, the Brazilian tax authorities will be able to test these prices using the prices of similar products traded by other companies. In addition, as mentioned earlier, the tax inspector may also use data collected from the customs authorities' electronic Integrated System for International Trade (*Sistema Integrado de Comércio Exterior*, or SISCOEX), as well from Integrated System of Foreign Service Trade (*Sistema Integrado de Comércio Exterior de Serviços, Intangíveis e outras operações que produzem variações no patrimônio*, or SISCOERV).

Liaison with customs authorities

In principle, it should not be possible to have different import values for customs and transfer pricing purposes. However, in determining import sales prices, the transfer pricing rules and customs valuation rules are not the same. It is quite common to find that the customs and transfer pricing rules result in different import prices. In practice,

Brazil

many multinational companies find themselves having to use an import sales price for customs' purposes, which is higher than the price determined by the transfer pricing rules. As a result, these companies pay higher customs' duties and, at the same time, make a downward adjustment to the price for transfer pricing purposes.

Limitation of double taxation and competent authority proceedings

Should the Brazilian tax authorities adjust transfer prices, it is possible that the same income could be taxed twice, once in Brazil and once in the foreign country. Multinational companies conducting transactions with their Brazilian affiliates through countries that do not have double-tax agreements with Brazil, such as the US and the UK, cannot pursue competent authority relief as a means of preventing double taxation arising from an income adjustment. Conversely, multinational companies conducting transactions with their Brazilian affiliates through countries that have double-tax agreements with Brazil may appeal for relief under the competent authority provisions of Brazil's tax treaties. However, few taxpayers have tested this recourse, and none successfully. This is because Brazilian transfer pricing rules were enacted after the various tax treaties had been signed, so the reasons for evoking competent authority relief on transfer pricing grounds did not yet exist.

Advance pricing agreements (APAs)

While Brazil's transfer pricing rules do not expressly refer to the institution of APAs, the statutory rules offer some leeway for the negotiation of an advance ruling from the tax authorities, stating that a taxpayer's transfer prices are appropriate, even though they do not meet the fixed profit margins contained in the statute. The regulations specifically state that taxpayers may file ruling requests to alter the fixed profit margins for either industry sectors or individual taxpayers. Careful planning and substantial documentation will be necessary to justify lower margins to the Brazilian tax authorities.

To date, however, the few companies that filed ruling requests with the Brazilian tax authorities have not succeeded in obtaining different margins.

OECD issues

As with many other countries, Brazil is still in the early stages of developing its transfer pricing policies. Brazil's transfer pricing regime has been criticised abroad for its failure to abide by international transfer pricing principles. The Brazilian transfer pricing rules focus not on the identification of the true arm's-length price or profit but on objective methods for determining what the 'appropriate' transfer price should be for Brazilian tax purposes. The regulations themselves do not mention the arm's-length principle, and the rules do not expressly require that related parties conduct their operations in the same manner as independent parties.

Brazil is not an OECD member country. However, in the preamble to the tax bill that introduced the transfer pricing rules, the Brazilian government stated that the new rules conformed to the rules adopted by OECD member countries. In a ruling, the Brazilian tax authorities reaffirmed their opinion that Brazil's transfer pricing regulations are in line with the arm's-length principle as established in Article 9 of the OECD Model Tax Convention. Although these pronouncements appear to be an endorsement of the arm's-length principle as the norm for evaluating the results achieved by multinational enterprises in their international inter-company

transactions, the regulations do not provide the same level of explicit guidance and flexibility provided by the OECD Guidelines.

The fixed percentage margin rules, which have the appearance of safe harbours, are designed to facilitate administration and compliance and not necessarily to foster a fair and flexible system seeking maximum compatibility with the arm's-length principle. The Brazilian rules prescribe methodologies for computing arm's-length prices that are different from the methodologies approved by the US regulations and the OECD Guidelines and apply to transactions between certain unrelated parties. In other areas, such as technology transfers and cost-contribution arrangements, Brazil has failed altogether to establish transfer pricing rules.

The question is whether non-Brazilian OECD-compliant methods may be applied by taxpayers in valid situations when the three Brazilian transaction-based methods cannot be applied for practical reasons (for example, lack of applicability in general or lack of reliable information). In the case of transactions conducted with related parties in treaty countries, there is a strong basis supporting the conclusion that the treaties, which are based on the OECD model treaty and supersede Brazilian domestic laws, should allow a Brazilian company to apply profit-based methods accepted by the OECD.

In practice, however, the Brazilian tax authorities have demonstrated that they clearly do not agree with this interpretation, especially when it comes to methodologies not provided in the Brazilian transfer pricing regulations. In transfer pricing audits, the Brazilian tax authorities have repeatedly rejected economic studies prepared in line with the arm's-length principle under observance of the OECD Guidelines as acceptable documentation. It can be assumed that the Brazilian tax authorities do not want to set a precedent that would allow multinational companies to bypass the rigid Brazilian documentation methods in favour of more flexible OECD approaches. Defending the use of OECD methodologies may eventually be resolved in the courts, although such a resolution would involve a lengthy and costly legal process.

Disguised dividend distributions

Brazil's income tax law lists seven types of related party transactions (domestic and international) that are deemed to give rise to disguised distributions of dividends. In summary, such disguised distributions of dividends encompass all transactions between a Brazilian legal entity and its individual or corporate administrator(s) and/or controlling partner(s) or shareholder(s), which are negotiated at terms more favourable than fair market value. In the concrete case of related party financing transactions, these rules have a certain analogy to thin capitalisation rules or practices. Amounts characterised as disguised dividends are added to the taxable income of the legal entity deemed to have performed such a disguised distribution. This rule does not apply when the taxpayer can substantiate that the terms of the related party transactions were at fair market value. However, as previously mentioned, compliance with these disguised dividend distribution rules is less rigorously enforced than compliance with the transfer pricing rules, which focus exclusively on international inter-company transactions.

18.

Bulgaria

Introduction

The Bulgarian tax legislation requires that taxpayers determine their taxable profits and income by applying the arm's-length principle to the prices for which they exchange goods, services and intangibles with related parties (i.e. transfer prices). Interest on loans provided by related parties should be consistent with market conditions at the time the loan agreement is concluded.

The transfer pricing rules apply for transactions between resident persons, as well as for transactions between resident persons and non-residents.

Statutory rules

Bulgarian transfer pricing rules are provided in the Corporate Income Tax Act (CITA), Tax and Social Security Procedures code, as well as in the Ordinance № H-9 for implementation of the transfer pricing methods, issued by the Minister of Finance on 29 August 2006.

The CITA sets the arm's-length principle and explicitly determines cases where the prices are deemed not to comply with the principle (e.g. in cases of receiving or granting loans against an interest, which differs from the market interest rate effective at the time the loan agreement is concluded).

The Tax and Social Security Procedures code includes a definition of related parties and stipulates the method to be used when determining prices on transactions between related parties.

Definition of related parties

For tax purposes, related parties are:

- Spouses, relatives of the direct descent without restrictions and relatives of the collateral descent up to the third degree included, and in-law lineage, up to and including the second degree.
- Employer and employee.
- Persons, one of whom participates in the management of the other or of its subsidiary.
- Partners.
- Persons in whose management or supervisory bodies one and the same legal or natural person participates, including when the natural person represents another person.
- A company and a person who own more than 5% of the voting shares of the company.

- Persons whose activity is controlled directly or indirectly by a third party or by its subsidiary.
- Persons who control together directly or indirectly a third party or its subsidiary.
- Persons, one of whom is an agent of the other.
- Persons, one of whom has made a donation to the other.
- Persons who participate directly or indirectly in the management, control or capital of another person or persons where conditions different from the usual may be negotiated between them.
- Persons, one of whom controls the other.

In addition, according to specific provisions in the Tax and Social Security Procedures code, if a party to a transaction is a non-resident person, the revenue authorities may deem that the parties are related if:

- the non-resident entity is incorporated in a country, which is not a European Union (EU) Member and in which the profit or the corporate tax due on the income, which the non-resident has realised or would realise from the transactions, is below 40% of the tax due in Bulgaria, except if there is evidence that the non-resident person is subject to preferential tax treatment, or that the non-resident has sold the goods or services on the domestic market, and
- the country in which the non-resident is incorporated, denies or is not able to provide information regarding the effected transactions or the relations, when there is an applicable double-tax treaty with this country.

Methods for determining market prices

For the purposes of transfer pricing rules, market prices are determined by:

- the Comparable Uncontrolled Price (CUP) method
- the Resale Price Method (RPM)
- the Cost Plus Method (CPM)
- the Transactional Net Margin Method (TNMM), and
- the Profit Split Method (PSM).

The Ordinance № H-9 for implementation of the transfer pricing methods stipulates the methods to be used when determining prices on related party transactions, the application of each method, as well as the approach of the tax authorities in case the taxpayer has transfer pricing documentation in place.

Documentation requirements

According to the Bulgarian legislation, the taxable person is obliged to hold evidence that its relations with related parties are in line with the arm's-length principle. The tax provisions do not contain specific requirements regarding the filing of transfer pricing documentation with revenue authorities.

The recently issued internal transfer pricing guidelines of the National Revenue Agency, however, contain indications as to the types of documents that the revenue authorities may request from taxpayers during tax procedures (e.g. during tax audits, procedures for double-tax treaty application, etc.). Although the guidelines do not introduce obligatory transfer pricing documentation requirements for taxpayers, they do specify the approach the revenue authorities should follow when examining intragroup transactions.

Bulgaria

According to the Ordinance № H-9 for implementation of the transfer pricing methods, if companies have available transfer pricing documentation the revenue authorities are obliged to start their analyses of the intragroup prices based on the method chosen by the taxpayer.

Other regulations

The Bulgarian National Revenue Agency published internal transfer pricing guidelines on 8 February 2010. Generally, the guidelines contain information on recommended documentation that the revenue authorities should request during tax procedures, the transfer pricing methods, as well as some procedural rules for the avoidance of double taxation. The guidelines will be used by the revenue authorities when auditing related party transactions and are not obligatory for taxpayers.

Legal cases

To date there have been few court cases related to transfer pricing issues, and all of them occurred prior to the implementation of the Ordinance № H-9. Most of them set the general principle for determination of the prices on related party transactions by referring to the transfer pricing methods stipulated in the tax legislation.

Burden of proof

Taxpayers should be able to prove that the transfer prices are market-based. If the taxpayer does not provide evidence that the transfer prices are market-based, the revenue authorities may estimate the market prices. In such a case, the burden of proof shifts to the revenue/tax authorities and they should back up their findings with sufficient evidence.

Tax audit procedures

Transfer pricing may be examined during a regular tax audit, as there are no separate procedures for transfer pricing investigations.

During a tax audit, the revenue authorities may request additional information in order to make an assessment related to transfer pricing. The term for provision of information by the taxpayer will be determined in the tax authority's request (however, the term cannot be less than seven days).

Revised assessments and the appeals procedure

If the transfer prices are not market-based, the revenue authorities may adjust the taxable result of the entity, and assess additional tax liabilities. Any tax assessments can be appealed at an administrative level. If the appeal fails, the assessments may be challenged in the court.

The statute of limitations (i.e. the period within which state authorities are entitled to collect the tax liabilities and other related mandatory payments) is five years from the end of the year in which the tax liabilities became payable. However, this period could be extended in certain cases (e.g. a tax audit). However, the maximum period of the statute of limitation is 10 years.

Additional tax and penalties

Apart from an adverse tax assessment in respect of additional tax liabilities, the taxpayer may be subject to certain penalties.

If the taxpayer does not determine his tax obligations correctly and files a tax return declaring lower tax liabilities than as per strictly applying the transfer pricing provisions, a penalty between 250 and 1,500 euros (EUR) may be imposed.

The difference between the agreed transfer prices and the market price may be considered as a hidden profit distribution, which will be associated with a penalty equal to 20% of the respective difference.

If the taxpayer does not provide evidence that the prices agreed with the related parties are market-based, a penalty between EUR 125 and EUR 250 may be levied.

Resources available to the tax authorities

Bulgarian revenue authorities do not have special teams dealing with transfer pricing issues. The relevant investigations are performed as a part of the general tax audit procedures.

Use and availability of comparable information

The taxpayers may use all relevant sources of comparable information, in order to support the arm's-length compliance of the transfer prices with the relevant market conditions.

If the tax authorities challenge the transfer prices, they may use various sources such as statistical information, stock market data, and other specialised price information. The tax authorities should duly quote the source of its information.

In Bulgaria there are no databases containing information on unrelated party transactions.

The financial statements of the local companies are publicly available, but are not collected in a single database that can be used for transfer pricing studies.

Risk transactions or industries

No transactions or industries can be considered exposed to transfer pricing investigations at a higher risk.

Limitation of double taxation and competent authority proceedings

The double-tax treaties concluded by Bulgaria provide taxpayers the opportunity to initiate a mutual agreement procedure for the purposes of eliminating double taxation.

Regulations with respect to the mutual agreement procedure and the exchange of information with EU Member States have been introduced in the Bulgarian Tax and Social Security Procedures Code as of 1 January 2007.

EU Arbitration Convention is applicable to Bulgaria per the European Parliament resolution of 17 June 2008.

There is no publicly available information on the competent authority proceedings undergone in Bulgaria.

Bulgaria

Advance pricing agreements (APAs)

There is no possibility of obtaining APAs, pursuant to the local legislation. However, it is possible to obtain a written opinion from the revenue authorities on a case-by-case basis. Such opinions are not binding, but they may provide protection from assessment of interest for late payment and penalties.

Anticipated developments in law and practice

Although certain transfer pricing rules have been present in the Bulgarian tax legislation for a long time, there are no developed transfer pricing practices. However, in view of the recent amendments to the legislation, we expect revenue authorities will begin to pay greater attention to this area.

Liaison with customs authorities

Pursuant to the customs legislation, the base on which the customs' duties are calculated may be amended when the parties in the transaction are related. There are rules for determining the arm's-length price for customs' duties purposes using available data on comparable transactions.

OECD issues

Bulgaria is not a member of the Organisation for Economic Co-operation and Development (OECD). However, the general principles of the OECD Guidelines are implemented in the Bulgarian transfer pricing rules and followed by the Bulgarian tax authorities.

Joint investigations

We are currently unaware of any simultaneous transfer pricing audits performed by the Bulgarian tax authorities and those of other countries.

Thin capitalisation

According to the Bulgarian thin capitalisation rules, the interest expenses incurred by a resident company may not be fully deductible if the average debt-to-equity ratio of the company exceeds 3:1 in the respective year. However, even if the debt-to-equity test is not met, the thin capitalisation restrictions may not apply if the company has sufficient profits before interest to cover its interest expenses.

Interest under bank loans or financial leases are not restricted by the thin capitalisation rules unless the transaction is between related parties or the respective loan or lease is guaranteed by a related party.

The Bulgarian thin capitalisation rules also do not apply to interest disallowed on other grounds (e.g. for transfer pricing purposes) and interest and other loan-related expenses capitalised in the value of an asset in accordance with the applicable accounting standards.

Even if some interest expenses are disallowed under thin capitalisation rules, they may be reversed during the following five consecutive years if there are sufficient profits.

Management services

The Bulgarian transfer pricing rules do not contain specific tax regulations regarding management services.

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Canada

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Introduction

Canadian transfer pricing legislation and administrative guidelines are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines. Statutory rules require that transactions between related parties occur under arm's-length terms and conditions. Penalties may be imposed where contemporaneous documentation requirements are not met. There have been three major transfer pricing cases litigated in Canada, and the number of cases is expected to increase as the transfer pricing-related audit activity of the Canada Revenue Agency (CRA) continues to intensify under ongoing mandates from the federal government.

Canada has adopted International Financial Reporting Standards (IFRS), which became effective for public companies in their first tax year beginning on or after 1 January 2011 (or earlier with approval of the Canadian Securities Administrators). IFRS is optional for private companies. A Canadian company's transfer pricing policies may need to be reassessed in light of IFRS, as accounting practices transition to comply with the new standards. For example, Canadian companies will need to assess how the adoption of IFRS affects comparability to US companies used in a transactional net margin method (TNMM) analysis, and how to address multiple-year analysis that includes periods of different accounting practices.

Statutory rules

General anti-avoidance rule

A general anti-avoidance rule (GAAR) (ITA section 245) can apply to any transaction considered to be an avoidance transaction. The CRA may apply this section in transfer pricing situations, if section 247(2), (*see below*), does not apply.

Statutory rules specific to transfer pricing

The Canadian statutory rules on transfer pricing included in section 247 of Canada's Income Tax Act (ITA) are effective for taxation periods beginning after 1997. These rules embody the arm's-length principle.

'Transfer price' is broadly defined to cover the consideration paid in all related party transactions. 'Qualifying cost contribution arrangements' are also specifically addressed in the Canadian rules (*see Qualifying cost-contribution arrangements section, below*).

Transactions between related parties will be adjusted where the terms and conditions differ from those that would have been established between arm's-length parties. That is, the nature of the transaction can be adjusted (or recharacterised) in circumstances where it is reasonable to consider that the primary purpose of the transaction is to

Canada

obtain a tax benefit. A reduction, avoidance or deferral of tax (or increase in a refund of tax) will be viewed to be a 'tax benefit'.

The legislation does not include specific guidelines or safe harbours to measure arm's length; rather, it leaves scope for the application of judgment. The best protection against a tax authority adjustment, and penalties, is the maintenance of contemporaneous documentation. The nature of the documentation required to avoid penalties is described in the legislation.

The legislation is supported by administrative guidelines in the CRA's Information Circular 87-2R (IC 87-2R) and the CRA's Transfer Pricing Memoranda (TPM-02 through TPM-12). IC 87-2R is cross-referenced to the OECD Guidelines.

To summarise the highlights of the Canadian legislation and administrative guidance:

ITA

- Related party transactions may be adjusted if the CRA determines that they are not on arm's-length terms (section 247(2)).
- Transfer pricing adjustments that result in a net increase in income or a net decrease in a loss may be subject to a non-deductible 10% penalty (section 247(3)) for taxation years beginning after 1998 (*see Additional tax and penalties section, below*).
- Set-offs may reduce the amount of the adjustment subject to penalty where supporting documentation for the transaction that relates to the favourable adjustment is available (section 247(3)) and is approved by the Minister of National Revenue (the Minister) (section 247(10)).
- Penalties may not apply to a transaction where reasonable efforts were made to determine and use arm's-length transfer prices. Contemporaneous documentation standards are legislated for that purpose (section 247(4)).

IC 87-2R

- Describes the following five arm's-length pricing methods recognised by the CRA: comparable uncontrolled price (CUP), cost plus, resale price, profit split and TNMM. The CRA examines the application of the method selected by a taxpayer to ensure that it produces the most reliable measure of an arm's-length result (paragraphs 47 to 63).
- Provides administrative guidelines on cost-contribution arrangements, intangible property and intragroup services.

Secondary adjustments

Where property or services have been obtained by a resident taxpayer from a related non-resident at an overvalued amount or transferred from a resident taxpayer to a non-resident at an undervalued amount, a benefit will have been conferred on the non-resident unless the parties complete a corrective transaction. The benefit amount will be deemed to be a dividend and will be subject to non-resident withholding tax of 25%. The withholding tax may be reduced depending on the provisions of a relevant tax treaty. These provisions may apply to transactions with any related party, not just the parent or a shareholder. This result is accomplished through the combination of provisions in ITA sections 15(1), 56(2), 214(3)(a) and 212(2).

The federal budget tabled on 29 March 2012 consolidated the desired effect of these provisions into section 247. Under the new provisions, secondary adjustments are

deemed to be a dividend paid to the related non-resident regardless of whether the non-resident has an ownership interest in the Canadian company. As a deemed dividend, the amount is subject to withholding tax as high as 25%, which could be reduced under the relevant treaty. The amount of the deemed dividend and associated withholding tax can be reduced, at the Minister's discretion, if the amount of the primary adjustment is repatriated to the Canadian taxpayer.

Legislation relating to inter-company debt

The following legislation applies to inter-company debt and interest charges:

Section 15(2) – Loan treated as a dividend

This provision applies where a loan or any other indebtedness owing to a corporation resident in Canada by a non-resident shareholder or a non-resident person not acting at arm's length with a non-resident shareholder has not been repaid within one year (i.e. 365 days) from the end of the corporation's tax year in which the indebtedness arose. Where this provision applies, the amount is deemed to have been paid as a dividend and is subject to non-resident withholding tax of 25%. The withholding tax may be reduced depending on the provisions of a relevant tax treaty. Anti-avoidance rules prevent a long-term loan from being disguised by a series of short-term loans and repayments. There are exceptions to these rules, such as loans to a foreign corporation that is a foreign affiliate (defined as a foreign corporation in which the Canadian corporation has an equity interest of at least 1% and together with related parties has an equity interest of at least 10%).

The ITA provides a mechanism for the non-resident to apply for a refund of withholding tax paid, within a certain period of time, upon the repayment of the loan or indebtedness when the repayment is not part of a series of loans and repayments.

Section 17 – Deemed interest income

Where a loan or other indebtedness owing from a non-resident to a corporation resident in Canada is outstanding for one year (i.e. 365 days) or longer without a reasonable rate of interest being charged, the corporation is deemed to earn income from the loan or other indebtedness computed at a prescribed rate of interest and this amount, net of any interest actually received, is included in the corporation's income for tax purposes. Section 17 does not apply, however, if section 15(2) as described above applies to the loan or indebtedness and a refund of the withholding tax has not been received by the non-resident. Loans to controlled foreign affiliates are excluded from the deemed interest rule provided that the funds loaned are used by the controlled foreign affiliate to earn income from an active business. Accordingly, loans made downstream to these affiliates can be non-interest-bearing. However, the deductibility of any interest expense incurred in Canada relating to making such a loan must be considered under the general interest deductibility guidelines.

Avoidance of these rules through the use of a trust or partnership is not possible where a corporation resident in Canada is a beneficiary or partner of the trust or partnership. A further anti-avoidance provision imputes interest to the Canadian resident corporation on an amount owing between two non-residents when it is reasonable to conclude that such indebtedness arose because of a loan or transfer of property by the corporation to a person or partnership.

Canada

Section 80.4(2) – Deemed benefit treated as a dividend

Where a related non-resident has received a loan from or become indebted to a corporation resident in Canada at a rate of interest less than the prescribed rate or at a rate otherwise considered favourable to the non-resident, then the non-resident will be deemed to have received a shareholder benefit under section 15(1). Loans to foreign affiliates are excluded from the deemed benefit rule. The amount of the benefit is calculated by comparing the interest rate charged with the prescribed rate of interest. This benefit is deemed to be a dividend and is subject to non-resident withholding tax of 25%. The withholding tax may be reduced by the provisions of a relevant tax treaty. This section does not apply, however, where section 15(2) as described above applies or where the non-resident is a foreign affiliate of the Canadian taxpayer.

Section 18(4) – Thin capitalisation

The thin capitalisation rules can result in the permanent denial of an interest expense deduction to a corporation resident in Canada (*see Thin capitalisation section, below*).

Section 78(1) – Unpaid expenses included in income

This provision applies where a corporation resident in Canada has previously deducted an amount owing to a related non-resident and has not paid or settled the liability within two tax years following the year in which the liability was incurred. In these circumstances, the unpaid amount is included in the income of the corporation in the third tax year following the year in which the liability was incurred. Alternatively, an election may be filed to have the liability deemed as paid and loaned back to the corporation on the first day of the third tax year, although this may result in a withholding tax liability on the amount deemed as paid. If such an election is filed late (i.e. more than six months after the end of the third year), 25% of the unpaid amount will still be included in income in the third year.

Reporting requirements relating to transfer pricing

Section 231.6 – Foreign-based information or documentation

The CRA may formally serve notice requiring a person resident or carrying on business in Canada to provide foreign-based information or documentation where this is relevant to the administration or enforcement of the ITA. Such notices must set out the time frame for production, a reasonable period of not less than 90 days. Supporting documents for inter-company charges and transfer pricing are prime examples of the types of information likely to be formally required. Information or documentation not produced following the delivery of the notice may not be used as a defence against a later reassessment. Taxpayers can bring an application to have the requirement varied by a judge. Failure to provide the information or documentation may lead to possible fines or possible imprisonment as discussed in section 238(1). In a 2003 decision, the Tax Court of Canada (TCC) prohibited GlaxoSmithKline Inc. from submitting foreign-based documents as evidence at trial because the documents had not been provided to the CRA when it served notice. In a 2005 decision, the TCC upheld the CRA's right to request such documentation from Saipem Luxembourg, S.A.

Section 233.1 – Annual information return: non-arm's-length transactions with non-resident persons

Persons carrying on business in Canada are required to file an annual information return reporting transactions with related non-residents. For every type of transaction (e.g. tangible property, services, royalty arrangements, factoring, securitisations and

securities, lease payments, securities lending, derivative contracts, etc.) it is necessary to identify the transfer pricing methodology used.

The prescribed form, Form T106, Information Return of Non-Arm's-length Transactions with Non-Residents (*see also Tax audit procedures section, below*), also asks for the North American Industrial Classification System (NAICS) codes for the transactions reported, whether any income or deductions are affected by requests for competent authority assistance or by assessment by foreign tax administrations, and whether an advance pricing arrangement in either country governs the transfer pricing methodology.

A separate T106 form is required for each related non-resident that has reportable transactions with the Canadian taxpayer. Each form asks if contemporaneous documentation has been prepared for transactions with that related non-resident. The CRA imposes late-filing penalties with respect to these forms.

A *de minimis* exception removes the filing requirement where the total market value of reportable transactions with all related non-residents does not exceed Canadian dollars (CAD) 1 million.

Foreign reporting requirements

Canadian residents are required to report their holdings in foreign properties and certain transactions with foreign trusts and non-resident corporations. Significant penalties are assessed for failure to comply with these rules.

Section 233.2 – Information returns relating to transfers or loans to a non-resident trust

Generally, amounts transferred or loaned by a Canadian resident to a non-resident trust, or to a company controlled by such a trust, must be reported annually on Form T1141. The filing deadlines generally depend on whether the Canadian resident is an individual, corporation, trust or partnership. The rules are complex and should be reviewed in detail for possible application.

Section 233.6 – Information return relating to distributions from and indebtedness to a non-resident trust

A Canadian resident that is a beneficiary of a non-resident trust and is either indebted to or receives a distribution from such trust must report such transactions on Form T1142.

Section 233.3 – Information return relating to foreign property

Form T1135 should be filed where the cost of the Canadian resident taxpayer's total specified foreign property exceeds CAD 100,000 at any time in the year. The foreign property definition is comprehensive. Specific exclusions from the definition include personal assets (e.g. condominiums), property used exclusively in an active business and assets in a pension fund trust.

Section 233.4 – Information return relating to foreign affiliates

Where a person (including a corporation) or a partnership resident in Canada has an interest in a corporation or trust that is a foreign affiliate or a controlled foreign affiliate, the person or partnership is required to file an information return (Form T1134A or T1134B) for each such corporation or trust. Financial statements of the

Canada

corporation or trust must also be submitted. The filing deadline for these information returns is 15 months after the tax year-end of the person or partnership.

Treaty-based disclosure

Any non-resident corporation carrying on business in Canada that claims a treaty-based exemption from Canadian tax must file a Canadian income tax return, together with Schedules 91 and 97. This filing will identify those non-resident companies that are carrying on business in Canada without a permanent establishment (PE) or are eligible for any other type of treaty exemption from Canadian income tax.

Other regulations

The CRA releases information explaining its interpretation of various taxation matters through a series of publications, as follows:

- Information circulars, which deal with administrative and procedural matters.
- Interpretation bulletins, which outline the CRA's interpretation of specific law.
- Advance tax rulings, which summarise certain advance tax rulings given by the CRA.
- Other documents.

These publications describe departmental practice only and do not have the authority of legislation. However, courts have found that these publications can be persuasive where there is doubt about the meaning of the legislation. News releases are another source of information, which communicate changes in and confirm the position of the CRA on income tax issues.

The CRA has published relatively few guidelines on transfer pricing. Those available are summarised below.

Information Circular (IC) 87-2R: International Transfer Pricing

IC 87-2R provides guidance with respect to the application of the transfer pricing rules as amended in 1998 to conform to the 1995 OECD Guidelines.

The CRA has published other documents on various transfer pricing matters to complement IC 87-2R. As of 30 August 2012, the following documents were available on the CRA website:

- 16 March 2001, IC 94-4R regarding advance pricing arrangements (*see Advance pricing arrangements section, below*).
- 27 March 2003, TPM 02 – Repatriation of Funds by Non-Residents – Part XIII Assessments: This document explains the CRA's policy on the repatriation of funds following a transfer pricing adjustment under section 247(2) of the ITA; as this memo has not been updated to reflect subsequent legislative changes since the date of issue (*see Secondary adjustments, above*), some information may no longer be valid.
- 20 October 2003, TPM 03 – Downward Transfer Pricing Adjustments under Subsection 247(2) [of the ITA]: This document provides guidance on dealing with downward transfer pricing adjustments that may result from an audit or a taxpayer-requested adjustment.

- 27 October 2003, TPM 04 – Third-Party Information: This document provides guidelines on the use of confidential third party information in the context of transfer pricing audits by CRA auditors.
- 13 October 2004, TPM 05 – Contemporaneous Documentation: This document provides directives to CRA auditors concerning requests for contemporaneous documentation pursuant to section 247(4) of the ITA.
- 1 January 2005, IC 71-17R5 regarding competent authority assistance under Canada's tax conventions (*see Limitation of double taxation and competent authority proceeding section, below*).
- 18 March 2005, IC 94-4RSR (Special Release) regarding advance pricing arrangements for small businesses (*see Advance pricing agreements section, below*).
- 16 May 2005, TPM 06 – Bundled Transactions: This document explains the circumstances in which the CRA will accept bundled transactions.
- 2 August 2005, TPM 07 – Referrals to the Transfer Pricing Review Committee: This document replaces TPM 01 (a 26 March 2003 document with the same title), which remains available on the CRA website. TPM 07 provides guidelines for referrals by CRA auditors to the International Tax Directorate and the Transfer Pricing Review Committee (TPRC) regarding the possible application of the penalty under section 247(3) of the ITA or the possible recharacterisation of a transaction pursuant to section 247(2)(b). The revised TPM seeks to ensure a more open dialogue with taxpayers for consistent and fair application of the transfer pricing penalties.
- 5 December 2005, TPM 08 – The Dudley Decision – Effects on Fixed Base or Permanent Establishment Audits and Regulation 105 Treaty-Based Waiver Guidelines: This document provides guidelines and a general framework for permanent establishment determinations.
- 18 September 2006, TPM 09 – Reasonable Efforts under Section 247 of the Income Tax Act: This document provides guidance as to what constitutes reasonable efforts to determine and use arm's-length transfer prices or arm's-length allocations; it also provides examples of situations where taxpayers are at greater risk for a transfer pricing penalty.
- 28 October 2008, TPM 11 – Advance Pricing Arrangement (APA) Rollback: This document cancels and replaces TPM 10 with respect to APA rollbacks and clarifies CRA policy regarding an APA request to cover prior tax years, sometimes referred to as an APA 'rollback'.
- 12 December 2008, TPM 12 – Accelerated Competent Authority Procedure (ACAP): This document provides guidance on ACAP, which provides for the resolution of a mutual agreement procedure (MAP) case to be applied to subsequent years.

The CRA's guidance on 'range issues' as they arise in testing a taxpayer's (or its affiliate's) profitability was published in an article presented at the Canadian Tax Foundation 2002 Tax Conference by Ronald I. Simkover, Chief Economist, International Tax Directorate, CRA.

Legal cases

GlaxoSmithKline v. The Queen 2008 TCC 324 (FCA decision at 2010 FCA 201)

This case was heard by the Supreme Court of Canada (SCC) on January 13, 2012 and was the first transfer pricing case to be heard by the SCC. A decision is expected in late 2012.

Canada

Facts

The facts that gave rise to the initial dispute occurred during the period from 1990 to 1993. Pharmaceutical company GlaxoSmithKline Inc. (GSK Canada), which had been distributing the ulcer drug Zantac since 1982, was purchasing ranitidine, the active ingredient in Zantac, from Adechsa, a Switzerland-based related party. The ranitidine was manufactured in Singapore. The CRA concluded that the price GSK Canada paid for the ranitidine over the period was too high, based on comparable prices paid by generic drug producers.

The TCC decided in favour of the CRA. GSK Canada appealed to the FCA, which set aside the decision and returned the case to the TCC for reconsideration. The Crown appealed to the SCC, and GSK Canada cross-appealed.

TCC decision

The Crown framed the case as one of tax avoidance by GSK Canada due to the low tax rate in Singapore, where the bulk of the profit was earned. The TCC followed the hierarchy of methods using the 1995 OECD Guidelines and accepted the Crown's CUP analysis, focusing only on the supply agreement. Under this agreement the ranitidine was supplied without associated intangibles such as brand name (which came from the licence agreement for 6%); this was deemed comparable to the generics' supply agreements. The TCC rejected GSK Canada's resale price comparables, where brand and the ranitidine were obtained in one, or linked agreements, as well as its TNMM analysis, holding that the sole issue was the price of ranitidine, not the price to sell Zantac, and therefore the business circumstances that allowed Zantac to sell at a premium to generics were not relevant.

FCA decision

The FCA found that the TCC ignored the fact that GSK's transaction took place in the branded pharmaceutical market, and that business realities such as the use of the brand name and resulting higher prices should be taken into account, thus bringing into question the comparability of the generic CUPs. The FCA recognised that the high profitability associated with selling Zantac did not belong to GSK Canada and that only in a fictitious world could one buy ranitidine at low generic prices and sell at high Zantac prices. In doing so, the FCA also recognised the importance of the factors that a reasonable business person dealing at arm's length would consider in a similar situation. It also found that the TCC should not have separated the licence and supply agreements in considering the reasonableness of the price.

Crown's appeal to the SCC

In its appeal, the Crown argued that the OECD Guidelines require respect for the legal structure adopted by the taxpayer and that bundling the licence and supply agreements (as suggested by the FCA) violated this principle. It also submitted that transfer prices should be assessed on a 'transaction by transaction' basis, not lumped together to test the bottom-line result. Essentially it suggested that the arm's-length standard has been displaced by a 'reasonable business person' test, thus moving Canada away from the OECD Guidelines. As such, it argued, the question is no longer how the price compares to arm's-length prices but whether the taxpayer acted 'reasonably' in paying the amount that it did.

GSK's response (cross-appeal)

GSK Canada responded that it did not recharacterise or bundle the transactions, but rather considered both agreements because both were relevant to determining the

appropriate transfer price, that is, analysing the circumstances of the supply agreement included consideration of the licence agreement. This principle (i.e. consideration of relevant circumstances) is endorsed by the OECD Guidelines. GSK Canada also challenged the FCA order to return the matter to the TCC as this effectively extended the statutory limitation period by giving the Minister another kick at the can. GSK Canada argued that it had successfully ‘demolished’ the assessment at the FCA and was entitled to have the matter set aside.

General Electric Capital Canada Inc. v. The Queen 2009 TCC 563 (FCA decision at 2010 FCA 344)

On 15 December 2010 the Federal Court of Appeal (FCA) dismissed the Crown’s appeal of the 2009 TCC decision in the General Electric Capital Canada case, which favoured the taxpayer.

Facts

This transfer pricing case involves the deductibility of guarantee fees paid by a subsidiary to its parent.

During its 1996 to 2000 taxation years, General Electric Capital Canada Inc. (GECC) deducted CAD 136 million in guarantee fees paid to General Electric Capital Corporation (GECUS), its US-based parent company, for explicitly provided financial guarantees. The Minister disallowed the deductions on the basis that the fees provided no value to the taxpayer. The TCC allowed GECC’s appeals and ordered that the Minister’s reassessments be vacated, finding that the 1% guarantee fee paid was equal to or below an arm’s-length price. The Crown appealed, contending first that the TCC judge made a number of legal and factual errors and second that his behaviour during the trial gave rise to a reasonable apprehension of bias against the Crown’s position. The Crown asked that the matter be remitted for a new trial before a different judge. The FCA dismissed the Crown’s appeal, finding no errors of fact or law and no procedural bias.

TCC decision

The TCC decision was in many ways a compromise between the position of the Crown and that of the taxpayer. The Crown argued that GECC did not benefit from the explicit guarantee because of the ‘implicit’ guarantee that existed by virtue of the parent-subsidiary relationship and therefore, no payment was required for the explicit guarantee. GECC argued that although such implicit support is recognised in the market, it is a factor inherent in a non-arm’s-length relationship and as such cannot be considered under the arm’s-length principle. The TCC rejected both positions, finding that the implicit support derived from GECC being a member of the GE family was a relevant factor that should be considered as part of the circumstances surrounding the transaction. However, even after considering the implicit support, the TCC found, using the ‘yield’ approach, that there was significant benefit from the explicit guarantee. Because the benefit exceeded the price charged for the guarantee, the TCC found in favour of the taxpayer.

Crown’s appeal

The Crown identified the following four errors of law:

- The judge failed to identify the relevant transaction because he took into account a fact that did not exist, namely the removal of the explicit guarantee and its impact on GECC’s cost of borrowing.

Canada

- The judge erred in preferring the evidence of GECC's expert to that of the Crown's insofar as the GECC expert failed to address certain significant characteristics relevant to assessing the value of the guarantee.
- The judge failed to conduct a reasonableness check.
- The judge should not have relied on the business judgment of a former GECC executive because it was subjective.

The Crown also contended that the judge's behaviour during the trial gave rise to a reasonable apprehension of bias against it.

All of these arguments were discussed and dismissed by the FCA. The bias argument was rejected on the grounds that the behaviour in question (i.e. the TCC judge engaging in 'excessive pursuit' of the possible impact of a removal of the guarantee) related to an issue that had 'no substantial connection with the outcome' of the trial.

GECC's appeal

GECC argued that the judge misapplied the relevant transfer pricing law when he reduced the arm's-length price of the guarantee on account of implicit support. Specifically, implicit support cannot arise if the parties are assumed to be truly arm's length. It arises only as a result of the non-arm's-length relationship that must be ignored under the arm's-length principle.

GECC also argued that the TCC judge erred by adopting the yield or 'benefit to the borrower' approach instead of focusing on a market price for the guarantee. Because market participants would have charged up to 300 basis points to guarantee the debt, the yield approach undervalued the guarantee.

The FCA rejected both arguments, stating that the concept underlying subsections 69(2) and 247(2)(a) and (c) is simply 'to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length'. This determination involves 'taking into account all the circumstances which bear on the price, whether they arise from the relationship or otherwise'.

The FCA discussed the statutory objective, 'which is to prevent the avoidance of tax resulting from price distortions which arise in the context of non-arm's-length relationships'. Further, 'the elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective'. In this case, because implicit support is a factor that an arm's-length person would find relevant in pricing a guarantee, the FCA's view was that it had to be considered, and ignoring it would be turning 'a blind eye on a relevant fact and deprive the transfer pricing provisions of their intended effect'.

The FCA judge also cited the *GlaxoSmithKline Inc.* decision (*see above*), which found that all relevant circumstances must be taken into account when determining an arm's-length price, holding that 'there is no doubt that the existence of the implicit guarantee is relevant to the inquiry and must be considered in identifying the arm's-length price'.

On the matter of which approach is appropriate, the FCA took the view that if the explicit guarantee provided no benefit, 'an arm's-length party standing in the shoes of [GECC] would not have paid anything towards it.' It further found that 'the assessment of the benefit is but a means to ascertain whether a guarantee fee would have been paid by an arm's-length party'.

This responded to only one question – whether an amount should be paid at all – but did not address whether the yield approach should on its own be used to establish the arm's-length price.

In conclusion, the FCA rejected all appeal issues raised by both the Crown and GECC and dismissed the appeal.

Alberta Printed Circuits Ltd. v. The Queen (2011 TCC 232)

In this case, the TCC found in favour of the taxpayer, Alberta Printed Circuits, Ltd. (APCI Canada), in respect of the application of the comparable uncontrolled price (CUP) method to determine arm's length set up service fees paid to a related company in Barbados (APCI Barbados). However, despite the TCC's rejection of the CRA's analysis supporting its reassessments, it substantially disallowed the fees paid by APCI Canada to APCI Barbados for other services. While the TCC found that there was an absence of any compelling evidence to show the arm's-length nature of the charge for these other services, it nonetheless computed a charge for the services that left a significant portion of the CRA's reassessments in place.

Other relevant cases

The CRA continues to focus on financial transactions in its transfer pricing audits, as evidenced by two cases heard by Canadian courts in 2011/2012.

At issue in *McKesson Canada Corporation v. The Queen* was whether the discount rate for factoring accounts receivable agreed to by related parties differed from the rate that would have been agreed to had the parties been dealing at arm's length. A decision is pending.

In *The Queen v. GE Canada Company*, the Crown is seeking to disallow guarantee fees paid by the taxpayer's predecessors to their US parent, arguing that the guarantees serve no commercial purpose and as such would not have been entered into by arm's-length parties. (See *GECC case, above*; *GE Company is the successor to GECC by amalgamation and inherited its debts*).

Burden of proof

Under the Canadian taxation system, the taxpayer makes a self-assessment of tax that is then assessed by the CRA (either with or without an audit). In the event of an audit, the burden of proof to satisfy the tax authorities that transfer prices are arm's length lies with the taxpayer.

The transfer pricing legislation also requires that the taxpayer show that it has made reasonable efforts to determine and use arm's-length transfer prices in order to exclude any related adjustments from penalty. The maintenance of complete and accurate contemporaneous documentation, as provided in the legislation, will constitute reasonable efforts for these purposes (see *Tax audit procedures section, below*).

Tax audit procedures

Selection of companies for audit

The CRA is changing the way it selects files for audit with the introduction of a risk-assessment approach that targets taxpayers considered to have the highest risk of non-compliance. This model will focus not only on corporations but on partnerships and trusts as well.

Canada

There will be three categories: ‘High’ (will be audited), ‘Medium’ (may dictate a restricted audit related to specific concerns) and ‘Low’ (unlikely to be audited pending future evaluations). Sources of information that will be used to determine which category a taxpayer falls into include (but are not limited to) the following:

- The taxpayer’s history of compliance.
- Data gathered from internal databases created from information required to be filed by law.
- Information received from tax treaties and tax information exchange agreements signed with other countries and provinces.

Provision of information and duty of the taxpayer to cooperate with tax authorities

Sections 231.1 to 231.5 of the ITA provide guidance on the authority of a person authorised by the Minister in regard to an audit. Basically, the rights of an auditor are far-reaching and taxpayers are expected to cooperate. As discussed earlier, section 231.2 authorises an auditor to issue a requirement for information that the taxpayer has not readily provided.

As discussed earlier, section 231.6 of the ITA requires that foreign information or documents that are available or located outside Canada be provided to the CRA if relevant to the administration or enforcement of the ITA. Failure to comply may result in the inadmissibility of foreign-based information or documents if defending a later reassessment in court.

The transfer pricing audit procedure

The risk-assessment approach (*see also Tax audit procedures section, above*) applies to transfer pricing audits as well. These audits can be initiated in two ways: as part of a regular corporate audit (where transfer pricing may be included in the audit at the discretion of the audit case manager), or when a local international tax auditor screens a file solely for a transfer pricing audit, primarily using Form T106 (*see also Statutory rules section, above*), which taxpayers must file annually.

CRA auditors are required to provide a taxpayer with a written request for contemporaneous documentation at the initial contact stage of a transfer pricing audit. The documentation must be provided within three months of the date of service of the request. Canada’s transfer pricing legislation offers no opportunity to negotiate an extension of the three-month deadline; the time frame is specified in the ITA and is not discretionary. If the deadline is not met, the taxpayer will be deemed not to have made reasonable efforts to determine and use arm’s-length transfer prices and may be subject to penalty if any resulting adjustment exceeds the legislated penalty threshold.

After the CRA has received the contemporaneous documentation, the auditor usually visits the taxpayer’s premises (and in some cases the premises of the non-resident related party) to confirm the information provided. In some circumstances, the auditor may determine that the taxpayer is low risk and not proceed further.

Throughout the audit process, the auditor can refer the case to the CRA’s head office to obtain technical assistance from economists.

Contemporaneous documentation

The CRA continues to pursue a relatively aggressive programme of transfer pricing enforcement. Any transfer pricing adjustment may be subjected to a 10% penalty, with some *de minimis* exceptions (see *Additional tax and penalties section, below*), unless the taxpayer has made reasonable efforts to determine and use arm's-length prices. This requires contemporaneous documentation to be on hand when the tax returns for the year are due (i.e. six months after the end of the taxation year for corporations).

As a minimum, the taxpayer should have a complete and accurate description of the following:

- The property or services to which the transaction relates.
- The terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction.
- An organisation chart – the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into.
- A functional analysis – the functions performed, property used or contributed and the risks assumed in respect of the transaction by the participants in the transaction.
- The data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.
- The assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocation of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

Where contemporaneous documentation has been prepared for a prior year, the ITA provides that only those items that pertain to a material change in respect of a transfer pricing transaction must be addressed.

Statute of limitations

The statute of limitations for most taxpayers is four years. However, transactions with related non-resident persons can be subject to audit for up to seven years after the tax year is initially assessed. In the rare situation where an audit may take longer, the CRA can ask the taxpayer to sign a waiver to extend beyond the seven years, which must be signed within the seven-year period. The CRA has stated that it is committed to timely review and audit.

The appropriate tax treaty should be consulted, as treaties often include a provision whereby a taxpayer must be reassessed within a specified period in order to preserve its right to request competent authority assistance in the event of double taxation. Such a reassessment can be raised regardless of whether the audit is completed.

Reassessments and the appeals procedure

Many transfer pricing issues can be resolved with the field auditor or the auditor's supervisor based on information provided and discussions held during the audit. If an issue cannot be resolved, the CRA issues a Notice of Reassessment for tax owing based on its audit findings. At this stage, a taxpayer may have two options. The first is to pursue the issue through the CRA's appeals division and possibly the Canadian tax courts. The second is to request relief from double taxation through the competent

Canada

authority process (available only if the transfer pricing reassessment involves a related entity in a country that has a tax treaty with Canada).

In either case, the taxpayer should file a Notice of Objection. This Notice must be filed within 90 days of the date of mailing of the Notice of Reassessment and can either initiate the appeal process (if that is the desired option), or be held in abeyance (at the taxpayer's request) while the taxpayer pursues relief through the competent authority process. If the taxpayer pursues the appeal process and is not satisfied with the result, it may seek a resolution in the Canadian tax courts. If the taxpayer pursues relief through the competent authority process, the Notice of Objection will protect the taxpayer's rights of appeal in the event that the issue is not resolved through this process.

A taxpayer can request competent authority assistance after it has proceeded through the appeal process and/or obtained a decision from a Canadian tax court. However, in its dealings with the foreign competent authority the Canadian competent authority is bound by any settlement with the CRA's appeals division or a Canadian court decision. Whether relief from double taxation is provided is at the sole discretion of the foreign competent authority.

A large corporation (as defined under the ITA) may be required to remit 50% of any amounts owing to the federal government as a result of the reassessment (tax, interest and penalties) while appealing the Notice of Reassessment. This relief is not available in the case of withholding taxes and provincial taxes.

Additional tax and penalties

Transfer pricing penalty provisions apply for tax years commencing after 1998. Transfer pricing adjustments can result from the following circumstances:

- A net increase in income or a net decrease in loss.
- A reduction in the taxpayer's tax cost of non-depreciable and depreciable capital property and eligible capital property.

These transfer pricing adjustments are liable for a 10% penalty, subject to the following exceptions:

- Penalties will not be applied where the net transfer pricing adjustment does not exceed the lesser of 10% of the taxpayer's gross revenue and CAD 5 million.
- No penalties will be applied where the taxpayer has made reasonable efforts to determine that its prices are arm's length and to document such on or before the date its tax return is due for the taxation year (*see Transfer pricing audit procedure section, above*). Taxpayers must be able to provide this documentation to the Minister within three months of a request.

The legislation allows favourable adjustments to reduce unfavourable adjustments when determining the amount subject to penalty. However, to obtain a set-off, taxpayers must have documentation supporting the transaction to which the favourable adjustment relates and the Minister's approval of the favourable adjustment; taxpayers without contemporaneous documentation cannot benefit from set-offs.

The CRA's TPM-09 provides additional guidance on what constitutes reasonable efforts to determine and use arm's-length transfer prices. According to TPM-09, a reasonable effort is defined as 'the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances'. Further, the CRA considers a taxpayer to have made reasonable efforts when it has 'taken all reasonable steps to ensure that [its] transfer prices or allocations conform to the arm's-length principle'.

Canada's penalties are based on the amount of the transfer pricing adjustment and can apply when the taxpayer is in a loss position, such that no increased taxes are payable as a result of the adjustment. In the event of capital transactions, the penalty applies to the taxable portion of any gain. Each case where a penalty may apply is referred to the TPRC, which makes a determination as to whether reasonable efforts were made.

Interest (at rates prescribed by the CRA) is charged on the underpayment of income-tax liabilities and withholding tax. This interest is not deductible for income-tax purposes. Interest is not charged on transfer pricing penalties unless the penalty is not paid within the required time frame.

Risk transactions or industries

Although the CRA may not be targeting any particular industry for transfer pricing audits, it has begun to adopt an industry-based audit approach by developing tax service offices (TSOs) that have expertise in specific industries, including pharmaceutical (TSO in Laval, Quebec), automotive (Windsor, Ontario), banking (Toronto, Ontario) and oil and gas (Calgary, Alberta). It is not yet known whether this approach will be extended to other industries. Over time, the CRA is expected to become more consistent in its approach to transfer pricing audits in these industries and to develop national industry-specific audit procedures.

Specific transactions scrutinised by the CRA include intragroup services, inter-company debt, interest charges, guarantee fees, royalty payments, intellectual property (IP) migration, contract manufacturing arrangements and restructuring and plant closures. Again, the CRA may not focus on a particular type of transaction but is paying more attention to transactions involving IP, which are routinely referred to the CRA's specialist teams in Ottawa for review.

The CRA has an Aggressive International Tax Planning (AITP) division, which is part of the International and Large Business Directorate. The AITP initiative is aimed at identifying and responding to international transactions that may be designed to avoid paying income tax in Canada.

Limitation of double taxation and competent authority proceedings

Two articles in Canada's income-tax treaties are relevant to transfer pricing.

- The Associated Enterprises article (Article 9) provides a definition of related parties for the purpose of the treaty and provides that each State can make adjustments to related party transactions based on the arm's-length principle. Certain treaties may stipulate a time limit to make application for assistance under this article. In the absence of a time line, the time provided under domestic legislation prevails.

Canada

- The MAP article (Article 25) states that the competent authorities shall endeavour to resolve any taxation (e.g. double taxation) that is not in accordance with the treaty.

A taxpayer does not need to wait for the issuance of a Notice of Reassessment before filing a request for competent authority assistance. However, the competent authority will not act on the request until a reassessment has been issued.

The competent authority process for a Canadian taxpayer that has been reassessed can be summarised as follows. The non-resident related party must file a request for competent authority assistance (complete submission) in its country of residence within the time frame provided in the treaty. A similar request is normally filed simultaneously with the Canadian competent authority by the Canadian resident. The foreign competent authority informs the Canadian competent authority that it has received the request and requests a position paper outlining the details of the reassessment. The Canadian competent authority obtains the auditor's working papers (including additional information provided by the Canadian taxpayer), reviews the case and, if unable to unilaterally resolve the double taxation, provides the position paper to the foreign tax administration, after which negotiations between the competent authorities take place to resolve the double taxation. Once the competent authorities reach agreement, they advise the taxpayers in their respective countries of the proposed settlement. Once the taxpayers have accepted the proposed settlement, the necessary adjustments are processed in each country.

As the timing for filing a competent authority request varies from treaty to treaty, it is important to consult the MAP article of the relevant treaty. Generally, the competent authority submission must be filed within two years of the date of the Notice of Reassessment.

Canada currently has two treaties where the Associated Enterprises article requires that the other competent authority be notified of potential double taxation within six years of the end of the taxation year under audit. Once notification is provided, the MAP articles in those treaties do not impose a time frame within which the competent authority submission must be filed.

If a request for competent authority assistance with a submission or notification is not filed on time, a taxpayer may be denied relief by the competent authority of the non-resident related party.

The CRA's Competent Authority Services Division is responsible for the competent authority function as it pertains to the MAP and Exchange of Information articles in the treaties. Case officers in this division meet quarterly with their US counterparts and occasionally with governments of other foreign jurisdictions to discuss specific cases.

An amendment to the Canada-US treaty providing for binding arbitration in MAP cases was ratified on 15 December 2008, and a Memorandum of Understanding (MOU) regarding the conduct of these arbitration proceedings was released on 26 November 2010. The MOU establishes the procedures for arbitration cases and indicates that the two countries have resolved their differences regarding the scope of the treaty's arbitration provision, the types of cases eligible for arbitration and the manner in which issues will be resolved in arbitration proceedings. The process is described as

'baseball' arbitration, i.e. the arbitration board (comprising three members) selects one of the proposed resolutions provided by the competent authorities as its determination.

Arbitration may only be invoked by the taxpayers with the filing of the required non-disclosure agreements. Generally, such agreements can be filed two years after the competent authorities have agreed they have received a complete submission to resolve the case.

TPM 12 – Accelerated Competent Authority Procedure was released on 12 December 2008. This document provides guidance on the process where, at the taxpayer's request, the issues that gave rise to a MAP case can be addressed in subsequent years by the competent authorities (*see Statutory rules section, above*).

The CRA's MAP programme report for 2011 includes the following highlights:

- A total of 743 new cases were accepted during the year, with 740 completed.
- Of new cases accepted, 94 were categorised as 'negotiable' (i.e. involving another tax administration).
- Of the 740 cases in inventory that were completed, 95 were negotiable.
- The average time to complete the 84 Canadian-initiated cases was 32 months, while the 11 foreign-initiated completed cases took an average of 20 months.
- Full relief was granted in 85% of the negotiable cases, no relief was granted in 13 cases and partial relief was granted in one case.

Advance pricing arrangements (APAs)

Canada was one of the first countries to implement an APA programme. The service is intended to assist Canadian taxpayers in determining acceptable transfer pricing methodology and, where negotiated with tax authorities of other jurisdictions, provide certainty on covered transactions. An APA is intended to consider proposed pricing arrangements or methodologies that have prospective application and is designed to seek agreement on an appropriate transfer pricing methodology for a specified cross-border transaction between related parties. The service is offered in addition to competent authority assistance on the appropriateness of historic transactions that have been challenged by one or both of the jurisdictions involved.

APAs can be unilateral, bilateral or multilateral. At the conclusion of the procedure, there is a binding agreement between the taxpayer and the CRA and, in the case of bilateral or multilateral APAs, between the CRA and the other tax authorities involved.

IC 94-4R, dated 16 March 2001, outlines the procedures and guidelines for obtaining APAs in Canada.

The CRA has established the following policies regarding the rollback of transfer pricing methodologies agreed upon through the APA process:

- A rollback will be considered if a request for contemporaneous documentation has not been issued by the CRA, the facts and circumstances are the same, and the foreign tax administration and the CRA both agreed to accept the APA rollback request.
- A waiver must be filed for each year in question in accordance with the ITA.

Canada

- Once an APA is in force, transactions occurring in tax years covered by the APA and the rollback period are not subject to a transfer pricing penalty.
- The CRA will not issue a request for contemporaneous documentation for transactions in a year that a taxpayer has requested to be covered by an APA rollback at a pre-filing meeting.
- An APA rollback will not be permitted when a taxpayer requests a unilateral APA.

The first year of a unilateral APA will be the first taxation year for which a tax return has not been filed in which the transfer pricing methodology has been agreed to.

IC 94-4RSR (Special Release) addresses APAs for small businesses. The following are highlights of this release:

- The programme will have a fixed non-refundable administration fee of CAD 5,000.
- Taxpayers must have gross revenues of less than CAD 50 million or a proposed transaction to be covered by the APA of less than CAD 10 million.
- The programme will cover only transactions of tangible property and routine services.
- Site visits will not be performed.
- The minimum information required from a taxpayer is a functional analysis. The CRA will perform the economic analysis if requested to do so.
- The programme applies only to a unilateral APA without a rollback.
- Taxpayers' annual reporting under the programme will be limited to stating in writing whether the critical assumptions have or have not been breached.

Due to a staffing shortage in the competent authority division in 2011, the CRA has implemented the following changes to the APA programme:

- CRA case officers must present a business case to the competent authority with respect to the necessity of site visits.
- There is reluctance to accept requests for a unilateral APA.
- The CRA is relying increasingly on the taxpayer to provide analyses the CRA would normally undertake.
- At the pre-filing meeting, there is increased scrutiny concerning the viability of a taxpayer to enter the APA programme.

The 2011 annual report on the APA programme published by the CRA reports the following:

- Twenty cases were accepted into the programme.
- The active case inventory was 95 cases.
- Sixteen cases were completed, of which 14 were bilateral and two were unilateral.
- Of the completed cases, bilateral APAs took an average of 50.3 months to complete, while unilateral APAs took an average of 28.4 months to complete.
- The TNMM continues to be the predominant methodology used in APAs (43% of completed and in-progress cases), followed by the profit split (21% of completed and in-progress cases) and the cost plus method, at 15%.
- When the TNMM is used, the most common profit level indicator used is the operating margin (used 61% of the time), followed by total cost plus (25% of the time) and the Berry ratio and return on assets (combined, 14% of the time).

Liaison with customs authorities

Customs programmes are administered by the Canada Border Services Agency (CBSA).

Canada has implemented the World Trade Organisation's Valuation Agreement, under which the primary basis of the value for customs' purposes is the '*price actually paid or payable*' in a sale for export. As a matter of policy, the CBSA will generally accept that the transfer price was not influenced by the relationship between a buyer and seller if the transfer price was determined in accordance with the OECD Guidelines. However, the CBSA closely scrutinises other payments flowing from the buyer to the related seller (e.g. 'management fees') to determine whether these should be part of the '*price paid or payable*' for the goods. In a 2009 policy statement (Memorandum D13-4-13), the CBSA clearly states that it considers any payment beyond the actual selling price to be part of the dutiable value of the goods, unless the importer can demonstrate that it should not be.

In the course of a 'valuation verification' (i.e. an audit of the values declared on customs entries), an importer that purchases goods from a related party can expect to be asked to provide a copy of the documentation (such as a transfer pricing study) that demonstrates that the transfer price was determined in accordance with the OECD Guidelines.

There is no routine exchange of information between the CBSA and the CRA. However, the two agencies have been encouraged to have greater cooperation as anticipated by the OECD Guidelines. The two agencies have tended to stress the difference between a value calculated for income-tax purposes and a value calculated for customs purposes, given the different legislative bases.

It should also be noted that income-tax decisions that are adverse to the taxpayer may not result in the recovery of duty or tax that may have been payable on the import of goods. Importers are not required to report to the CBSA downward adjustments to transfer prices that are affected after importation, but neither can a duty refund be claimed based on the reduced customs price. However, post-importation increases in the transfer price must be reported to the CBSA, and additional duty (if any) must be paid. Failure to do so may result in penalties being assessed against the importer.

OECD issues

Canada is a member of the OECD. The Canadian transfer pricing legislation was redrafted in 1997 to conform with the OECD Guidelines.

On 22 July 2010 the OECD issued revised guidelines that address a number of issues concerning comparability, including factors to consider when assessing comparability of transactions as well as the selection of an appropriate transfer pricing method. The revised OECD Guidelines also address business restructuring issues.

On 26 June 2012, the governments of US and Canada entered into an agreement to follow the Authorized OECD Approach for determining the amount of profit to attribute to a permanent establishment (PE), which allows profits to be established for a PE regardless of whether the enterprise as a whole shows a profit or loss.

Canada

Joint audits

Most tax treaties have exchange-of-information provisions, including a provision for joint audits. Canada and the US have an agreement in place for joint audits. Both groups of auditors on complex audits initiate these reviews to minimise the time and effort.

Thin capitalisation

Rules regarding thin capitalisation and restrictions on the amount of deductible interest since 1972 are well-entrenched in Canada and usually enforced through the general audit procedures of CRA assessors and auditors. However, there are proposed changes to these rules as a result of the 2012 federal budget.

Where a corporation resident in Canada has average 'outstanding debts to specified non-residents' that exceed two times the corporation's 'equity' (as defined for the purposes of the thin capitalisation rules), a portion of the related interest expense is not deductible in computing the corporation's income for tax purposes. Proposed legislation would (i) reduce the permissible ratio of debt to equity to 1.5:1 (effective for taxation years starting after 2012) and (ii) treat the denied interest as a dividend subject to non-resident withholding tax (effective for taxation years ending after 2012).

'Outstanding debts to specified non-residents' is a defined term and generally refers to interest-bearing debts or other obligations owed either to non-resident shareholders who own (together with related persons) 25% or more of the voting shares of the corporation or to persons related to such shareholders. The average of such debts is determined using the greatest amount of such debt outstanding at any time during each calendar month that ends in the year. Proposed legislation would require the corporation to include certain debts of partnerships of which the corporation is a member, either directly or through multiple tiers of partnerships (effective for taxation years starting after 2012).

'Equity' is defined to include:

- The retained earnings of the corporation as at the beginning of the year, except to the extent that those earnings include retained earnings of any other corporation.
- The average of all amounts, each of which is the corporation's contributed surplus (determined, in the CRA's view, in accordance with Canadian generally accepted accounting principles) at the beginning of each calendar month that ends in the year, to the extent that it was contributed by a specified non-resident shareholder of the corporation.
- The average of all amounts each of which is the corporation's paid-up capital at the beginning of each calendar month that ends in the year, excluding the paid-up capital in respect of shares of any class of the capital stock of the corporation owned by a person other than a specified non-resident shareholder of the corporation.

International groups that have a Canadian holding company for their Canadian operating company or companies should be cautious when a related non-resident makes a loan directly to the Canadian operating company. The Canadian operating company may not have any direct non-resident shareholders and, accordingly, a portion or the entire amount of the interest could potentially become non-deductible under the thin capitalisation rules. Where possible, loans from related non-residents

should be made to the Canadian holding company that has the direct non-resident ownership, keeping in mind the lack of consolidated tax filing in Canada and the 'back-to-back' anti-avoidance provisions included in the thin capitalisation rules.

It should also be noted that because of the difference in timing with respect to including debt and equity in the statutory averaging formula, interest may become non-deductible even where equity and debt are contributed concurrently, because the thin capitalisation calculation does not recognise increases in equity amounts until the beginning of the next calendar month.

Intragroup services (management fees)

For intragroup service fees to be tax-deductible in Canada, a specific expense must be incurred and the expense must be reasonable in the circumstances. There should also be documentary evidence to support the amount of the charge, such as a written agreement to provide the services and working papers evidencing the expense charged.

Intragroup service charges are governed by section 247 of the ITA; there is no specific transfer pricing legislation for intragroup service fees, though the CRA's position on this issue is included in IC 87-2R. The withholding tax legislation in section 212 of the ITA provides insight into what constitutes intragroup services.

Qualifying cost-contribution arrangements

Qualifying cost-contribution arrangements provide a vehicle to share the costs and risks of producing, developing or acquiring any property, or acquiring or performing any services. The costs and risks should be shared in proportion to the benefits that each participant is reasonably expected to derive from the property or services as a result of the arrangement. Where a participant's contribution is not consistent with its share of expected benefits, a balancing payment may be appropriate.

20.

Chile

Introduction

Article 22 of Law 19,506, published in the Official Gazette on 30 July 1997 introduced four paragraphs to Article 38 of the Income Tax Law. Said paragraphs contain the basic Chilean transfer pricing rules, which became effective from calendar year 1997. A minor amendment to these rules was introduced by Law 19,840, published in the Official Gazette on 23 November 2002.

In addition, the Chilean tax authority (*Servicio de Impuestos Internos – SII*) issued Circulars No. 3 and 57, both in 1998. These circulars contain the guidelines for the application of the rules by the tax inspectors.

On 30 April 2012, the President of the Republic of Chile sent to the Parliament a tax bill that includes Article 41 E to the Income Tax Law. Said article introduces specific transfer pricing legislation.

Statutory rules

General

In general, Chilean transfer pricing rules are consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines. There is a specific interpretation of the application of the CUP method, which is described below.

Scope of the rules

The rules apply to all types of transactions, including, among others, the following transactions:

- Sale of goods.
- Provision of services.
- Transfer of technology.
- Use of patents and trademarks.
- Financing transactions (interest, commissions and other payments).

The proposed transfer pricing legislation would allow the Chilean tax authority to challenge prices, values or profitability on transactions under the following circumstances:

- Transactions carried out with foreign related parties.
- Transactions derived from business restructurings and reorganisations that imply the shift to tax havens or preferential tax regimes of goods or activities able to generate taxable income.

- Transactions carried out with entities resident in countries included in a list of tax havens or preferential tax regimes, with whom Chile has not entered into an exchange of information agreement.

Concept of a related party

The rules establish a broad concept of 'related parties', which includes the following:

- The branch or agency and its parent company, or another agency or related company of the parent company.
- A company incorporated abroad that participates, directly or indirectly, in the management, control or capital of a company established in Chile or vice versa.
- A person that participates, directly or indirectly, in the management, control or capital of both a Chilean enterprise and a foreign enterprise.
- When there is an agreement for exclusivity, joint performance, preferential treatment, or economic, financial dependence or deposits of trust.
- When the transaction is performed with an enterprise established in a tax haven or low-tax jurisdiction under the OECD.
- In some other cases where Circular 3 considers the transaction not entered into between independent parties.

Under the proposed transfer pricing legislation entities are considered as related parties when: a) an entity participates directly or indirectly in the management, control, capital, profits or revenues of the other entity; and b) when one person or the same persons participate directly and indirectly in the management, control, capital, profits or revenues of the other entity. Agencies, branches or any other form of permanent establishment are considered related parties of: their head office, other permanent establishments of the head office, related parties of the head office and, permanent establishments of the head office's related parties. Likewise, proposed transfer pricing rules establish that there is relationship between the parties when an entity carries out a transaction with a third party that, in turn, carries out a similar/identical transaction with a related party of that entity.

Methods

The tax authority is allowed to use the following methods:

- A reasonable profitability given the nature of the transaction.
- The resale price, meaning the resale price to third parties of goods acquired from a related company, less the profit margin earned in similar transactions among independent companies.
- The cost plus a reasonable profit margin.
- The international market value for which data from the national customs service and the Central Bank of Chile can be used.

Local taxpayers can apply the CUP method as a methodology for testing the arm's-length principle; however, the Chilean SII would not be entitled to use it as a tool to determine an eventual transfer pricing adjustment on the same cross-border transaction.

There is no best-method rule.

The proposed transfer pricing legislation does not explicitly mentions the adoption of the methods established in the OECD Guidelines, but the methods included are in line

Chile

with such guidelines. The proposed rules also adopt a most appropriate method rule and would allow the use of other unspecified methods when the methods described in the Chilean Income Tax Law are deemed not to be appropriate to determine an arm's-length nature of the inter-company transactions.

Other regulations

Neither the law nor the tax authority requires preparation of a transfer pricing study or compliance with reporting requirements. There is no transfer pricing documentation requirement. However, when conducting a transfer pricing examination, the tax authority welcomes transfer pricing studies voluntarily prepared by the taxpayer to support their pricing.

The Chilean tax authorities request certain Chilean taxpayers to report their transactions with non-resident taxpayers. The transactions must be reported on oath on a form provided by the Chilean tax authorities. The information to be disclosed includes: (1) identification of the Chilean taxpayer; (2) identification of and information about the non-resident taxpayer, including name, tax identification number, country of residence and type of relationship with the Chilean taxpayer (if any); (3) type of transaction; (4) method used to price the transaction; (5) amounts received or paid as a consideration for these transactions; and (6) profit or loss margin from these transactions.

Pursuant to the proposed transfer pricing legislation, taxpayers will be required to keep all the information that supports the application of a transfer pricing method allowed by the proposed article 41 E of the Chilean Income Tax Law. Transfer pricing documentation must be contemporaneous with the tested transactions since it should be available to the Chilean tax authority within 30 days of it being requested. Additionally, the bill introduces the obligation to file an annual sworn statement requiring the following specific information:

- Summary of the transactions carried out with related and unrelated parties.
- Methods applied to verify the arm's-length nature of the inter-company transactions.
- Information about the foreign related parties, such as country of residence and tax identification number.

The tax bill also includes the possibility of performing transfer pricing corresponding adjustments, but those have to be authorised by the Chilean tax authority and will only be allowed if cases involve a country with whom Chile has a valid double taxation treaty. The Chilean tax authority can consent the corresponding adjustments only when the date for administrative appeals court procedures is not due. Moreover, the adjustment must be based on the application of one of the transfer pricing methods allowed in the Chilean Income Tax Law, among other requirements.

Cases

At present, there is no administrative guidance or judicial precedence.

Burden of proof

There are no specific rules on the burden of proof relating to transfer pricing. However, under the general rules in the Tax Code, it is generally considered that the burden of proof lies with the SII.

Tax audit procedures

The tax authority has a specialised group that performs transfer pricing examinations. This group is part of the International Tax Inspection Department (*Departamento de Fiscalización Internacional*).

There is evidence of transfer pricing examinations into mining companies, retailer companies, and pharmaceuticals groups.

Advance pricing agreements (APAs)

At present, there are no provisions enabling taxpayers to obtain APAs with the tax authority. However, the tax authority has expressed its intention to implement APAs in the future.

The proposed transfer pricing legislation includes the possibility to enter into APAs (unilateral or multilateral). The Chilean tax authority can reject, totally or partially, the request and such decision would not be subject to an administrative appeal procedure. APAs would be valid for four years and are subject to renewal or extension. The Chilean tax authority or the taxpayers can invalidate an APA when there is a significant change in the circumstances under which the APA is granted.

Anticipated developments in law and practice

It is expected that transfer pricing examination activity will increase in the near future. It is also expected that the tax inspectors will become more skilled in this area, due to increasing training and experience.

The head of the Chilean SII has revealed in several seminars and interviews that the SII will attack tax evasion in Chile via the auditing of transfer pricing issues in key industries.

Liaison with customs authority and Central Bank of Chile

The tax authority is allowed to request information from the customs authority and Central Bank of Chile for transfer pricing examinations.

Tax treaty activities

It is interesting to note that Chile has been very active in the area of treaties, expanding its tax treaty network and concluding free-trade agreements with the European Union and the US.

OECD issues

On 11 January 2010, Chile became a member of the OECD, although the local transfer pricing regulations do not expressly recognise the standards set by the OECD Guidelines. However, the tax authority has generally adopted the arm's-length principle, and tax inspectors use the OECD Guidelines as general guidance.

21.

China, People's Republic of

Introduction

The transfer pricing regime in China is generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines and has developed rapidly over the past few years. China's corporate income tax (CIT) law, together with its detailed implementation regulations (DIR), contain the key transfer pricing and anti-avoidance concepts that govern transfer pricing enforcement in China.

In January 2009, China's State Administration of Taxation (SAT) issued a circular titled *Guo Shui Fa* [2009] No. 2 (Circular 2), the 'Implementation Measures of Special Tax Adjustments – trial version', which provides further guidance on the above concepts. Circular 2 marked a significant step up in China's transfer pricing enforcement regime.

Statutory rules

The CIT law

The highest level of legislation in China is represented by laws, which can be enacted only by the National People's Congress (NPC).

The current CIT law was promulgated on 16 March 2007 by the NPC and became effective on 1 January 2008. Articles relevant to transfer pricing are found mainly in Chapter 6, 'Special Tax Adjustment'. The CIT law provides the arm's-length principle as the guiding principle for related party transactions and empowers the tax authorities in China to adjust a taxpayer's taxable income if it fails to comply with the arm's-length principle in its dealings with related parties.

The DIR of the CIT law

The second level of tax legislation is represented by detailed implementation regulations, which are promulgated by a super-ministerial organisation known as the State Council.

The DIR of the CIT law, promulgated on 6 December 2007, provides more specific guidance relating to all aspects of the CIT law.

Specifically with respect of Chapter 6, the DIR not only expands on various concepts in the CIT law (such as cost-sharing, controlled foreign corporations, thin capitalisation and general anti-avoidance), but also imposes contemporaneous transfer pricing documentation requirements and a special interest levy that could create a significant impact for taxpayers.

Circular 2

The third level of tax legislation is represented by circulars issued by the SAT. The formal circulars issued by the SAT are usually designated as *Guo Shui Fa* and the

SAT also issues less formal letter rulings (known as *Guo Shui Han*) that can take the form of replies by the SAT to specific issues raised to them by one of their underlying tax bureaux.

Circular 2, promulgated by the SAT in January 2009 with an effective date of 1 January 2008, lays out detailed rules on administering all the aspects covered by special tax adjustments. Circular 2 supersedes past notices, affirms prior positions and introduces a set of new obligations.

Circular 2 also sets the foundation for future developments. In fact, the connotation that its contents are a 'trial version' (as stated in the title) provides the SAT with flexibility to issue further circulars to interpret and clarify the concepts.

Burden of proof

In China, the burden of proof that a related party transaction was conducted at arm's length rests with the taxpayer. According to Paragraph 2 of Article 43 of the CIT law, if the tax authorities conduct a transfer pricing investigation, the taxpayer under investigation, its related parties and other relevant companies are obligated to provide 'relevant information' upon request. If the taxpayer under investigation fails to provide information in relation to its related party transactions or provides false or incomplete information that does not truly reflect the situation of its related party transactions, the tax authorities are authorised to deem the taxpayer's taxable income.

According to the DIR, information required by the tax authorities during a transfer pricing investigation may include the following:

- The taxpayer's contemporaneous transfer pricing documentation.
- Relevant overseas information regarding resale price (or transfer price) and/or ultimate sales price of tangible goods, intangible goods and services involved in the related party transactions.
- Other relevant information relating to related party transactions.

Information reporting

Annual tax return disclosure of related party transactions

China's annual related party transaction disclosure forms (required under Article 11 of Circular 2) were officially introduced by the SAT in December 2008 under *Guo Shui Fa* [2008] No. 114 (Circular 114). Circular 114, which took effect on 1 January 2008, contains the following nine transfer pricing-related forms that Chinese taxpayers must file as part of their new CIT returns:

- Form 1: Related Party Relationships Form.
- Form 2: Summary of Related Party Transactions Form.
- Form 3: Purchases and Sales Form.
- Form 4: Services Form.
- Form 5: Financing Form.
- Form 6: Transfer of Intangible Assets Form.
- Form 7: Transfer of Fixed Assets Form.
- Form 8: Foreign Investment Status Form.
- Form 9: Foreign Payments Status Form.

China, People's Republic of

These forms, which generally need to be filed along with the Chinese CIT returns, require taxpayers to indicate whether they have contemporaneous documentation in place to substantiate their inter-company arrangements and to provide detailed information on each type of related party transaction (including specifying the applicable transfer pricing method).

In addition, a 'special tax adjustment' option in the annual CIT return package allows taxpayers to make voluntary upward adjustments to their taxable income.

While the statutory filing deadline for CIT returns is 31 May, some local-level tax authorities may impose an earlier filing due date. Therefore, it is essential for taxpayers to closely monitor and follow the local requirements specified by the local-level tax authorities.

Contemporaneous transfer pricing documentation

Under Circular 2, Chinese taxpayers generally are required to have contemporaneous transfer pricing documentation in place unless they meet any of the following criteria:

- The annual amount of related party purchases and sales transactions is less than 200 million renminbi (CNY) and the annual amount for all other types of transactions (i.e. services, royalties, interest) is less than CNY 40 million.
- The related party transactions are covered by an advance pricing arrangement (APA).
- The foreign shareholding of the enterprise is below 50%, and the enterprise has only domestic-related party transactions.

The contemporaneous transfer pricing documentation requirement was expanded by a subsequent circular to include certain loss-making companies with limited functions or risks, as discussed later in this section.

According to Article 14 of Circular 2, the contemporaneous transfer pricing documentation package should contain 26 specific items grouped under the following five areas:

- Organisational structure (four items).
- Description of business operations (five items).
- Description of related party transactions (seven items).
- Comparability analysis (five items).
- Selection and application of transfer pricing method (five items).

(Additional items are required for contemporaneous cost-sharing and/or thin capitalisation documentation.)

According to Circular 2, Chinese contemporaneous documentation must be:

- prepared and maintained for each tax year
- completed by 31 May of the following year (e.g. 31 May 2010 for 2009 tax year) and kept for 10 years (e.g. until 31 May 2020 for 2009 tax year)
- provided within 20 days of a request (or within 20 days of elimination of any force majeure), and
- in Chinese (including any source materials provided in English as part of the documentation).

As with the annual filing, some local-level tax authorities may impose due dates or submission timelines other than those listed above, and taxpayers should be prepared to submit documentation earlier if required by the in-charge tax authorities.

Tax underpayments that result from special tax adjustments (including transfer pricing adjustments) are subject to an interest levy that includes a 5% penalty component. That penalty component can be avoided if the taxpayer prepares and submits contemporaneous documentation in a timely manner upon request, or if the taxpayer is otherwise exempted from the documentation requirement. The interest levy is discussed in more detail later.

Documentation requirement for loss-making companies with limited functions/risks

According to Article 39 of Circular 2, companies engaged in simple manufacturing activities based on orders from related parties must earn a stable rate of return and should not be expected to bear the risks or suffer the losses associated with excess capacity, product obsolescence and other such factors. In July 2009, the SAT issued *Guo Shui Han* [2009] No. 363 (Circular 363). Circular 363 re-emphasises the SAT's position towards losses incurred by companies with limited functions and risks, and even goes one step further than Circular 2 by requiring all loss companies with limited functions and risks to prepare and submit contemporaneous documentation to their in-charge tax authorities by 20 June following the loss-making year – regardless of whether the amount of related party transactions exceeds the materiality thresholds. It is worth noting that, through Circular 363, the SAT has expanded the focus of scrutiny to trading companies and contract R&D service providers in addition to simple manufacturers.

Collection and review of contemporaneous transfer pricing documentation

On 12 July 2010, the SAT issued Circular *Guo Shui Han* [2010] No. 323 – Notice of the SAT Regarding the Sample Review of Contemporaneous Transfer Pricing Documentation (Circular 323), mandating local-level tax authorities to carry out a nationwide evaluation of taxpayers' 2008 and 2009 contemporaneous transfer pricing documentation. Circular 323 specifies that the local-level tax authorities must select for collection and review the documentation of at least ten percent of taxpayers which are subject to the documentation requirements for each year. Various tax authorities have provided feedback based on this review including common problem areas seen in documentation reports. This review process has continued in the following years (i.e. 2011 and 2012) and tax authorities are observed to be more active in collecting contemporaneous transfer pricing documentation from taxpayers.

Tax authorities in certain locations have shown distinct interests in collecting contemporaneous documentation. A number of local-level tax authorities have taken either a 'blanket' approach (whereby all taxpayers exceeding the thresholds have been required to submit documentation) or a 'targeted' approach (e.g. focusing on large multinational companies with significant related party transactions, or creating a list of potential audit targets and requesting them to provide documentation) to the collection of documentation. The documentation collection efforts may have multiple objectives, including the creation of an internal database, identification of potential audit targets and proactive tax compliance enforcement.

China, People's Republic of

Audit targets

Circular 2 provides insight into the procedural aspects of a Chinese transfer pricing audit, from the tax authorities determining which enterprises will be subject to audit and conducting the audit to issuing a 'special tax adjustment notice', collecting underpaid taxes (and interest) and a five-year post-audit follow-up period. These provisions are generally in line with China's previous transfer pricing rules and the way that those prior rules were enforced in practice.

According to Circular 2, transfer pricing audits typically will focus on companies with the following characteristics:

- Significant amount or numerous types of related party transactions.
- Long-term consecutive losses, low profitability, or fluctuating pattern of profits/losses.
- Profitability lower than those in the same industry, or with profitability that does not match their functions/risks.
- Business dealings with related parties in a tax haven.
- Lack of contemporaneous documentation or transfer pricing-related tax return disclosures.
- Other situations clearly indicating a violation of the arm's-length principle.

Circular 2 also provides that, in principle, no transfer pricing audits will be carried out on, and no transfer pricing adjustment will be made to, transactions between domestic-related parties that had the same effective tax burden, as long as such transactions did not result in the reduction of the country's total tax revenue.

It is also worth noting that the SAT has been continuing to strengthen its focus on nationwide and industry-wide transfer pricing audits. In a nationwide audit, companies within a multinational group are simultaneously audited, whereas industry-wide audits focus on companies in specific industries. The automotive, real estate, pharmaceutical, shipping and freight forwarding, telecommunication, trading, services, finance, and retail industries are examples of industries identified as targets in 2012.

Audit information request

According to the CIT law, its DIR and Circular 2, not only the taxpayer under a transfer pricing investigation, but also its related parties and other relevant companies (i.e. potential comparable companies) are obligated to provide information as requested by the in-charge tax authorities.

As previously mentioned, the taxpayer under an investigation should provide contemporaneous documentation to tax authorities within 20 days of a request and should provide other relevant documents required during an investigation within the prescribed time frame, according to the 'Notice of Tax Related Issues' from the tax authority. If timely submission of required documents is not possible due to special circumstances, the taxpayer under investigation shall apply in writing for an extension. An extension of up to 30 days may be granted, subject to the approval from the in-charge tax authority. Related parties of the taxpayer under investigation or comparable companies shall provide relevant information within the time frame as agreed with the tax authorities (which generally will not be longer than 60 days).

If the taxpayer under audit fails to provide information within the prescribed time frame as required by the tax authority or refuses to provide information as requested, it may be subject to one or more of the following:

- An administrative penalty of up to CNY 10,000 in accordance with the Tax Collection and Administration Law.
- A special tax adjustment as determined by the tax authority by means of deeming the taxpayer's taxable income.
- An additional 5% interest levy on the amount of underpaid tax resulting from the adjustment.

The audit procedure

Special tax investigation procedures

Tax audits in China may be conducted at the taxpayers' offices or at the tax authorities' offices. A transfer pricing audit (or a special tax investigation) procedure typically comprises the following main steps:

- Desktop review and selection of transfer pricing audit targets by the tax authority.
- Notification to the taxpayer of a transfer pricing audit and field investigation by the tax authority to raise inquiries, request accounting records and conduct on-site verification.
- Information request to taxpayer under investigation, its related parties, or other relevant companies for relevant documents.
- Negotiation and discussion with the taxpayer under investigation and the tax authority.
- Initial assessment notice issued by the tax authority.
- Further negotiation and discussion between the taxpayer and the tax authority, as needed.
- Final assessment and issuance of 'Special Tax Adjustment Notice' if there is an adjustment or 'Special Tax Investigation Conclusion Notice' if the related party transactions under investigation are considered to be at arm's length.
- Settlement of underpaid taxes and interest levy.
- Post-audit follow-up management by the tax authority.

In addition, Article 123 of the DIR provides that adjustments may be made on a retroactive basis for up to ten years as a result of a special tax investigation.

Internal working guidelines for special tax adjustment cases

SAT issued *Guo Shui Fa* [2012] No. 13 (Circular 13) <Internal Working Guidelines for Special Tax Adjustments (Trial)> and *Guo Shui Fa* [2012] No. 16 (Circular 16) <Working Guidelines on Joint Review for Major Special Tax Adjustments Cases (Trial)>, which took effect on 1 March 2012.

Circular 13 sets out the roles, responsibilities, and internal working guidelines for the different tax authorities across China in respect of special tax adjustments, such as centralising management on special tax adjustments and developing an information database to identify suspicious transfer pricing violations.

In Circular 16, the SAT has introduced a joint panel review mechanism for Major Special Tax Adjustment Cases in order to standardise the administration on major

China, People's Republic of

special tax adjustment (MSTA) cases. According to Circular 16, MSTAs include the following:

- Cases involving a taxpayer with registered capital over CNY 100 million and average annual revenues from main operation over CNY 1 billion during the investigation period.
- Nation-wide industry joint audit or group audit cases.
- Other cases so designated by the SAT.

Post-audit follow-up administration

On 16 April 2009, the SAT issued tax Circular *Guo Shui Han* [2009] No. 188 (Circular 188), to further strengthen its transfer pricing follow-up administration. The circular reiterates the requirement found in Article 45 of Circular 2 that tax authorities are to follow up for five years after any adjustment, during which period post-adjustment enterprises must submit contemporaneous transfer pricing documentation by 20 June of each year. This documentation will be used by the Chinese tax authorities to closely monitor the related party transactions of the enterprises under transfer pricing follow-up administration. Decreases in operating profits or sustaining of business losses will be closely scrutinised and possibly disallowed by the Chinese tax authorities if the underlying nature of the related party transactions remains unchanged. If an APA is initiated, monitoring shall be continued until the APA is signed. This longer post-audit supervision period (previously three years) indicates that transfer pricing compliance violations are being taken more seriously.

Transfer pricing methods

Article 111 of the DIR lists six 'appropriate methods' for conducting transfer pricing investigations. Those six methods, which are the same as those provided in the OECD Guidelines, are as follows:

- Comparable uncontrolled price method.
- Resale price method.
- Cost-plus method.
- Transactional net margin method.
- Profit split method.
- Other methods consistent with the arm's-length principle.

Chapter 4 of Circular 2 provides guidance on the application of each of the five specified methods. Circular 2 does not stipulate any hierarchy or preference in methods used by tax authorities during a transfer pricing audit assessment; instead, it endorses implicitly the selection of the most appropriate transfer pricing method. According to Article 22 of Circular 2, a comparability analysis should be carried out when selecting a transfer pricing method and the following five comparability factors should be taken into consideration:

- Characteristics of the assets or services involved in the transaction.
- Functions and risks of each party engaged in the transaction.
- Contractual terms.
- Economic circumstances.
- Business strategies.

Use and availability of comparable information

As directed in a tax circular prior to the new CIT law, Chinese tax authorities are encouraged by the SAT to use the information databases of the National Bureau of Statistics and Bureau van Dijk in transfer pricing audits (Note that, in recent years, the SAT has subscribed to Bureau van Dijk's OSIRIS database.)

However, Article 37 of Circular 2 specifically states that both public information and non-public information (i.e. 'secret comparables') may be used by the Chinese tax authorities during transfer pricing investigations and evaluations. The CIT law and its DIR also empower tax authorities to collect relevant information (e.g. contemporaneous documentation) from potential comparable companies in the same industry during an audit. Obviously, such information cannot be obtained in the public domain.

Other relevant provisions under Circular 2 regarding the use of comparable information involve the following:

- Although Circular 2 has introduced the interquartile range as a method of testing profitability, it is stated that in the context of a transfer pricing investigation, companies with profitability below the median level may still be subject to an adjustment to achieve at least the median profitability level of the comparables.
- During transfer pricing investigations, the use of working capital adjustments is discouraged and would require approval from the SAT if it is absolutely necessary.

Assessments and appeal procedures

Transfer pricing audits in China are usually settled through negotiation. While the conduct of the taxpayer should not significantly affect the outcome, a friendly working relationship with the tax authorities is always to the taxpayer's advantage, as Chinese tax legislation gives broad discretionary powers to tax authorities.

When an enterprise under audit receives an initial assessment from the tax authority and disagrees with the assessment, it may provide written explanations and documents supporting the reasonableness of its transfer prices. Further discussions and negotiations may continue until the tax authority reaches a conclusion and issues a written notice of audit assessment in the form of a 'Special Tax Adjustment Notice' or a 'Special Tax Investigation Conclusion Notice'. Once the written notice is issued, the decision is considered final and further negotiation is not possible.

If the taxpayer disagrees with the adjustment, such dispute could be resolved through the appeal procedures. China's Tax Collection and Administration Law provide both administrative and judicial appeal procedures for resolving tax disputes. The taxpayer may appeal to the tax authority at the next higher level within 60 days for an administrative appeal, and a decision on the appeal must be made within 60 days. Before proceeding with the appeal process, the taxpayer is required to pay the taxes, interest levy, and fine and surcharge (if any).

If the taxpayer is not satisfied with this decision, it may start legal proceedings in China's People's Court within 15 days upon receiving the written decision. There have been very few cases relating to transfer pricing brought before the People's Court at the local level. The local court has generally found in favour of the SAT. Because there is limited experience in court cases and the SAT has great discretionary powers,

China, People's Republic of

taxpayers generally should seek mutually satisfactory resolution before the issuance of the adjustment notice.

For related party transactions between China and a treaty country, mutual consultation between the SAT and the competent authority (CA) of the treaty country is available to taxpayers to resolve double taxation issues resulting from transfer pricing adjustments.

Interest levy and penalties

Special interest levy

Under the CIT law, special tax adjustments (including transfer pricing adjustments) are subject to a special interest levy. The special interest levy mechanism is different from surcharges and fines, which constitute the current penalty measures of tax collection and administration.

Article 122 of the DIR defines the rate for the special interest levy as based on the CNY loan base rate applicable to the relevant period of tax delinquency as published by the People's Bank of China in the tax year to which the tax payment relates, plus five percentage points. This interest levy is not deductible for CIT purposes.

Although companies with annual related party transactions below the materiality thresholds for contemporaneous documentation are not subject to the 5% penalty component of the interest levy, such protection does not apply in situations where the amount of related party transactions originally falls below the thresholds, but the restated amount of related party transactions as a result of a transfer pricing adjustment exceeds the relevant threshold. Circular 2 further provides that the 5% penalty component of the interest levy would be waived if the taxpayer has prepared and provided contemporaneous documentation in a timely manner.

Fines

Taxpayers that fail to file the Annual Related Party Transactions Disclosure Forms to tax authorities or fail to maintain contemporaneous documentation and other relevant information in accordance with Circular 2 shall be subject to different levels of fines, ranging from less than CNY 2,000 up to CNY 50,000, in accordance with Articles 60 and 62 of the Tax Collection and Administration Law.

Taxpayers that do not provide contemporaneous documentation or relevant information on related party transactions or provide false or incomplete information that does not truly reflect the situation of their related party transactions shall be subject to different levels of fines, ranging from less than CNY 10,000 up to CNY 50,000, in accordance with Article 70 of the Tax Collection and Administration Law and Article 96 of the Tax Collection Regulations. In addition, tax authorities also have the authority to deem such taxpayers' taxable income by reference to the profit level of comparable companies, or the taxpayer's cost plus reasonable expenses and profit, or apportioning a reasonable share of the group's total profits; or the deemed profit determined based on other reasonable methods according to Article 44 of the CIT law and Article 115 of the DIR.

Surcharge

In the context of transfer pricing adjustments, taxpayers that have exceptional difficulty and cannot remit the tax payment on time shall apply for an extension in accordance with Article 31 of the Tax Collection Law and Articles 41 and 42 of the

Tax Collection Regulations. A daily surcharge of 0.05% will be levied in accordance with Article 32 of the Tax Collection Law if they do not apply for an extension and fail to remit the underpaid taxes and interest levies before the deadline set by the tax authorities on the adjustment notice.

Corresponding adjustments

Circular 2 provides that corresponding adjustments should be allowed in the case of a transfer pricing adjustment to avoid double taxation in China. If the corresponding adjustment involves an overseas related party resident in a country with which China has a tax treaty, then the SAT will – upon application by the taxpayer – initiate negotiations with the CA of the other country based on the mutual agreement procedure (MAP) article of the treaty. (The statute of limitation for the application of corresponding adjustments is three years; an application submitted after three years will not be accepted or processed.) Application for the initiation of the mutual agreement procedures should be submitted to both the SAT and the local tax authorities simultaneously.

Where payment of interest, rent, or royalties to overseas related parties was disallowed as the result of a transfer pricing adjustment, no refund of the excessive withholding tax payment will be made. This treatment may result in double or even triple taxation for multinational companies in some cases.

If the original adjustment is imposed by the overseas tax authority, then the Chinese enterprise could submit a formal application for a corresponding adjustment to the relevant Chinese tax authority within three years of the overseas related party's receipt of the notice of the transfer pricing adjustment.

Circular 2 indicates that corresponding adjustments are not available in cases of income taxes assessed on deemed dividends that result from non-deductible interest expenses under the thin capitalisation rules.

Circular 2 also states that the results of a corresponding adjustment or mutual agreement will be sent to the enterprise in written form from the SAT, via the in-charge tax authority.

In 2011, the SAT concluded bilateral APA/ MAP cases that eliminated CNY 3.2 billion of international double taxation for multi-national enterprises (MNE). In the same year, the Chinese tax authorities conducted ten rounds of bilateral negotiations for 29 cases with seven countries. This is an important indication of the support of China's tax authorities for engaging in MAP procedures as a useful method for resolving tax and transfer pricing issues related to multinationals with operations in China. Taxpayers should be aware that this option is available as a way to resolve prior-year double taxation issues, and an important supplement to the bilateral APA programme, as will be mentioned later, which mainly focuses on elimination of double taxation ex ante.

Resources available to the tax authorities

China's tax authorities are organised in a multi-layer structure, with the SAT being the central office at the top, guiding provincial, municipal, and county or district level offices across the country. A dedicated group of officers are assigned at both the central and local levels to handle matters including transfer pricing and special tax adjustment cases. At the central level, the SAT currently has a small group of officials

China, People's Republic of

to monitor, develop and interpret transfer pricing regulations in China. These officials have frequent exchanges with tax authorities in other countries and with the OECD. Initiation and conclusion of a transfer pricing audit requires the approval of the central SAT officials, who will act in a supervisory and supporting role to local tax officials at various levels or locations who will directly conduct audits, with simultaneously orchestrated efforts leading to an increased burden on taxpayers. In cases involving mutual agreement procedures or bilateral/multilateral advance pricing arrangements, the SAT takes the lead role in the competent authority discussions.

The SAT has been advocating a three-pronged approach of 'administration, services and investigation' in relation to transfer pricing administration. In administration, the focus is on taxpayers' compliance and prevention of transfer pricing abuses; in services, the focus is on APA and MAP as these are considered services by the tax authorities to taxpayers; and in investigation, the focus is on formal transfer pricing audits. For the SAT, this is a significant, philosophical change in tax administration, as historically the focuses have always been on tax administration and investigation, and providing services to taxpayers has become an emphasis only recently although the addition is certainly a welcome sign to taxpayers. *Guo Shui Fa* [2012] No. 41 (Circular 41) reiterates the importance of developing an anti-tax avoidance system which integrates administration, service, and investigation, which is consistent with SAT's prior anti-avoidance circulars, especially *Guo Shui Han* [2011] No.167. Circular 41 also provides a comprehensive roadmap on China's international taxation policies for the 12th five-year period (i.e. years from 2011 to 2015).

Advance pricing arrangements (APA)

Circular 2 provides guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing and renewing APAs. In general, these provisions are a restatement of the previous rules on APAs (i.e. *Guo Shui Fa* [2004] No. 118), with several modifications and amendments. The following points are worth noting:

- The SAT has specified that APAs will, in general, be applicable to taxpayers meeting the following conditions: 1) annual amount of related party transactions over CNY 40 million; 2) the taxpayer complies with the related party disclosure requirements; and 3) the taxpayer prepares, maintains and provides contemporaneous documentation in accordance with the requirements.
- The term for an APA will cover transactions for three to five consecutive years (the previous provisions provided that APAs normally cover two to four years).
- Upon approval of the tax authorities, an APA may be rolled back (i.e. the pricing policy and calculation method adopted in the APA may be applied to the evaluation and adjustment of related party transactions in the year of application or any prior years) if the related party transactions in the year of application are the same as or similar to those covered by the APA.
- An APA will be respected by the relevant state and local tax bureaus at all levels as long as the taxpayer abides by all the terms and conditions of the APA. This can be regarded as a positive sign from the SAT to ensure certainty of APAs.
- Pre-filing meetings with tax authorities may now be held anonymously.
- While a taxpayer with an effective APA is exempted from the contemporaneous documentation requirements under Chapter 3 of Circular 2 with respect to the covered transactions, it is required to file an annual APA compliance report that needs to be provided to tax bureaus within five months of the end of each tax year.

- For bilateral or multilateral APAs, taxpayers should submit their applications (including pre-filing and formal applications) to both the SAT and the in-charge municipal or equivalent level tax authorities simultaneously. Circular 2 also states that, where the SAT accepts an application for a bilateral or multilateral APA, the SAT will enter into negotiations with the competent authority of the treaty partner based upon the relevant treaty's mutual agreement procedures.
- Circular 2 states that, in the event that an APA is applied for but not ultimately reached, any non-factual information regarding the taxpayer that was gathered during the application and/or negotiation process may not be used for tax investigations.

The APA guidance under Circular 2, in particular the introduction of the rollback provision, anonymous pre-filing meetings, and dual application at both the SAT and in-charge municipal or equivalent tax authority level (for bilateral and multilateral APAs), makes China's APA programme more attractive to taxpayers through the removal of some of the uncertainty that has historically surrounded it. This guidance, together with the SAT's emphasis on services to taxpayers, demonstrates the importance and commitment that the SAT is placing on APAs and their desire to create a successful APA programme in China.

In April 2012, the SAT released the second annual APA report providing official statistics on both in-progress and completed APAs for the period from 1 January 2005 to 31 December 2010. Key trends highlighted by the report include:

- The rise in the number of bilateral APA applications.
- The risk in the number of applications related to intangible assets and provision of services or financing, which now exceed the number of applications related to tangible goods transactions.
- The transactional net margin method (TNMM) continues to be the most popular method for the transactions covered in the signed APAs.

Cost-sharing arrangement (CSA)

CSAs for joint development of intangibles and sharing of services are covered in Circular 2. The SAT's intention for CSAs is to encourage intellectual property development and accessibility to intellectual property rights for taxpayers in China.

Similar to the OECD's transfer pricing guidelines, Circular 2 requires the following items to be contained in a cost-sharing agreement:

- Name of participants, their country (region) of residence, related party relationships, and the rights and obligations under the agreement.
- Content and scope of intangible assets or services covered by the cost sharing agreement, the specific participants performing research and development activities or service activities under the agreement, and their respective responsibilities and tasks.
- Term of the agreement.
- Calculation methods and assumptions relating to the anticipated benefits to the participants.
- The amount, forms of payment, and valuation method of initial and subsequent cost contribution by the participants, and explanation of conformity with the arm's-length principle.

China, People's Republic of

- Description of accounting methods adopted by participants and any changes.
- Requirements on the procedure and treatment for participants entering into or withdrawing from the agreement.
- Requirements on the conditions and treatment of compensating payments among participants.
- Requirements on the conditions and treatment of amendments to or termination of the agreement.
- Requirements on the use of the results of the agreement by non-participants.

Circular 2 states that the costs borne by the participants in a CSA should be consistent with those borne by an independent company for obtaining the anticipated benefits under comparable circumstances, and that the anticipated benefits should be reasonable, quantifiable, and based on reasonable commercial assumptions and common business practices. Failure to comply with the benefit test will be subject to adjustment by tax authorities in the event of an audit assessment.

Some other relevant provisions of Circular 2 with respect to CSAs include the following:

- Service-related cost sharing agreements generally should be limited to group procurement or group marketing strategies.
- Buy-in and buy-out payments are required when there is a change to the participants of an existing cost sharing agreement.
- During the term of a CSA, if there is a mismatch between the shared costs and the actual benefits, then compensating adjustments should be made based on actual circumstances to ensure the shared costs match the actual benefits.
- If a CSA is not considered arm's length or does not have a reasonable commercial purpose or economic substance, costs allocated under the agreement (as well as any appropriate compensating adjustments) will not be deductible for CIT purposes.
- Taxpayers may apply for an APA to cover a CSA.
- Participants to intangible development-related CSAs should not pay royalties for intangible properties developed under the CSA.
- The costs allocated under a CSA and deducted for CIT purposes by the taxpayer would need to be clawed back if its term of operation turns out to be less than 20 years from the signing of the CSA.
- In addition to the contemporaneous transfer pricing documentation requirements under Chapter 3, Circular 2 also includes specific requirements for preparation of contemporaneous documentation for CSAs, which needs to be submitted to the tax authorities by 20 June of the following year.

Controlled foreign corporations (CFC)

Article 45 of the CIT law provides for the inclusion in a Chinese taxpayer's taxable income the relevant profits of its CFCs established in countries with effective tax burdens that are substantially lower than China's.

Circular 2 provides guidance for calculating the amount of the deemed income and any associated tax credits. Pursuant to Circular 2, the deemed dividend income from a CFC attributed to its Chinese resident enterprise shareholder should be determined using the following formula:

$$\text{Income attributed to a Chinese resident enterprise shareholder in the current period} = \text{Amount of deemed dividend distribution} \times \frac{\text{Number of shareholding days}}{\text{Number of days in the CFC's tax year}} \times \text{Shareholding percentage}$$

Circular 2 allows for the exemption from recognition as Chinese taxable income any deemed dividend from a CFC that meets at least one of the following criteria:

- Is established in a country with an effective tax rate that is not low, as designated by the SAT.
- Has income derived mainly from active business operations.
- Has annual profit of less than CNY 5 million.

Thin capitalisation

The thin capitalisation rules under the CIT law are designed to disallow the deduction of excessive related party interest expense pertaining to the portion of related party debt that exceeds a certain prescribed debt-to-equity ratio.

Circular *Cai Shui* [2008] No. 121 (Circular 121), jointly published by the Ministry of Finance and the SAT in October 2008, sets out the prescribed debt-to-equity ratios (2:1 for non-financial enterprises and 5:1 for enterprises in the financial industry) and other associated rules. Circular 121 also emphasises that 'excessive interest' from related party financing that exceeds the prescribed ratios may still be deductible if an enterprise can provide documentation to support that the inter-company financing arrangements comply with the arm's-length principle, or if the effective tax burden of the Chinese borrowing company is not higher than that of the Chinese lending company.

Where the debt-to-equity ratio exceeds the prescribed ratio, the portion of related party interest expense relating to the excess portion would not be deductible. Furthermore, the non-deductible outbound interest expense paid to overseas related parties would be deemed as a dividend distribution and subject to withholding tax at the higher of the withholding tax rate on interest and the withholding tax rate on dividends.

Chapter 9 of Circular 2 provides specific thin capitalisation administrative guidance, which includes the following:

- Mechanics for how to calculate the debt-to-equity ratio.
- Related party interest that is not arm's length will be subject to a transfer pricing investigation and adjustment before being evaluated for thin capitalisation purposes.

Preparation of contemporaneous thin capitalisation documentation is required in order to deduct excessive interest expense. Circular 2 stipulates that such documentation should include the following in order to demonstrate that all material aspects of the related party financing arrangements conform to the arm's-length principle:

- Analysis of the taxpayer's repayment capacity and borrowing capacity.
- Analysis of the group's borrowing capacity and financing structure.

China, People's Republic of

- Description of changes to equity investment of the taxpayer, such as changes in the registered capital, etc.
- Nature and objectives of debt investment from related parties, and the market conditions at the time the debt investment was obtained.
- Currency, amount, interest rate, term and financing terms of the debt investment from related parties.
- Collaterals provided by the enterprise and the relevant terms.
- Details of the guarantor and the terms of guarantee.
- Interest rate and financing terms of similar loans contemporaneous to the debt investment from related parties.
- Terms of conversion of convertible bonds.
- Other information that can support the conformity with the arm's-length principle.

SAT Announcement No. 34, issued on 9 June 2011 with effect from 1 July 2011, provides that, in order to obtain deductibility of interest expenses incurred in related party loans, enterprises are required to document that interest payments for loans to non-financial borrowers are 'reasonable', including standard interest rates for similar loans by financial institutions within the same province. The notice also addresses several other issues, including the implications of an investing enterprise's reduction or withdrawal of its investment.

General anti-avoidance rules (GAAR)

By including GAAR, the CIT law formally authorises Chinese tax authorities to make an adjustment if a taxpayer enters into an arrangement 'without reasonable commercial purpose'. This is the first time for China's CIT law to include such rules representing a strong indication of the Chinese tax authorities' growing scrutiny of business structures.

Pursuant to Circular 2, a general anti-avoidance investigation should focus on the following transactions/structures:

- Abuse of preferential tax treatments.
- Abuse of tax treaties.
- Abuse of organisational structures.
- Use of tax havens for tax avoidance purposes.
- Other arrangements without reasonable commercial purposes.

Circular 2 places a special focus on the principle of substance over form and also provides details about the various procedures for conducting a 'general anti-avoidance investigation' and making a 'general anti-avoidance adjustment', including the requirement that all general anti-avoidance investigations and adjustments be submitted to the SAT for final approval. In addition, Circular 2 provides that the Chinese tax authorities will disregard entities that lack adequate business substance (especially those in tax haven countries).

Anticipated developments in law and practice

The introduction of Chapter 6 under China's CIT law and the DIR, along with the promulgation of Circular 2, marks a significant shift in China's transfer pricing regime. Given that Chinese transfer pricing legislation is relatively new and untested, it can be expected that further tax circulars will be issued by the SAT over time in order

to clarify various matters concerning transfer pricing administration and special tax adjustments.

In addition, with the unification of the tax system, some tax officials formerly practicing in other areas are being redirected into the area of transfer pricing and anti-tax avoidance. This suggests that audit activity will increase in the near future. As mentioned earlier, the guidance from the SAT to the local-level tax authorities under Guo Shui Fa [2009] No. 85 has brought the issues of royalty and service fee remittance (as well as certain industries such as pharmaceuticals, automobiles, retail, etc.) on the radar screen in terms of transfer pricing and tax investigation. In addition, the SAT has been requiring local-level tax authorities to build up transfer pricing auditor resources to undertake fieldwork and to negotiate with taxpayers during investigations. Currently a core team of more than 200 transfer pricing specialists across China is being formed to enhance consistency and technical competency, and specialised anti-avoidance ‘SWAT’ teams dedicated to transfer pricing investigations are being set up in 14 coastal areas.

In March 2012, the SAT announced its anti-avoidance enforcement plan for 2012 and several new regulations related to transfer pricing, which can be categorised into four aspects:

- Specify the work responsibilities of ‘special tax adjustments’ administration (i.e. anti-avoidance measures including transfer pricing) between the Large Business Taxation Department and the International Taxation Department under the SAT. (This was subsequently enacted in law as Circular 13 discussed earlier).
- Encourage enterprises to perform transfer pricing self-adjustments. To better monitor transfer pricing administration, the SAT requires that the self-adjustment amount is reported to the SAT through tax authorities’ internal reporting process for review and approval. Chinese tax authorities can still perform special tax adjustment on taxpayers which have conducted self-adjustments. (This was subsequently enacted in law as Circular 16 discussed earlier).
- Provide for detailed working procedures on unilateral APAs. Similarly, the local in-charge tax authorities should report unilateral APA applications to the SAT through internal reporting process for review and approval before accepting the application.
- Establish a joint-hearing/panel review mechanism for major special tax adjustment cases. (This was subsequently enacted in law as Circular 16 discussed earlier).

OECD and United Nations issues

While China has observer status with the OECD, it has for the most part modelled its transfer pricing legislation after the OECD Guidelines. In general, China’s transfer pricing regulations reflect the same arm’s-length principle and support the same type of transfer pricing methodologies that are being adopted in the OECD member countries. However, a transfer pricing policy or practice that is acceptable in an OECD member country will not necessarily be followed in China (e.g. collaboration between the customs and tax authorities in determining the transfer price/import value of related party tangible goods transactions).

On 2 October 2012, the United Nations released ten chapters of its Practical Manual on Transfer Pricing for Developing Countries (UN Transfer Pricing Manual), in which China contributed a paper on its country practices for Chapter 10. The paper discusses the SAT’s views on a number of transfer pricing matters including reliability of

China, People's Republic of

comparables, location specific advantages, practical issues and solutions, alternative methods to TNMM and other experience and recommendations.

Joint investigations

China would not usually join another country in undertaking a joint investigation of a multinational group for transfer pricing purposes. However, the Chinese tax treaties generally contain an Exchange of Information article that provides the cooperation between the competent authorities in the form of exchanges of information necessary for carrying out the provisions of the treaty (including transfer pricing investigations). In practice, the methods of exchanging information include exchange on request, spontaneous exchanges and automatic exchanges.

In recent years, the Chinese tax authorities have also been exploring other forms of international cooperation, including joining the Joint International Tax Shelter Information Centre (JITSIC) as a member in 2010.

There are intra-country transfer pricing investigation cases in which authorities in different locations collaborate their efforts in conducting simultaneous audits on Chinese subsidiaries of a group corporation.

Special features

Multiple audits

In general, China does not allow consolidation of CIT returns for multinational companies. A multinational company with subsidiaries located in various parts of China may, therefore, be subject to multiple transfer pricing audits.

Management fees

Under Article 49 of the DIR, management fees paid to related parties are not deductible for CIT purposes. On the other hand, service fees are deductible. According to Article 8 of the CIT law, a taxpayer may deduct reasonable expenses (including service fees paid to its related parties) that are actually incurred and are related to the generation of income. As there is no clear guidance on how to distinguish between service fees and management fees, tax authorities in different locations may have different views and practices in this regard.

Business tax and other taxes

In establishing transfer pricing policies for China, it is important for foreign investors to realise that income tax is not the only tax issue. Besides the Chinese CIT, other taxes such as business tax, value-added tax, consumption tax and customs duties can be quite significant. Therefore, in China, transfer pricing arrangements also must consider the implications of other taxes.

New ideas taking shape in China

Transfer pricing specialists at the SAT have mentioned the following areas in which they are shaping their positions:

- **Location savings:** The SAT officials have raised the point in CA discussions that more profits should be attributed to China due to the great efficiencies of its labour force, and more broadly, advantages specific to China including those resulting from government policies.

- **China country premium:** Many multinationals in the automobile industry now generate a majority of their profits in China. The SAT officials are discussing approaches to reasonably quantify such premium and they believe that this unique country premium should be taxed in China. China being one of the largest, fastest-growing markets is also being used as a basis by the SAT officials to argue for a premium for companies catering to the China market.
- **Marketing intangibles:** The SAT officials think that luxury goods companies operating in China cannot be regarded as limited-risk distributors and the claim that all the marketing intangibles belong to the overseas parent may not be easily accepted.
- **Review:** A national group of elite transfer pricing specialists is being formed to review and approve all transfer pricing audit cases in China. The group will be formed from the most experienced transfer pricing auditors from around China at all levels including city, county, provincial and national. The SAT is also considering bringing in additional economists or analysts to handle high-profile/important cases such as those in the automotive industry, which currently may be considered the most high-profile industry in China.

22.

Colombia

Introduction

Colombia first introduced transfer pricing regulations through Act 788 in 2002; in 2003, Act 863 specified and clarified the scope. Subsequently, the Regulatory Decree 4349 of 2004 (Regulatory Decree) enacted the enforcement of the formal and substantial transfer pricing obligations.

Colombian regulations regarding transfer pricing apply from fiscal year 2004 (in Colombia calendar year equals fiscal year for all companies), are consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines, and are part of a government effort to prevent income tax avoidance. The transfer pricing rules address specific issues such as financial transactions, application of the interquartile range, adjustment to the median when the taxpayer's margins or prices fall out of the interquartile range, and considerations of the industry and/or life business cycles.

Colombian tax authorities (*Dirección de Impuestos y Aduanas Nacionales*, or DIAN) are entitled to assess taxpayers' transactions subject to the rules as from year 2005.

Statutory rules

Transfer pricing rules apply to taxpayers engaging in cross-border transactions with foreign related parties. These rules impact only the income and complementary tax computation regarding ordinary and extraordinary income, expenses (costs and deductions) and the determination of assets and liabilities between related parties. Therefore, the rules do not affect the determination of other taxes under such transactions, such as industry and trade tax, value-added tax and customs.

All transactions with related parties are subject to the rules, including transfer or use of tangible and intangible property, provision of services and financial transactions such as loans and investments.

Regarding the application of any of the transfer pricing methods, the rules clarify that income, costs, gross profit, net sales, expenses, operating profits, assets and liabilities should be determined based on Colombian generally accepted accounting principles (GAAP).

Related economic party or related party

The concepts of 'related economic party' and 'related party' should be considered synonyms and are basically defined by references to other rules that include situations ranging from statutory to economic dependency and control of companies by individuals. In this matter, Section 260-1 of the Colombian Tax Code remits to the following regulations:

- Commercial Code, which addresses the meaning of ‘subordinated’ or ‘controlled entity’ (Sections 260 and 261), including branches and agencies (Sections 263 and 264).
- Section 28 of Act 222 of 1995, which defines the concept of ‘group’ and the notion of ‘unity of management and purposes’.
- Sections 450 and 452 of the Tax Code, which addresses subordination levels.
- Finally, unless otherwise proven, transactions among residents domiciled in Colombia and residents domiciled in tax havens will be considered to be transactions among related parties (as of today, only a draft of possible countries and jurisdictions considered by the national government as tax havens is known).

Transfer pricing methods

Following the OECD Guidelines, the transfer pricing rules specify the methods for the transfer pricing analysis, as well as the comparability factors that should be taken into consideration when assessing controlled transactions in relation to those performed by independent third parties in comparable transactions. In Colombia, Section 260-2 of Tax Code establishes the following six transfer pricing methods:

- Comparable uncontrolled price (CUP).
- Resale price (RPM).
- Cost plus (CPM).
- Profit split (PSM).
- Residual profit split (RPSM).
- Transactional net margin (TNMM).

Best method rule

Transfer pricing rules do not establish a ranking for selecting a transfer pricing method, nor do they provide guidance as to the specific cases in which the methods will have to be used. In practice, taxpayers should select the most appropriate method applicable to the transaction(s) under review and adequately support the rejection of the other methods.

The most appropriate method is the one that better reflects the economic reality of the transaction, is compatible with the company’s enterprise and commercial structure, has the best quantity and quality of information, contemplates a better degree of comparability, and requires fewer adjustments.

Tested party

For the application of transfer pricing methods that require the selection of a tested party, the Colombian transfer pricing rules do not determine which party should be subject to analysis. Therefore, it is permissible to choose as the tested party either the local or the foreign related party when conducting the transfer pricing analysis.

Formal obligations

Income tax payers obliged to fulfil transfer pricing requirements are those that perform transactions with related parties located abroad that at year-end exceed the established caps of gross equity equal to or higher than 100,000 taxable units (TU) or gross income equal to or higher than 61,000 TU, as well as those taxpayers that engage in transactions with residents or those domiciled in tax havens. For FY 2012 one TU is equivalent to 26,049 Colombian pesos (COP) (adjusted every year by inflation) approximately USD 14.71, at an exchange rate of COP 1,800 per USD.

Colombia

For the enforcement of the obligations, taxpayers should report on the informative return all transactions entered into with foreign related parties, regardless of the amount. However, for supporting documentation purposes, only those transactions exceeding 10,000 TU by type of transaction are subject to a transfer pricing analysis.

Following is a short description of the requirements regarding the individual and consolidated informative returns, and the supporting documentation.

Individual informative return

Pursuant to the regulatory decree, the return must contain the following:

- Form fully completed.
- Taxpayer's fiscal identification.
- Income tax ID and country of domicile of the related parties involved in the controlled transactions.
- Transfer pricing method used to determine the prices or profit margins.
- Interquartile range obtained in the application of the transfer pricing methodology.
- Assessment of sanctions, when necessary.
- Electronic signature of the taxpayer or its legal representative, its agents or the special agent.
- If applicable, adjustment included in the income tax return.

Consolidated informative return

In cases of control or holdings, when the controller or headquarters or any of its subordinated entities must file an individual informative return, the controller or head office must file a consolidated informative return listing all transactions, including those involving affiliates that are not required to file the individual informative return. Additional considerations:

- In cases of joint control, the DIAN must be informed, in writing, which of the controllers will file the consolidated return.
- When the controller or head office has a branch and one or more subsidiaries in Colombia, the branch is required to file the consolidated return.
- When there is no branch, the subordinate with the higher net equity at 31 December of the related fiscal year would be responsible for complying with this formal obligation.
- The content of the consolidated return is similar to that of the individual return. However, all transactions performed by the related parties must be consolidated by type of transaction.

Filing of the informative returns

The forms of the informative returns are generally due in mid-July and should be filed through the Electronic Media and Payment System. The forms to be used are N° 120 for the individual informative return and N° 130 for the consolidated informative return.

Supporting documentation or transfer pricing study

The supporting documentation should be prepared and filed through the Electronic Media and Payment System on a yearly basis and it is generally due in August/September of the following year to the related fiscal year. If applicable to the type of transaction and the method selected, the supporting documentation must contain among other the following information:

General information:

- Description of the taxpayer's organisational and functional structure.
- General description of the business.
- Equity composition with name, income tax ID and ownership percentage of partners or shareholders.
- General description of the industry or sector to which the company belongs, indicating the taxpayer's position in it.
- Name, income tax ID, domicile, description of the business purpose and activity of the related parties, including ownership details and subsidiaries. The facts that give rise to the relationship must be informed.

Specific information:

- Detailed description of each type of transaction.
- For contracts or agreements, parties, purpose, terms and prices must be specified.
- For transactions with residents or those domiciled in tax havens, a copy of the documentation that certifies that the transaction took place must be included.
- Functional analysis by type of transaction, including a short description of the activities, classification of used assets and inherent risks of the transactions, among others.
- General information about commercial strategies.
- Information about the industry and description of substitute goods or services.
- Politic or normative changes that could affect the result of the transaction.
- Method used by the taxpayer in the transfer pricing analysis, selected in accordance with the best-method rule;
- Profit-level indicator used in the analysis.
- Identification and determination of the comparable companies, information sources, inquiry dates and indication of the rejection criteria of non-accepted comparable companies.
- Technical adjustments' description and, when needed, generic description of the principal differences between Colombian accounting practice and the accounting practices in those countries where the comparable companies are domiciled.
- Detailed conclusions of the level of compliance with arm's-length standard.

Annex information:

- Financial statement (general purpose).
- Balance sheet, profit and losses statement, production costs statement and sales costs statement segmented by type of transaction.
- Copy of the contracts or agreements.
- In economic or special business situations, pertinent supporting information, such as marketing studies, projections and reports must be attached.

Other regulations**Related rules**

The following Tax Code provisions do not apply whenever taxpayers' transactions are analysed according to transfer pricing rules:

- Determination of the gross profit in case of transfer of assets (Section 90).
- Other non-deductible payments (Section 124-1).
- Non-deductibility of losses in case of transfer of assets to economic related parties (Section 151).

Colombia

- Non-deductibility of losses derived from the transfer of a company's assets to its partners (Section 152).
- Cases in which occasional losses are not accepted (Section 312, paragraphs 2 and 3).

The majority of the above-mentioned rules aim to control transactions between related parties, albeit in a very general manner. As a result, it would not be appropriate to apply these rules in a case in which arm's-length values for controlled transactions would be analysed through transfer pricing rules.

It is also established that transactions to which transfer pricing rules apply will not be subject to the limitations on costs and deductions established in the tax code Section 260-7.

Until fiscal year 2009, Section 16, Act 1111 of 2006, established that the Colombian Ministry of Mines and Energy fixed the exportation sale price of minerals when they exceed USD 100 million. However, Section 67 of Act 1430 of 20 December 2010 repealed Section 16 of Act 1111.

Act 1370 of 2009 modified the first paragraph of Section 287 of the Tax Code, which states that for income-tax purposes, some accounts payable with related parties should be considered as equity. The modification consisted of including the definition of '*related party*' as stated in Section 260-1 (applicable as from FY 2010 onwards).

Tax havens

To determine if a country or jurisdiction qualifies as a tax haven, Act 863 of 2003 specified the criteria by which the national government can issue such qualification. A country or jurisdiction will be considered a tax haven if it fulfils the first requirement and any one of the other three listed below:

- Nonexistence of taxation or low, nominal rates as compared to those applied in similar transactions in Colombia.
- Lack of an effective information exchange, or the existence of regulations or administrative practices that could limit the exchange of information.
- Lack of transparency at a legal level, regulatory or administrative functioning.
- Absence of requirements for the development of a real economic activity that is important or substantial to the country or territory or the simplicity by which a jurisdiction accepts the establishment of private entities without a substantive local presence.

The Colombian government has the authority to issue through a decree the list of countries and jurisdictions considered to be tax havens. However, such a decree has not been issued to date.

On the other hand, for foreign policy reasons, the Colombian government has the authority to exclude a country or jurisdiction, even if it fulfils the above-mentioned characteristics.

Legal cases

Tax authorities have started transfer pricing audits, requesting that a taxpayer amend its income-tax return when failing to fulfil the arm's-length principle. It is expected that such requests will be brought before courts.

Burden of proof

The transfer pricing rules shift the burden of proof to the taxpayers, allowing them to develop their transfer pricing policies and to document all their cross-border related party transactions subject to the rules.

Tax audit procedures

Tax authorities have become more aggressive and have improved their transfer pricing knowledge. They have focused on:

- taxpayers failing to fulfil transfer pricing rules
- informative return formal penalties (e.g. late filing)
- requests for income tax return amendments for failure to comply with the arm's-length principle
- inter-company debt
- inter-company services fees, formalities to deduct and supporting documents to prove the benefit and rendering of the service.

It is expected that upcoming audits will focus on method selection and accepted/rejected comparables.

The audit procedure

Tax authorities use the regular or standard audit procedure, such as on-site examinations and/or written requests. During the examination, the tax authorities may request additional information and must be allowed to have access to the company's accounting records. In general, the audit procedure is as follows:

- Ordinary tax notice; in general, tax authorities grant 15 calendar days to answer it.
- Special tax notice; taxpayers have three months to answer it.
- Official assessment; taxpayers may appeal (two months) or file a complaint before a tax court (four months).
- If the taxpayer appeals, tax authorities have one year to issue a tax authority's final judgment. Once the tax authority's final judgment is issued, the taxpayer has four months to file a complaint before a tax court.
- Once the complaint is in a tax court, the process may take up to three and a half years.
- If the tax court's decision is adverse to the taxpayer, it may file a complaint before a final tax court. This process may take approximately 18 months.

Additional tax and penalties

Formal penalties for transfer pricing rules are established in Sections 260-10 and 260-11 of the Tax Code.

Colombia

Summary of Penalties

Case	Supporting Documentation		Informative Return		
	Inconsistent/ After deadline/ Not the requested/ Mistaken/ Does not permit verification	Not filed	Late filing	Amendment	Not filed
Rate	1%	1%	1% per month or month fraction	1%	20%
Base	Total value of transactions with related parties				
Cap	15,000 TU	20,000 TU	20,000 TU	20,000 TU	20,000 TU
Effect		Rejection of the cost or deduction			Could not be used as a proof
Different Base	0.5% of the net income reported in the income tax return of the same fiscal year or in the last income tax return filed. If there is no income, 0.5% of the total assets reported in the income tax return of the same fiscal year or in the last income tax return filed.				10% of the net income reported in the income tax return of the same fiscal year or in the last income tax return filed. If there is no income, 10% of the total assets reported in the income tax return of the same fiscal year or in the last income tax return filed.
Other Considerations			After tax notice, penalty will be doubled	Inconsistent information could be amended between the two years after the deadline established for the return and before the notification of the requirement.	

Section 260-2 of the Tax Code states that if the analysis of a transaction falls outside the range, the price or margin to be considered to be at an arm's-length nature will be the median of such range. In practice, and according to the type of transaction,

taxpayers should recognise additional taxable income or reject costs and deductions if they have failed to comply with this rule.

In addition, the paragraph of Section 260-10 states that:

‘In accordance with transfer pricing rules, there will be sanctionable inaccuracy with the inclusion in the income-tax return, informative returns, supporting documentation or in reports filed to tax authorities of false, mistaken, incomplete or disfigured data or factors, and/or the determination of income, costs, deductions, assets and liabilities in transactions with related parties, with prices or margins that do not match those used by independent parties in comparable transactions, which derive in a lesser tax or payable value, or in a greater balance in favour of the taxpayer. The applicable sanction will be the one established in Section 647 of the Tax Code, which can be up to 160% of the additional tax’.

It is important to bear in mind that amendments to the income-tax return can be made only if such return has its statute of limitations open, which in general terms is two years.

Use and availability of comparable information

Comparable information is required in order to determine arm’s-length prices and should be included in taxpayers’ transfer pricing documentation. Colombian companies are required to make their annual accounts publicly available by filing them to the Colombian Superintendent of Societies (*Superintendencia de Sociedades*). This financial information can be accessed through the Internet and is considered reliable data. PwC Colombia has made an important investment accruing and formatting this information so it can be used for supporting documentation purposes as of fiscal year 2007.

Limitation of double taxation and competent authority procedure

Where there is an agreement to avoid double taxation signed by Colombia with a foreign jurisdiction, in case such jurisdiction adjusts the profits (as a result of a transfer pricing audit) of the foreign related party, the taxpayer in Colombia is allowed to request a reciprocal adjustment, subject to approval of the Colombian tax authorities, on its income-tax return.

Notwithstanding such an agreement, it is necessary to harmonise the statute of limitations of the income-tax return in Colombia with what is pursued by the agreements to avoid double taxation in order to be able to request the reciprocal adjustment.

Currently, Colombia has enforced the following treaties to avoid double taxation: Andean Community (Bolivia, Ecuador and Peru), Spain (23 October 2008), Chile (1 January 2010) and Switzerland (1 January 2011).

In addition, there are treaties signed, in process and negotiation with the following countries: Belgium, Canada, Czech Republic, France, Germany, Japan, Mexico, Netherlands, Portugal, South Korea, and the United States.

Colombia

Advance pricing agreements

As of 1 January 2006, taxpayers can request an APA. These regulations refer to the content duration, time limits so that the APA may be authorised by the tax authorities, time limits so that taxpayers could request an APA, modification of an APA and cancellation of the agreement, among others.

Anticipated developments in law and practice

Law

Changes in the transfer pricing rules or enactment of new rules are not expected in the near future.

Liaison with customs authorities

There are no records or evidence of any direct communication between customs and tax authorities regarding transfer pricing.

OECD issues

Although Colombia is not a member of the OECD, the tax authorities have generally adopted the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published by the OECD, as a specialised technical reference and not as a supplementary source of bylaw interpretation.

Joint investigations

There have been no requests to other tax authorities for specific information concerning transfer pricing.

23.

Croatia

Introduction

Transfer pricing provisions in Croatia were introduced through the Corporate Income Tax (CIT) Act on 1 January 2005, but only in recent years the Croatian tax authorities have recognised the importance of transfer pricing. The result is an educated transfer pricing team of the tax authorities with access to the Amadeus database, as well as an increased number of audits related specifically to transfer pricing.

Generally, Croatian transfer pricing regulations mostly rely on the arm's-length principle and methods specified by the Organisation for Economic Co-operation and Development (OECD) Guidelines.

Statutory rules

Transfer pricing regulations application

The transfer pricing regulations are applied to all cross-border transactions between domestic entities and their related parties, as well as to transactions between resident related parties, where one party has:

- preferential tax status, i.e. pays profit tax at the decreased tax rate
- the right to utilise tax losses carried forward from the past periods.

Legislative framework

Transfer pricing rules are prescribed by the CIT Act and by the CIT Ordinance.

According to the transfer pricing provisions of the CIT Act and the related ordinance, the business relations between related entities will only be recognised if a taxpayer has and provides (at the request of the tax authority) the following information:

- Information about the group, the position of the taxpayer in the group and the analysis of related transactions, i.e. general information about the group and the specific information about the taxpayer.
- Identification of the method selected, a description of information reviewed, the methods and analyses used to determine the arm's-length price and the rationale for selecting the specific method.
- Documentation about the assumptions and valuations made in the course of determining the arm's-length price (which would underline benchmark analysis, functional analysis and risk analysis).
- Documentation about all calculations made in the course of the application of the selected method in relation to the taxpayer and any comparables used in the analysis.
- Updated documentation that relies on a prior-year analysis containing adjustments because of material changes in relevant facts and circumstances.

Croatia

According to the CIT Act, the following methods can be used to determine the arm's-length price:

- The comparable uncontrolled price method.
- The resale price method.
- The cost-plus method.
- The profit split method.
- The net-profit method (which is equivalent to the transactional net margin method under the OECD Guidelines).

Arm's-length principle

Prices between a Croatian entity and its foreign-related party or domestic-related party (under certain conditions) must be charged at arm's length. The prices between related entities which are different from the market prices will not be recognised for tax purposes.

Definition of related parties

The General Tax Act defines related entities as legally independent companies which, in their mutual relations, satisfy the following:

- Two or more natural or legal persons which for carrying out the obligations under the tax-debt relationships constitute a single risk because one of them, directly or indirectly, holds control in the others or, directly or indirectly, has significant influence on others.
- Apart from control of significant influence, related entities will also be those where deterioration or improvement of the economic and financial condition of one person can cause the deterioration or improvement of the economic and financial condition of others, because there is a possibility of the transfer of losses, profits or payment capability.

Deadline for submitting the TP documentation

Although the tax regulations state that TP documentation should be available on the Tax Authority request, the recent Tax Authority's initiative demonstrates that the documentation should be available at the time of CIT return submission, which is four months upon the financial year-end.

Other regulations

There are no other regulations, but the OECD Guidelines can be used as a general guide. Additionally, the tax authority has issued the Guidebook for the Surveillance of Transfer Pricing. It is not a binding regulation and its purpose is to serve as a guideline for the tax authority's inspectors during the transfer pricing surveillance. However, it can also be used as a guideline for taxpayers.

Legal cases

There are no legal cases in Croatia related to transfer pricing.

Burden of proof

The burden of proof lies with the local taxpayer.

Tax audit procedures

In Croatia, in order to be fully recognised for tax purposes, all costs incurred between two companies must meet the following conditions:

- They should be proven as necessary and provided for the benefit of the local company.
- The description of the services on the invoice must correspond to the services actually provided.
- The invoice must be supported with documentation of services provided (e.g. in case of consulting or advisory activities, this may include various correspondence, emails, reports, projects, etc.).
- The value on the invoice should be an arm's-length price.

Currently there is no special tax audit procedure specific to transfer pricing that differs from the regular tax audit procedure. However, the tax authority has published the Guidebook for Surveillance of Transfer Pricing, which is designed for internal use, but is also available to all taxpayers.

Revised assessments and the appeals procedure

The standard legal procedure is for the tax authority to issue a resolution at the conclusion of the tax audit (i.e. first instance).

Prior to the issuance of the resolution, the tax authority issues 'tax audit minutes'. The taxpayer has an opportunity to object to the tax audit minutes and make written comments/remarks about the statements made in the minutes. Subsequently, the tax office issues the written resolution.

If, at the first-instance level, the tax office does not accept the taxpayer's objection to the resolution, the taxpayer can appeal to the Central Tax Office (i.e. second instance). In the second instance, the Central Tax Office will issue a second-instance resolution. With this second-instance resolution, the Central Tax Office can resolve the conflict itself or prepare instructions for the first instance as to how to resolve the conflict.

In the event that the second-instance resolution is unfavourable and not acceptable to the taxpayer, the taxpayer may next appeal the second-instance resolution.

Additional tax and penalties

Current Croatian legislation does not proscribe additional tax and penalties in relation to transfer pricing. The general penalties contained in the law apply to these cases as well. However, if the prices between related entities are different from those between non-related resident and non-resident entities, any excess amounts will not be recognised for taxation purposes.

Resources available to the tax authorities

The Tax Authority has access to the Amadeus database. The Tax Authority is also known to use publicly available, relevant data from other companies that operate in the Croatian market.

Use and availability of comparable information

See previous section.

Croatia

Risk transactions or industries

Transfer pricing is an area of increasing interest for the Croatian Tax Authority. So far, they are not organised on an industry-specific basis, but special attention has been directed towards management fees and royalties charged between related parties, which may trigger an inspection.

Limitation of double taxation and competent authority proceedings

While mutual agreement provisions exist in Croatian tax treaties, there is currently little practical experience in this area. Croatia has signed 52 Double Tax Treaties (DTT).

Advance pricing agreements (APAs)

Croatia does not have an APA programme in place.

Anticipated developments in law and practice

We do not have information about potential law changes or practice developments in the near future. Croatia should join the European Union (EU) on 1 July 2013, but as the TP regulation is already in accordance with OECD Guidelines, no major changes should be introduced.

Liaison with customs authorities

Tax Authorities are related with the customs authorities and should they identify irregularities, they will notify customs authorities.

OECD issues

None. Croatia is not as yet a member of the OECD, but the transfer pricing provisions generally reflect the arm's-length principle and methods provided by OECD Guidelines.

Joint investigations

We are not aware of joint investigations at this time.

Thin capitalisation

Thin capitalisation provisions were introduced on 1 January 2005. These provisions state that interest payments on loans from a shareholder of a company holding at least 25% of shares or voting power of the taxpayer will not be recognised for tax purposes if the amount of the loan exceeds four times the amount of the shareholder's share in the capital or their voting power, except the interest payments on loans received from a financial organisation.

A third-party loan will be considered to be given by a shareholder if it is guaranteed by the shareholder.

Management services

These services consist of various consulting and business services, which are attracting the attention of the Tax Authority. The Tax Authority is very aggressive in challenging the deductibility of this type of expense. Therefore, in order to prove these services are tax-deductible, the taxpayers must satisfy the terms stated under the tax audit procedures section (i.e. have sufficient support or evidence for the provision of the services).

24.

Czech Republic

C

Introduction

The Czech tax authorities have begun to recognise the importance of transfer pricing, resulting in an increase in the number of tax audits that focus on related party transactions, or at least much more frequent scrutiny of these transactions.

Statutory rules

Acceptance of OECD Guidelines

The Czech Republic has been a member of the Organisation for Economic Co-operation and Development (OECD) since 21 December 1995. The OECD Guidelines on transfer pricing were translated into the Czech language and published by the Czech Ministry of Finance in 1997 and 1999. Although the OECD Guidelines are not legally binding, they are generally accepted by the Czech tax authorities.

Arm's-length principle in Czech tax legislation

Czech transfer pricing legislation covers transactions between companies as well as individuals and applies equally to domestic and cross-border transactions. The legislation contains a general definition of the arm's-length principle, which basically reflects the arm's-length principle in the OECD Guidelines.

The legislation states that a taxpayer's tax base will be adjusted for any related party transaction undertaken by the taxpayer in which the price differs from what would have been agreed between unrelated parties in current business relationships under the same or similar terms (conditions).

Definition of related parties

Based on Czech tax legislation, parties are considered to be related if one party participates directly or indirectly in the management, control or capital of the other, or if a third party participates directly or indirectly in the management, control or capital of both of them, or if the same persons or their close relatives participate in the management or control of the other party (excluding the situation where one person is a member of the supervisory boards of both parties). Participation in management suffices for the assumption of a relationship, even without equity ownership. Participation in control or capital means ownership of at least 25% of a company's registered capital or voting rights. Individuals are related if they are close relatives. Parties are also deemed to be related if they enter into a commercial relationship mainly for the purpose of reduction of the tax base (or increase of a tax loss).

Methods for determination of the arm's-length price

In general, there are no provisions in the Czech tax legislation on how an arm's-length price should be determined in related party transactions. However, as mentioned

Czech Republic

above, the OECD Guidelines are generally accepted by the Czech tax authorities. It is therefore recommended to apply the methods described in the OECD Guidelines.

Czech transfer pricing guidelines and documentation rules

In accordance with the guideline of the Czech Ministry of Finance D-332 (regarding use of the international standards for taxation of transactions between related parties), followed by the guidelines of the Czech Ministry of Finance D-333 (regarding transfer pricing advanced pricing agreements) and D-334 (regarding scope of transfer pricing documentation), Czech companies should follow the principles of the OECD Guidelines.

The Czech tax legislation does not prescribe any obligation to maintain any transfer pricing documentation (including preparation of a benchmarking study or a functional and risk analysis). Nevertheless, documentation proving that the arm's-length principle was followed in related party transactions might be required by the Czech tax authorities during a potential tax audit. It is therefore highly recommended that such documentation be prepared in advance and that the transfer pricing methodology applied in transactions with related parties be properly documented.

In addition, as a member of the European Union, the Czech Republic has adopted the EU Transfer Pricing Documentation Code (master file approach). However, it is at the taxpayer's discretion to follow the code.

Based on the legally nonbinding guideline D-334 on transfer pricing documentation issued by the Czech Ministry of Finance, documentation for transfer pricing should contain at least the following information:

- Master file:
 - Information about the group (business description, organisational structure, inter-company transactions, functional and risk profile of companies within the group, etc.).
- Local file:
 - Detailed description of the business and business strategy.
 - Description of the business transactions in which the above company participates.
 - Benchmarking analysis including a functional and risk analysis.
 - Information about the transfer pricing policy and selection of the method.
 - Relevant information on internal and/or external comparables if available.
 - Description of the role the company plays in the group's inter-company transfer pricing policy.

The above contents should be sufficient for the tax administrator to determine whether the company acts in compliance with the arm's-length principle.

Advance pricing agreements (APAs)

Based on the Czech Income Taxes Act, if a company is in doubt as to whether the method used for determining the prices applied in existing or future transactions is in compliance with the arm's-length principle, it can submit a written request to the Czech tax authorities for an APA (i.e. a binding transfer pricing ruling).

Practical experience shows that the average time needed for processing an APA in the Czech Republic is approximately eight months. So far, mostly unilateral APA requests have been filed along with one bilateral APA request. However, the Czech Ministry of Finance has expressed that it is also prepared to deal with a multilateral APA, if required.

Customs

According to customs legislation, the base on which customs duty is calculated may be adjusted when the seller and buyer are related. There is a description of how an arm's-length price will be determined for customs duty purposes using available data on comparable goods.

Reporting under the Commercial Code

Starting in 2001, the Czech Commercial Code introduced new rules and regulations relating to groups of companies, including reporting requirements. Group companies may conclude a controlling agreement listing the companies that are subject to common management by the controlling company. In the absence of such an agreement, the new reporting requirements impose an obligation on companies having a common majority shareholder to report intragroup transactions.

A document on intragroup transactions is to be prepared as part of the annual report and filed with the relevant commercial court. This document must outline all transactions carried out in the fiscal year between the subsidiary company and the majority shareholder, and also with any sister company. There are no guidelines in the legislation as to what level of detail is required. The document is available to the public, including the Czech tax authorities and minority shareholders, which increase the risk of transfer pricing investigations. The report on intragroup transactions is also subject to a statutory audit review.

Penalties and interest on late payments

If the tax authorities successfully challenge a company's transfer prices, then additional tax, a penalty and interest on late payments may be due.

With effect from 1 January 2011 (for tax due after 1 January 2011), the penalties and interest on late payments are calculated as follows:

- A penalty in the amount of 20% applies if tax is increased or a tax deduction is decreased as a result of the tax audit.
- A penalty in the amount of 1% applies if a tax loss is decreased as a result of the tax audit.

In addition to the penalty, interest on late payments applies. Interest is calculated as the National Bank's repo-rate (effective on the first day of the relevant half-year) increased by 14%. This interest charge is applicable for a maximum period of five years.

No penalty applies if the taxpayer reassessed the tax base voluntarily in an additional tax return (only interest on late payment applies in that case).

Czech Republic

Tax audit procedures

Obligations of the taxpayers

Based on the Tax Procedure Code, which governs tax audit procedures, the taxpayer has two main obligations:

- To declare the tax liability to the tax authorities in a tax return.
- To be able to substantiate the liability declared.

In principle, the tax authorities may request that the taxpayer provide evidence to substantiate all facts relevant to the tax return. This also applies to documentation on the taxpayer's approach to transfer pricing.

Approach of the tax authorities

In practice, rather than requesting general information, the authorities will specify their requirements. They must grant the taxpayer sufficient time to compile the required information (although practice shows that in a transfer pricing inquiry situation, this might be an issue, given the complexity of transfer pricing and the documentation required).

In cases where the tax authorities have requested evidence to substantiate items included in the tax return, it is the tax authorities themselves that decide whether that evidence is adequate. Where it is considered inadequate, the tax authorities may reassess the taxpayer's liability on the basis of their own sources of information, such as third-party valuations or information obtained from other taxpayers' returns or investigations.

However, in order to be able to make an assessment, the tax authorities should have a reasonable basis to challenge the declared tax liability. In transfer pricing disputes, they should primarily:

- provide sufficient evidence that the arm's-length principle was not followed, and
- demonstrate that, as a consequence of non-compliance with the arm's-length principle, the taxpayer has declared an incorrectly low tax liability.

Negotiations between the taxpayer and the tax authorities on the tax liability are rare (e.g. they may occur when the taxpayer cannot substantiate the declared liability and the tax authorities cannot obtain adequate evidence from their own sources to issue a reassessment).

Burden of proof

The burden of proof effectively lies with the taxpayer because, in order to mount a challenge, the tax authorities must only demonstrate that there is some basis for that challenge. It is the taxpayer who must then provide the evidence to refute the challenge.

Transfer pricing practice

Transfer pricing inquiries

The number of transfer pricing inquiries has increased in recent years, and the Czech tax authorities are becoming more confident in this area. The practical knowledge of transfer pricing and the level of detail under review by tax offices when scrutinising

transfer prices may vary in different regions. However, the level of sophistication of the tax authorities is constantly increasing.

As of 2012, a new Specialised Financial Office was established and will focus on companies with turnover exceeding 2 billion Czech koruna (CZK); banks, including branches of foreign banks; credit unions; insurance and reinsurance companies, including branches of foreign insurance and reinsurance companies; and companies which form a VAT group with entities defined above. The Specialised Financial Office has audit teams dedicated to transfer pricing.

These developments prove that the Czech tax administration recognises the importance of transfer pricing, which has resulted in an increase in the number of tax audits that focus on related party transactions, particularly those involving services, low-risk functions and losses.

Further, there is a growing trend in relying on the APA process with the Czech tax authorities to resolve transfer pricing uncertainties.

Investment incentives

Currently, the Czech government gives the opportunity for manufacturing companies, technology centres and strategic services investing in the Czech Republic to participate in an investment incentives programme. The investment incentives package contains various benefits such as a ten-year tax holiday.

Czech tax legislation contains a specific provision on the interplay between a tax incentive and transfer pricing. Based on this provision, if a company that was granted investment incentives does not comply with the arm's-length principle, it may lose the granted tax incentive. This may result in suspension of the tax relief and assessment of severe penalties. Therefore, the Czech tax authorities are highly focused on transfer pricing when examining companies that utilised investment incentives.

Anticipated developments

Because many of the neighbouring countries (e.g. Poland, Hungary and Slovakia) have introduced transfer pricing documentation rules, the Czech Republic will likely follow this trend.

Thin capitalisation rules in Czech tax legislation

A thin capitalisation provision is also included in the Czech tax legislation.

The main rules are outlined below:

- The debt-to-equity ratio for related party loans to equity is 4:1 (6:1 for banks and insurance companies). Unrelated party loans (e.g. bank loans) are not subject to thin capitalisation.
- The tax deductibility test applies to interest as well as to other financial costs on loans (i.e. interest plus other related costs such as bank fees, etc.).
- Financial costs paid on profit participating loans are fully tax non-deductible.
- Back-to-back financing (i.e. credits and loans between related parties provided through an unrelated intermediary, such as a bank) is also subject to thin capitalisation rules.

25.

Denmark

Introduction

The Danish transfer pricing rules, which are based on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines, have evolved considerably since their initial implementation in the late 1990s. The Danish transfer pricing rules can be found in Section 2 of the Danish Tax Assessment Act (DTAA), and Section 3B and Section 17 of the Danish Tax Control Act (DTCA). Section 2 of the DTAA implements the arm's-length principle and section 3B of the DTCA imposes notification requirements on the taxpayer and requires the preparation of transfer pricing documentation, while section 17 of the DTCA enacts fines and penalties for noncompliance with the documentation requirements.

In addition, the Danish Tax Authorities (DTA) issued Executive Order (no. 42) in 2006 and have issued guidelines regarding the transfer pricing documentation requirements. The latest version of the guidelines was issued on 24 January 2013. The main aim is to ensure that all the requirements in the statutory rules are observed when documenting controlled transactions, truly demonstrating the adoption of the arm's-length principle.

In August 2009, the DTA introduced a valuation guideline in relation to the valuation of businesses, parts of businesses and intangible assets. The valuation guidelines are not binding for the taxpayer, but are considered the best practice for the valuation of companies and part of companies, including valuation of goodwill and other intangible assets. Further, the guidelines offer recommendations in the application of valuation models as well as recommendations to the content of documentation in relation to a valuation. These guidelines were updated on 15 January 2013.

In 2010, the DTA issued an action plan to focus on loss making companies and companies that do not pay tax, so called 'zero tax' companies. In June 2012, the Parliament passed a new bill on 'zero-tax' companies, tightening the rules on applicable penalties for failure to submit compliant transfer pricing documentation and authorising the DTA to, under certain conditions, impose an independent auditor's statement regarding compliance with the arm's-length principle.

In 2011, the DTA issued transfer pricing adjustments in the amount of 6.2 billion Danish kroner (DKK) and in 2012 the amount increased to DKK 21.1 billion.

Statutory rules

Section 2 of the DTAA does not address only cross-border transactions, but all transactions between related parties. Section 2 of the DTAA provides that the arm's-length principle applies to taxpayers which:

- are controlled by an individual or company
- control companies (i.e. directly or indirectly own more than 50% of the share capital or control more than 50% of the votes in another company)
- are related to a company (i.e. are controlled by the same shareholders)
- have a permanent establishment situated abroad, or
- are a foreign individual or a foreign company with a permanent establishment in Denmark.

In this context the term ‘control’ means that a company or individual owns (directly or indirectly) more than 50% of the share capital or controls more than 50% of the votes or has an agreement regarding controlling interest in another company. Related parties are parties that are controlled by the same (group of) shareholder(s), and the term ‘controlled transactions’ means commercial or financial transactions between parties, where one party either controls or is controlled by the other party or between related parties.

The arm’s-length principle applies to transactions with all of the above-mentioned individuals, companies and permanent establishments. Prior to 2005, the rules on documentation applied only to cross-border transactions, but to satisfy non-discrimination principles of EU law, the scope was extended to also include domestic transactions. Consequently, the arm’s-length principle applies to both domestic and cross-border transactions.

A foreign legal company included in a Danish joint taxation also falls under the Danish documentation requirements with respect to controlled transactions with other foreign companies or foreign individuals.

Disclosure on the tax return

In accordance with section 3B of the DTCA, Danish companies must, in addition to preparing transfer pricing documentation, complete an appendix (form no. 05.021) to their tax return disclosing the nature and scope of transactions with related parties. Disclosure is only a requirement if the total amount of the company’s controlled transactions during the income year exceeds DKK 5 million. The deadline for tax return filing for taxpayers with 31 December year-end is 30 June the following year.

Companies with related party transactions must state for a pre-defined group of transactions (e.g. purchase of goods), whether the sum of inter-company transactions amount to:

- less than DKK 10 million
- between DKK 10 million and DKK 100 million, or
- more than DKK 100 million.

The company must also state whether the controlled transactions exceed 25% of the total transactions within each pre-defined group of transactions. In addition, one off transactions, such as an inter-company sale of fixed assets, must also be disclosed.

Sections 5 and 14 of the DTCA provide that the DTA may impose penalties on companies that do not file in due time or file incorrect or misleading information, e.g. regarding their eligibility for SME status.

Denmark

Danish transfer pricing documentation

Since 1999 documentation supporting transfer prices has been required. The documentation has to be sufficient for the tax authorities to assess whether transfer prices are consistent with the arm's-length principle.

The documentation rules can be found in section 3B of the DTCA and the specific documentation requirements are listed in Executive Order no. 42 from 2006 and the latest version of the transfer pricing guidelines issued by the DTA on 24 January 2013 (Danish TP Guidelines).

Timing of transfer pricing documentation

Documentation of controlled transactions should be conducted on an on-going basis, however, in the Danish TP Guidelines it is stated that they should be completed no later than at the time of filing the company's tax return. The deadline for tax return filing for taxpayers with 31 December year-end is 30 June the following year.

Upon request by a tax inspector, the taxpayer must submit its transfer pricing documentation within 60 days. The 60-day period is the time to dispatch the material; hence, taxpayers are advised to prepare documentation in advance of an audit. Extensions to the 60-day period are not granted by DTA.

The aim of the Danish TP Guidelines regarding the documentation requirements is to ensure that all the requirements in the statutory rules are observed when documenting controlled transactions, truly demonstrating the adoption of the arm's-length principle.

Generally, transfer pricing documentation should be written in a report format and must include the following:

- Taxpayer's address and ID number.
- Legal and organisational structure.
- Summary of statutory financial results of the last three years (for each party to the controlled transactions).
- Description of group and Danish company, including history, and explanation of losses.
- Description of all controlled transactions (including value).
- Description of products or services, which are transferred in the controlled transactions.
- Analysis of functions performed, risks assumed, and assets employed by each party to the controlled transactions, i.e. description of value chain.
- Comparability analysis, including terms and conditions of controlled transactions.
- List of inter-company agreements.
- Description of price-setting methods considered.
- Selection of the most reliable price-setting method.
- Rejection of methods not selected as most reliable.
- Description of the relevant database searches, if performed (database searches are not required, unless requested by the DTA).
- Assumptions, strategies, and policies, if any, that influenced the determination of the transfer prices.

The transfer pricing documentation may be prepared in one of the following languages: English, Danish, Norwegian, or Swedish.

More than one company can be included in a single documentation report, as well as several financial years and multiple transactions can be tested and covered by the same report. However, if multiple companies or financial years are included in the same report, it is a requirement of the DTA that the report specifies for which company and for which year the specific information applies.

Small and medium sized entities

If a company is eligible for small and medium sized entities (SME) status, the transfer pricing documentation does not have to be completed. However, SME's must still transact in accordance with the arm's-length principle, and are still subject to tax return disclosure. SMEs are defined by the European Commission (Recommendation 2003/361/EC) as companies with (measured at group level):

- less than 250 employees, and
- a balance sheet sum of less than DKK 125 million, or
- an annual turnover of less than DKK 250 million.

The exemption does not apply to inter-company transactions with affiliates and permanent establishments in states outside the EU/EEC with which Denmark does not have a double tax treaty.

Independent auditor's statement

As of 1 January 2013, and upon request from the DTA, a taxpayer must also within 90 days submit an independent auditor's statement regarding compliance with the arm's-length principle.

The DTA can only request an independent auditor's statement on companies that have:

- inter-company transactions with residents in non-EU/EEA member states that do not have a double tax treaty with Denmark, or
- realised a negative operating profit (EBIT) for four consecutive years on average.

Note that the request may be given retroactively, i.e. under the statute of limitation rules, and the DTA may request an independent auditor's statement for the income year 2007 up until 1 May 2013.

Penalties for non-fulfilment

Penalties apply if a company does not submit compliant transfer pricing documentation within 60 days of a request from the DTA. Section 17 of the DTCA provides that penalties may be imposed if transfer pricing documentation has not been prepared.

From a practical perspective, the penalties regime has been tightened in 2012 and applies if the transfer pricing documentation does not exist or if the documentation is deemed inadequate. Two-tier penalties apply to the following:

- Failure to submit compliant transfer pricing documentation within 60 days of request from the DTA or failure to submit an independent auditor's statement may result in a fixed penalty of DKK 250,000 (EUR 35,000) per company, per year. The DKK 250,000 fine can be reduced by 50% if compliant transfer pricing documentation is subsequently submitted.
- In addition to the lack of documentation or inadequate documentation, if an income adjustment is issued (i.e. the arm's-length principle has not been

Denmark

observed), the minimum penalty will be increased with an amount of 10% of an upward adjustment.

The above applies to years not barred by the statute of limitations, i.e. income year 2007 is open to penalties until 1 May 2013.

Statute of limitations on transfer pricing adjustments

As a general rule, the DTA is not allowed to reopen a tax assessment detrimental to the taxpayer later than the end of April in the fourth year after the income year has expired.

This general time limit is extended by two years in respect of transfer pricing adjustments. For transfer pricing, the DTA may issue a notice of an adjustment no later than 1 May in the sixth year following the income year-end (e.g. notice of adjustment for the income year 2007 must be made no later than 1 May 2013). The final adjustment must be issued no later than 1 August, also in the sixth year following the income year-end.

Surcharge and interests on upward adjustments

Following an upward adjustment of taxable income, the taxpayer is subject to a surcharge and interests on the adjustment, i.e. tax payable.

First, a surcharge is added to the adjusted taxable amount. This is onetime charge calculated on the tax payable and is based on a percentage set by the Danish Minister of Taxation for the given year that the upward adjustment relates to.

Second, an interest rate will be levied on the tax payable (including the surcharge). The interest accrues monthly from 1 November (for the calendar year-end taxpayer) after the financial year in question until the date of payment of the additional tax e.g. if an upward tax adjustment is imposed on the income year 2007, the surcharge percentage from 2007 (5.8%) will apply and the monthly interest will accrue from 1 November 2008.

	Surcharge	Interest rate
2007	5.8%	0.6%
2008	6.3%	0.6%
2009	6.1%	0.6%
2010	5.1%	0.5%
2011	4.8%	0.5%
2012	4.3%	0.5%

Tax audits

In general, the DTA are allowed to request any information of relevance for the tax assessment and has the authority to make an estimated adjustment of the taxable income if information is not provided. In addition, the conduct of the taxpayer during an audit may influence the outcome because a refusal to provide documentation can reduce or even reverse the burden of proof of the DTA. While it is possible to negotiate with the DTA before the adjustment is finalised, it is not likely that the outcome of the audit will be a result of either negotiation or litigation, but rather an assessment raised by the DTA based on its audit findings.

Selection of companies for audit

Transfer pricing continues to be an audit theme and with the continued focus on transfer pricing, the DTA frequently audits the transfer prices of companies resident in Denmark. If a Danish company is part of a multinational group, the DTA will generally always issue a request for the transfer pricing documentation in a tax audit.

In addition, the DTA's current focus is multinationals that have loss making operations in Denmark or have an apparent lack of taxes paid to Denmark ('zero tax' companies).

Companies with the following characteristics can expect to face increased risk of extensive transfer pricing audits in Denmark during 2013:

- Continuous losses, i.e. zero tax.
- Business restructurings and/or IP transfers.
- Related parties in non-treaty countries.
- Operates a branch in Denmark.
- Companies operating under the Danish Tonnage Tax Act.
- Part of one of the largest 150 international Groups operating in Denmark.
- Companies engaged in business in the oil-industry under the Danish Hydrocarbon Tax Act.
- Companies making payments in connection with an intercompany captive/reinsurance programme.
- Companies relying on intercompany financing.

Risk transactions or industries

It is not possible to generally identify specific transactions or industries where transfer pricing adjustments are more likely than others. Transfer pricing adjustments are often not appealed and therefore not published. More straightforward cases, such as management fees and interest on inter-company loans, are still taken up during tax audits. However, the tax authorities in Denmark have become more experienced in transfer pricing matters and are not reluctant to engage in more complicated transfer pricing issues. Moreover, another trend often seen is that the DTA attempt to disregard the business model chosen by the taxpayer, e.g. by reclassifying for example a distributor to be a service provider. Resources continue to be dedicated to the transfer pricing area.

Simultaneous examinations

Denmark will cooperate with other countries in undertaking simultaneous examinations of multinational groups. Indeed, this has already been practiced within the Nordic countries, and it is conceivable that it will occur with respect to other countries as well.

Appeals procedure

A transfer pricing adjustment imposed by the DTA must in the first instance be appealed at the administrative level to the Danish National Tax Tribunal, after which it is possible to continue the appeal to the High Court and ultimately the Supreme Court.

Burden of proof

Taxpayers are under a legal obligation to maintain current transfer pricing documentation. To the extent that this requirement is not met, the burden of proof may be reversed to the taxpayer.

Denmark

In two of the most significant court cases regarding transfer pricing (Texaco and BP), the courts confirmed that the burden of proof lies with the DTA, but the taxpayer is required to disclose information relevant to the question of whether the arm's-length principle has been violated. This information would include items such as prices and profit earned by the parent company when dealing with other group companies and with unrelated customers. Where this information is not disclosed, the court concludes that the burden of proof on the DTA is reduced.

The DTA may estimate transfer pricing adjustments if the transfer pricing documentation is inadequate. This represents a significant shift in the balance of the burden of proof between the tax authorities and taxpayers. Furthermore, the conduct of the taxpayer during the investigation may influence the outcome because a refusal to provide documentation can reduce or even reverse the burden of proof of the DTA.

Legal cases

Transfer pricing disputes are rarely taken to court as most disputes are solved through compromise. There have been three significant cases on transfer pricing. The first two were the so-called 'oil cases', both from the late 1980s, and the latest, Swiss Re, was tried recently, i.e. in February 2012.

Burden of proof

The oil cases involving BP and Texaco were the first transfer pricing cases to be tried in Denmark. Both decisions were on the question of burden of proof and ruled in favour of the taxpayers. In the Texaco case, the court found that the taxpayer could be required to disclose information regarding prices and gross profit. This information was however not available to Texaco Denmark and by that not available to the DTA. The High Court ruled that, despite this lack of information, a comparison of prices with the Rotterdam Spot Market suggested that that they did not differ significantly and an adjustment could therefore not be justified.

The BP case built upon the Texaco case. A price analysis suggested that prices paid by BP Denmark were 9% higher than the Rotterdam Spot Market, thus the High Court found a minor increase in BP's taxable income justified. This decision was taken to the Supreme Court. The Supreme Court repeated that the burden of proof rested on the DTA, but that a taxpayer's failure or refusal to disclose evidence would reduce this burden. The conclusion reached by the Supreme Court was that, as BP Denmark dealt on long term contracts, a difference in the pricing could be caused by the contractual set-up. The DTA had failed to show that the difference in price was as a result of BP Denmark being a controlled company and not as a result of the contractual terms, and the Supreme Court ruled in favour of BP Denmark.

Statute of limitations

A recent judgement from the Supreme Court (Swiss Re – HD of 2/2 2012, 1. afdeling, 68/2010) expands the scope of section 2 of the DTAA to not only include pricing and terms, but also the legal qualification of a transaction.

The case concerned the DTA's adjustment of a loan agreement between a Danish company and a US holding company. The parties did not agree on the payment terms until three and a half months after they entered into the loan agreement. Thus, the DTA fixed the interest rate for the first three and a half months and disregarded the parties' agreement to remunerate in the form of capital gains. The tax-adjustment took

place in the 5th and the 6th year after the two taxable income years in question. The Danish National Tax Tribunal rejected the DTA's adjustment, due to the fact that the statute of limitations (four years) barred an adjustment.

The Ministry of Taxation took the case to High Court, who rejected the decision made by the Danish National Tax Tribunal.

Subsequently, The Supreme Court upheld the High Court's judgement by confirming that the extended statute of limitations, i.e. six years, applies to any adjustments related to inter-company transactions. The adjustment was therefore made by the DTA within the time limit. Furthermore, the Supreme Court pointed out that the possibility for transfer pricing adjustments applies to all economic issues and other conditions related to taxability (e.g. time of payment, accruals of interests, capital losses and the legal qualification of a transaction.)

Limitation of double taxation and competent authority proceedings

The DTA is, without any limitations in time, obliged to reopen a tax assessment on request by a taxpayer, if there has been a transfer pricing adjustment abroad.

It should be noted, however, that the DTA is always entitled to form its own opinion on the transfer pricing issue in question. The authorities may disagree with an adjustment made by a foreign tax authority and consequently refuse to make a corresponding adjustment.

A Danish taxpayer can avoid a secondary adjustment, if prices and terms are adjusted in accordance with a transfer pricing adjustment.

The Danish competent authority on transfer pricing matters is the central transfer pricing unit within the DTA. Danish administrative principles, while not permitting the mutual agreement procedure to become a process of litigation, grant the taxpayer the right to comment on and discuss the position taken by the authorities. If a corresponding adjustment is refused by the authorities, it is possible to appeal to the courts.

Transfer pricing disputes with the EU can be resolved in accordance with the Convention on the elimination of double taxation in connection with the adjustments of profits of associated enterprises (Convention of 23 July 1990, 90/436/EEC), which became effective in 2006.

Year-end and retroactive adjustments

Year-end and retro-active adjustments and true-ups require special attention in Denmark. They should preferably be used as a method of last resort and need to be supported by the underlying inter-company legal agreements or transfer pricing policies. Furthermore, consideration should be given to legal, accounting, VAT and customs issues depending on the type of adjustment.

Advance pricing agreements (APA) and binding rulings

It is possible to apply for bilateral APAs with countries with which Denmark has double tax treaties, by reference to the mutual agreement article. Although Denmark does not have an official APA program, APA applications are accepted and negotiated. The first

Denmark

bilateral APA involving Denmark was concluded in 2002, and since then numerous bilateral APA agreements have been concluded with Denmark. The number of bilateral APA requests has increased significantly during the last five years. Denmark was the first European country to conclude a bilateral APA with China.

The DTA are planning to issue Danish APA guidelines. However, these guidelines have been under way since 2008 and it remains uncertain when the final guidelines will be released. These guidelines will largely follow the recommendations from the Joint Transfer Pricing Forum under the EU Commission issued on 26 February 2007.

It is not common for the DTA to process unilateral APAs. However, taxpayers have the possibility of applying for a binding ruling concerning the tax treatment of a given transaction. Binding rulings will be provided by the Danish Tax Assessment Committee, and the response will typically be provided within three months. However, if upon request for a binding ruling, it is found that insufficient documentation has been submitted in order to provide a response or if the request is complicated, the authorities may extend its response time or reject the response.

Comparability analysis

Comparable database search

There is no compulsory requirement to prepare comparable databases searches. However, in the case of a transfer pricing audit, the DTA can explicitly require that a comparable database search using commercial databases be completed within 60 days upon request.

The comparability analysis is to provide, primarily, a basis for assessing whether the principles used by the taxpayer's group to determine prices in respect to its controlled transactions are in conformity with the arm's-length principle and secondly, the reasoning for the benchmarks used and the method chosen.

Criteria to consider for comparability analysis

The conditions concerning an inter-company transaction must be examined in order to determine whether the transaction or the company is comparable. The criteria set out in the Danish Executive Order No. 42 (issued in 2006) and the Danish TP Guidelines (latest version issued 24 January 2013) to assess comparability analysis are:

- characteristics of the products or services
- a functional analysis
- contractual terms
- economic circumstances, and
- business strategies.

In practice, the retrieval of comparable data related directly to transactions between independent companies operating under similar conditions remain infrequent as this type of direct observation implies access to detailed information that generally is confidential. Furthermore, even if the information is available, it would still be necessary for the transactions to be comparable, which also is seldom found in practice.

Conducting a sufficiently thorough comparability analysis that produces satisfactory and reliable results requires the databases used by the taxpayers to be publicly

available and the data to be comparatively numerous and sufficient to build an argument justifying that the selected independent companies are comparable with the tested company. Practical experiences show that no two transactions are identical. It is, therefore, necessary for the taxpayers to examine the results thoroughly on whether the differences found are significant enough to affect the comparability of the selected independent companies.

Elements of the comparability analysis write-up

In addition to the preparation of the comparability analysis, the comparability analysis must be described as part of the transfer pricing documentation. The descriptions must contain the following four elements:

- Identification of the tested transaction(s) and the pricing methods.
- Detailed written descriptions of the comparability searches providing the arguments and reasons for the qualitative and quantitative search steps.
- Explanation of the justification and range.
- Materials for the documentation from the database.

Although the Danish TP Guidelines provide an example of the presentation of the elements described above, it is stated that taxpayers may prepare the descriptions of their comparability analysis differently as long as the elements above are taken into account and references to Section 10 of the Executive Order no. 42 (2006) are provided thoroughly.

The transfer pricing methods listed in the Danish legislation are in line with the OECD Guidelines. The most reliable method to evaluate an inter-company transaction must be selected and applied. When the Transactional Net Margin Method is applied, the least complex company to the inter-company transaction under review (i.e. not necessarily the Danish company) should be the tested party.

Regional comparable searches (i.e. pan-European benchmarks) are accepted, but local comparable companies are preferred (e.g. Eastern European companies may be disqualified for not being comparable within certain industries).

Quantitative and qualitative search steps

According to the Danish TP Guidelines, the following search criteria are suggested, but not compulsory, to be included in a comparability search process:

- Identify the activity of the tested company: branch code(s), keywords related to the industry, key accounting data.
- Identify the economic circumstances: geographic boundary, size of the tested company's activity, number of years with activity.
- Identify the key accounting data to justify the pricing and qualification of the arm's-length principle.
- Verify the data available through additional qualitative steps through: internet, websites of companies and other possible methods.

It is pointed out that the selection of comparable companies must, nonetheless, be consistent. This section of the Danish TP Guidelines imply the need to avoid any cherry-picking of profitable companies among the independent companies available as comparables by both the taxpayers, when preparing a comparability analysis, and by the tax authorities during tax audits.

Denmark

Like many European countries that use the OECD Guidelines as the model for the local transfer pricing guidelines, Denmark recognises the use of average data of the past few years for the purpose of comparability analysis. Furthermore, the range of data available for multiple years might disclose facts that may have influenced the determination of the transfer prices. Companies relying on comparables, i.e. benchmark studies, are advised to update these on a regularly basis. How often depends on the industry and if there has been a major change which has affected the market.

In Denmark, the use of an arm's-length range is not explicitly specified in the legislation, but it is common practice for the data from the database to be measured using median as the statistical tool to determine the representative result of a sample set. The interquartile range also is used to determine the range of acceptable transfer prices. An interquartile range is advantageous because, by excluding outlying or extreme data point, which may be unrepresentative, the range frequently provides a good indication of representative values.

Limitations on interest deductibility

Thin capitalisation

Thin capitalisation applies to Danish companies and permanent establishments that have inter-company debt (controlled debt) to a related company or individual, which:

- directly or indirectly owns more than 50% of the share capital or 50% of the votes in the Danish company, and
- the debt to equity ratio of the Danish company exceeds the ratio 4:1.

If these conditions are met, tax deductibility for the interest and debt losses on the controlled debt, which exceeds the debt equity ratio of 4:1, is disallowed. The interest is not re-characterised as a dividend and is still treated as an interest with respect to withholding tax, etc.

If the Danish taxpayer can prove that the debt is on market terms, the deductibility is not disallowed.

The term 'controlled debt' includes both debt directly provided by a related company and debt where a related party has provided a guarantee to a third party in order to obtain the loan.

It is worth noting that:

- the thin capitalisation rules only apply if the controlled debt exceeds DKK 10 million
- the limitation of interest deductibility only applies to the part of the controlled debt that would need to be converted into equity in order to meet the 4:1 debt/equity ratio
- special consolidation rules apply when assessing the assets and debt of Danish group companies
- the 4:1 ratio is calculated on the fair market value of the company's assets.

Limitation on net financial expenses

Deductibility of interest expenses is limited in the following way and in the following priority:

- The above thin capitalisation rules apply.
- It is only possible to deduct net financial expenses in a Danish jointly taxed group equal to 3% (2013) of the tax value of qualifying assets at year-end. However, it is always possible to deduct net financial expenses of DKK 21.3 million.
- In addition, the taxable income before interest deduction may not be reduced by more than 80% as a result of net financial expenses; however, it is always possible to deduct DKK 21.3 million in a given year. Any unused net financial expenses may be carried forward.

The corporate tax rate

The corporate tax rate in Denmark is 25%.

OECD issues

Denmark is a member of the OECD and applies their interpretation of the OECD Guidelines.

26.

Dominican Republic

Introduction

With the enactment of Fiscal Rectification Law No. 495-06 (Tax Reform) of 28 December 2006, the Dominican Republic became the first country in the Caribbean to introduce the transfer pricing concept through the modifications made to Article 281 of the Dominican Tax Code.

The Tax Reform Law establishes that transactions between related parties should be made at arm's length or market value, meaning that the prices paid between related parties should be similar to those that should have been paid by independent third parties. The law stipulates that if this criterion is not met, the Tax Administration may challenge the values involved in the transactions. Furthermore, if the accounting methods do not allow the assessment of the actual results of a local related party, then the taxing authority may impute a result based on the ratio of gross income in the local subsidiary relative to the total income generated by the headquarter company and its total assets.

In 2011, the Tax Administration issued the General Rule 04-2011 to establish documentation requirements and further regulations on transfer pricing dispositions included in Law No. 495-06.

Statutory rules

The Dominican transfer rules are based on the internationally accepted arm's-length standard. This legislation does not specify any methods that make reference to the Organisation for Economic Co-operation and Development (OECD) standards.

The following related party transactions are expressly subject to this law:

- Inter-company payments made or received on goods and services.
- Allocation of corporate expenses which must be deemed necessary to maintain and preserve the taxable income of the subsidiary.
- Financial or credit operations.

The Tax Administration will be able to assess:

- prices that the branch or permanent establishment collects from its parent company or another branch or related company when these prices do not reflect the amounts that independent entities collect for similar operations
- prices paid or owed for goods or services rendered by the parent company, its agencies or related companies when these prices do not reflect normal market prices between unrelated parties, and

- corporate expenses distributed by the parent company to the branch or establishment in the country when these expenses do not correspond with the amount or price that independent entities collect for similar services. These expenses will have to be necessary for maintaining and conservation of the income of the permanent establishment in the country.

Furthermore, General Rule 04-2011 establishes that inter-company transactions subject to analysis include those that take place with foreign related parties, as well as transactions with low tax jurisdictions and free trade zones. Also, the rule establishes that even if there is not ownership, an exclusive relationship, favourable conditions in the transaction, or a permanent establishment may indicate that the parties are acting as related parties.

For these transactions, a comparability analysis needs to be prepared considering the comparability factors stipulated in the OECD Guidelines and included in the General Rule 04-2011. Also, the rule establishes the following transfer pricing methods:

- Transactional methods:
 - Comparable uncontrolled price (CUP) method
 - Cost plus (CP) method
 - Resale price method (RPM)
- Profit-based methods:
 - Transactional net margin method (TNMM)
 - Profit split method (PSM)
 - Residual profit split method (RPSM)

According to this rule, the most appropriate method shall be that which better fits the transaction evaluated. Nevertheless, the regulations establish that the transactional methods should be considered first.

Dominican taxpayers are required to file an informative return for related transactions within the next 60 calendar days after the Income Tax return is filed. Also, Contemporaneous documentation (transfer pricing report) must be available upon request by the Tax Administration.

Legal cases

No transfer pricing court cases have been introduced.

Burden of proof

The burden of proof lies with the taxpayer to demonstrate that the transfer policy complies with the general rules and the transactions have been conducted in accordance with the arm's-length standards.

Tax audit procedures

The Dominican legislation does not specify any methods for transfer pricing audits.

Risk transactions or industries

There are no indications that certain types or particular industries are at higher risk than others. All multinationals are in risk or assertion.

Dominican Republic

Advanced pricing agreements (APA)

The Tax Administration is empowered to subscribe APAs with taxpayers pertaining to the all-inclusive hotel industry, which are represented by the National Hotel and Restaurants Association, pursuant to Article 281 paragraph II of the Dominican Tax Code.

The APAs incorporate prices based on a standard parameter by zones, cost analysis and other variables that impact the tourism industry. These APAs have a duration of 18 months and once renewed they may remain in force for up to 36 months. In addition, the Tax Administration may challenge the prices included in the APA and, consequently, impose penalties stipulated in the Tax Code on taxpayers who do not meet the terms and requirements of the agreed APA. APAs may also be obtained in other industries with foreign involvement, such as the pharmaceutical, power and insurance industries.

OECD rules

The Dominican Republic is not a member of the OECD; nonetheless, the Dominican Republic does generally follow the OECD Guidelines and models. Transfer pricing legislation in the Dominican Republic does not make allusion to the Organisation for Economic Co-operation and Development (OECD) standards.

27.

Ecuador

E

Introduction

Ecuadorian transfer pricing rules apply to taxpayers undertaking cross-border operations from fiscal year 2005 onwards. The regulations expressly recognise the guidelines established by the Organisation for Economic Co-operations and Development (OECD) as technical reference in transfer pricing matters.

Statutory rules

Ecuadorian taxpayers should be able to demonstrate that their transactions with foreign-related parties are conducted in accordance with the arm's-length standard. Transfer pricing rules are applicable to all types of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions, reimbursement of expenses and licensing of intangible property). Transfer pricing rules apply to cross-border transactions with foreign-related parties in the following manner:

- Taxpayers with cross-border transactions with foreign-related parties for cumulative amounts between 1 million United States dollars (USD) and USD 3 million must file a transfer pricing annex within two months after the filing date of the tax return when the sum of the transactions is more than 50% of the total taxable income of a company.
- Taxpayers with cross-border operations with foreign-related parties for cumulative amount greater than USD 3 million during any given fiscal year must file a transfer pricing annex within two months after the filing of the income tax return (which normally occurs in April of the following year).
- Taxpayers with cross-border operations with foreign-related parties for cumulative amounts greater than USD 5 million must file, in addition to the transfer pricing annex, a comprehensive transfer pricing report within two months after the filing date of the tax return.

Any adjustments arising from the application of transfer pricing regulations must be included in the tax return and affect taxable income.

Related parties

Related parties are defined as individuals or entities in which one directly or indirectly participates in the direction, control or capital of the other, or in which a third party, individual or entity participates in the direction, control or capital of the others.

In order to establish any relationship among entities, the tax administration will consider, in general terms, the participation in the companies' shares or capital (more than 25%), the holders of the capital, the entity's administration, the distribution of dividends, the proportion of transactions carried out between entities (more than 50%

Ecuador

of total sales, or purchases, among others) and the pricing mechanisms used in such operations. Specifically, the regulations list the following situations as related parties:

- Head offices and their subsidiaries, affiliates and permanent establishments.
- Subsidiaries, affiliates and permanent establishments among themselves.
- The parties that share the same individual or entity directly or indirectly in the direction, administration, control or capital of such parties.
- The parties that maintain common directive bodies with a majority of the same members.
- The parties with the same group of shareholders participating directly or indirectly in the direction, administration, control or capital of such parties.
- The members of the directive bodies of the entity with respect to the entity, as long as the relationships between them are different to those inherent to their positions.
- The administrator and statutory auditors of the entity with respect to the entity, as long as the relationships among them are different to those inherent to their positions.
- The entity with respect to the spouses and relatives (fourth degree of consanguinity and second degree of affinity) of the directing shareholders, administrators and statutory auditors.
- The entity or individual with respect to the trusts in which it has rights.

The Ecuadorian law also deems transactions as being carried out by related parties when such transactions are not carried out at arm's length or when they take place with individuals or entities located in tax-haven countries or jurisdictions.

Comparability

Operations are deemed comparable if no differences exist between their relevant economic characteristics that significantly affect the price or value of the goods and services or the arm's-length margin; or, in instances where these differences exist, they can be eliminated through reasonable technical adjustments.

In order to verify whether the operations are comparable or if there are significant differences between them, the following factors should be considered when assessing the comparability of a transaction:

- The specific characteristics of the goods or services.
- The functions that each taxpayer performs, including the assets used and the risks undertaken.
- The terms and conditions (contractual or not) that exist between related and nonrelated parties.
- The economic circumstances of different markets, such as geographical location, market size, wholesale or retail, level of competition, among others.
- Business strategies, including those related to market penetration, permanence and expansion.

Methods

According to transfer pricing regulations, the following methods should be used when assessing the arm's-length principle in transactions with related parties:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost-plus (CP) method.

- Profit split method (PSM).
- Residual profit split method (RPSM).
- Transactional net margin method (TNMM).

Ecuador's transfer pricing regulations contain a best method rule. They also indicate that the methods must be applied hierarchically beginning from the CUP method through the TNMM, along with an explanation of why each method has been discarded. Transfer pricing regulations state that the application of the methods should be interpreted based on the OECD Guidelines, as long as they are not contrary to local legislation.

Transfer pricing regulations include the use of the interquartile range and the adjustment to the median if the taxpayer's result falls outside the range.

Transfer pricing annex

As previously stated, taxpayers exceeding the materiality threshold on cross-border operations with foreign-related parties during the fiscal year must present a transfer pricing annex. The annex must include:

- Identification of the taxpayer, including taxpayer identification number and fiscal year.
- Identification of foreign-related parties, including name, address, fiscal residence, taxpayer identification number in the country of fiscal residence.
- Operations with foreign-related parties, including type of operation, amount of operation, and method used to determine arm's-length compliance.
- The margin obtained by the taxpayer on each type of operation.
- Transfer pricing adjustment, if applicable.

Transfer pricing report

The transfer pricing report should include the following information:

- The background and functions performed by the group the taxpayer belongs to.
- The background, functions performed, risks borne and assets used by the taxpayer on its business.
- An explanation of the elements, documentation, circumstances and facts valued for the transfer pricing analysis or study.
- Details and amounts of the inter-company transactions, subject to analysis.
- Details of the related entities abroad with which the company carried out the transactions subject to analysis.
- A global and local analysis of the industry in which the taxpayer operates.
- Method used to support the transfer pricing, stating the reasons and fundamentals which led to considering it as the best method for the transaction under analysis.
- The identification of every selected comparable to justify transfer pricing.
- The identification of the information sources used to obtain the comparables.
- Description of the activities and characteristics of the business of the comparable companies.
- Listing of selected comparables that were rejected, stating the reasons for such consideration.
- Listing quantification and methodology used to practice adjustments necessary on selected comparable.
- Median and the interquartile range.

Ecuador

- Profit and loss statement of the comparable entities corresponding to the commercial years considered for the economic analysis, indicating the source of information.
- Conclusions.

Other regulations

The *Servicio de Rentas Internas* (SRI) enacted resolutions establishing the contents of the transfer pricing annex and the integral transfer pricing report, as described previously.

Legal cases

Transfer pricing rules were introduced as part of the Income Tax Law in January 2008. Currently, there are transfer pricing cases at the tax court level.

Burden of proof

In practice, the burden of proof lies with the taxpayer for filing the transfer pricing annex and the transfer pricing report.

Tax audit procedures

There are no specific tax audit procedures established for transfer pricing purposes. Transfer pricing obligations are audited as part of regular tax audits conducted by the SRI.

Tax audit-related inspections are carried out first as desk reviews based on detailed information provided by the taxpayers and, subsequently, at the taxpayer's office. Taxpayers must make available all basic accounting records, auxiliary records, as well as all sources of information supporting the financial statements, the tax returns and the transfer pricing annex and report.

Once the tax audit has been completed, inspectors prepare an assessment that either confirms the declared taxable income and the tax paid or requests payment of additional taxes arising from the objections resulting from the audit. Among these objections, the administration could challenge the adequacy of the transfer pricing study and establish different transfer pricing adjustments for income-tax purposes.

Revised assessments and the appeals procedure

Taxpayers have the right to file objections with the SRI against additional tax assessments established because of tax audits within 20 days of receipt of the notification of assessment. The SRI must issue its resolution within 120 days of the appeal. The lack of response of the SRI within 120 days is considered a tacit acceptance of the claim presented by the taxpayer.

If the appeal to the SRI is unsuccessful, the taxpayer can appeal before the Fiscal Court, which is organised into several chambers of three judges each. Each chamber processes claims and issues judgments independently from the others. In the event that taxpayers do not agree with the judgment made by a particular chamber of the court, they have the right to appeal before the entire court (i.e. all three chambers). Only legal issues are discussed before the full court.

Additional tax and penalties

Failure to file the transfer pricing annex or the comprehensive transfer pricing report on the established dates can result in a fine up to USD 15,000. The same fine may apply to cases where the information presented in the annex and the report is incorrect or differs from the information provided in the income-tax return.

Finally, the delayed presentation of the transfer pricing report or annex give rise to a fine up to USD 333.

Resources available to the tax authorities

There is a unit within the SRI that deals specifically with transfer pricing issues.

Use and availability of comparable information

Comparable information is required in order to determine arm's-length prices and should be included in the taxpayer's transfer pricing documentation. Ecuadorian companies are required to make their annual accounts publicly available by filing a copy with the local authority (e.g. the superintendence of companies). However, these accounts do not necessarily provide enough or sufficient information on potentially comparable transactions since they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign comparables. This practice would be acceptable under Ecuadorian transfer pricing regulations.

Tax legislation allows the SRI to use secret comparables.

Limitation of double taxation and competent authority proceedings

The domestic legislation is supplemented by the provisions of the double taxation treaties that Ecuador has signed with several countries (Brazil, Belgium, Chile, France, Germany, Italy, Romania, Spain, Canada, Mexico, Switzerland, Uruguay and the nations of the Andean Community: Colombia, Peru and Bolivia). These agreements generally include provisions on mutual agreement procedures, related parties and business profits.

Advance pricing agreements (APAs)

Ecuadorian legislation does establish the possibility of advance pricing agreements (APAs).

Anticipated developments in law and practice

Law

According to changes in tax legislation in force since 1 January 2010, taxpayers are excluded from applying transfer pricing rules if they comply with the following:

- Income tax due is higher than 3% of taxable income.
- There are no transactions with tax-havens or low tax jurisdictions.
- There is no contract in place with the government for the exploitation of non-renewable resources.

These taxpayers must file with the SRI until one month after the due date established for the filing of the income tax return, the relevant information of its operations with foreign related companies.

Ecuador

Practice

It is expected that tax authorities will become more skilled and aggressive in handling transfer pricing issues. Transfer pricing knowledge of tax inspectors is expected to increase significantly, as training improves and they gain experience in transfer pricing audits.

Liaison with customs authorities

Tax authorities and customs authorities may exchange information. Experience suggests, however, that the authorities do not deal very closely with each other where transfer prices are concerned.

OECD issues

Ecuador is not part of the OECD, but according to transfer pricing rules the OECD's transfer pricing guidelines for multinational enterprises and tax administrations are used as a technical reference for transfer pricing purposes.

Joint investigations

Transfer pricing regulations do not establish specific procedures for joint investigations.

Thin capitalisation

As of 1 January 2008, thin capitalisation provisions must be considered by taxpayers. In effect, if the amount of a foreign loan exceeds three times the amount of the paid capital, the interest expense will not be considered as a deductible expense for income-tax purposes.

Management services

In instances where the amount of a management charge has been calculated on an arm's-length basis, the management fee would normally be tax-deductible.

28.

Egypt

E

Introduction

In November 2010, the Egyptian Tax Authority (ETA) released its Egyptian Transfer Pricing Guidelines. The Egyptian Transfer Pricing Guidelines, which are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines, were developed to provide Egyptian taxpayers with detailed guidance on how to prepare documentation to support the arm's-length nature of their transactions as required by Income Tax Law No. 91 of 2005. The ETA, together with the Ministry of Finance, views transfer pricing as a key legislative initiative. Egypt was one of the first countries in the Middle East and North Africa to introduce specific transfer pricing rules in its tax code, and the first to release transfer pricing guidelines in Arabic. Transfer pricing laws were enacted in 2005 through Egyptian Income Tax Law No. 91 and its related Executive Regulations.

Statutory rules

Transfer pricing legislation

Transfer pricing in Egypt is governed by Income Tax Law No. 91 of 2005, Article (30) and its Executive Regulations, Articles (38), (39), and (40), collectively (TP Law). The TP Law defines the arm's-length principle, related parties and the transfer pricing methods together with the priority in which such methods should be applied. The TP Law is applicable to international and domestic transactions between related parties. As such, the TP Law is applicable to transactions carried out with parties in foreign tax jurisdictions or regimes and to domestic transactions with Egyptian free zones or local related parties operating within Egypt.

Related parties

A related party is defined as any person who has a relationship with a taxpayer that may lead to an effect on that taxpayer's taxable profit. Based on the TP Law, related parties include:

- A husband, wife, ancestors and descendants (family members).
- Capital associations and a person that holds at least 50% of the value of shares or voting rights, whether directly or indirectly.
- Partnerships, the joint partners and silent partners of those partnerships.
- Any two or more companies where a third party holds 50% or more of the value of shares or of the voting rights in each company.

Transfer pricing methods

The Egyptian Transfer Pricing Guidelines explicitly list the following methods:¹

¹ Although the methods of the Egyptian Transfer Pricing Guidelines are consistent with the methods described in the TP Law, the TP Law explicitly recognises only the three traditional transaction methods (i.e. CUP, RP and CP), but then notes that any other method as described via the OECD Guidelines is also acceptable if one of the traditional transaction methods cannot be applied.

Egypt

Traditional transaction methods:

- Comparable Uncontrolled Price (CUP) method.
- Resale Price (RP) method.
- Cost Plus (CP) method.

Transactional profit methods:

- Profit Split (PS) method.
- Transactional Net Margin Method (TNMM).

Other methods:

- Global Formulary Apportionment.

Other regulations

Since issuance of the TP Law, the corporate tax return has included disclosure requirements for related party transactions and general disclosure regarding a taxpayer's transfer pricing policies. The tax return inquires about a taxpayer's contribution in resident and non-resident subsidiaries and sister companies, specifically, the percentage and the value of the contribution as well as the annual yield from the contribution.

The tax return also includes disclosure of direct and indirect related party transactions with a certain amount of detail, specifically, requiring disclosure of the related party name, the type of relationship, characterisation of the transaction, as well as the value of the related party transactions for the return year and the preceding year. Additionally, the taxpayer is required to disclose the transfer pricing method chosen under the TP Law and the parties to the transaction.

Legal cases

There have been no specific transfer pricing cases in Egyptian courts. However, the ETA has had a tendency to challenge structures/transactions where there is inconsistency between the legal form and the economic substance of the arrangement. Where such inconsistencies have been apparent, the ETA has historically sought to adjust transactions such that it tests the outcome of the transaction based on the form of the transaction as well as based upon the economic substance of the transaction. This has been done many times on an arbitrary basis.

Burden of proof

The TP Law places burden of proof on the ETA, provided that the taxpayer can produce sufficient transfer pricing documentation (and other supporting documents, including potentially intercompany agreements, schedules, and invoices) to support its declared transactions on the tax return. According to the TP Law, however, the burden of proof shifts to the taxpayer in the event that the tax return is not filed or the taxpayer fails to produce proper transfer pricing documentation to support its tax return positions.

Tax audit procedures

Since 2005, the TP Law has been based on a self-assessment system. The ETA has just begun to audit corporate tax returns for 2005, and, due to the current political circumstances, the ETA discontinued the inspection process for 2005 returns and considered the uninspected returns as final. Consequently, there has been very limited practical experience of transfer pricing audits under current TP Law.

Penalties

ETA penalties, which are provided under the general corporate tax provisions in Article (136), can be up to 80% of the income adjustment. The specific penalty provisions state that if the tax payable (stated in the tax return) by the taxpayer is less than the final assessed tax, then the taxpayer is subject to a fine based on the percentage of the unincorporated tax amount:

- 5% of the tax payable on the unincorporated amount if such amount is equivalent to 10% up to 20% of the due tax.
- 15% of the tax payable on the unincorporated amount if such amount is equivalent to more than 20% up to 50% of the due tax.
- 80% of the tax payable on the unincorporated amount if such amount is equivalent to more than 50% of the due tax.

Use and availability of comparable information

The Egyptian Transfer Pricing Guidelines acknowledge that the principle of comparability is fundamental to the determination of arm's-length transfer prices. Therefore, comparables are required for the annual declaration. Local comparables are preferred, but not specifically required. Where local comparables are not available, the ETA expects that adjustments will be made accordingly.

Tax treaty network

Egypt has double-tax treaties with approximately 50 countries. Most, if not all, Egyptian double-tax treaties have been drafted according to the OECD model convention. With regard to application, treaty provisions are honoured by the ETA in most cases; however, recently some limitations have been placed on their application. Competent authority proceedings are not regularly used in Egypt.

Advance pricing agreements (APAs)

Article (30) of the Egyptian tax law as well as Article (39) of the Executive Regulations contain a provision stating that the head of the ETA may conclude agreements with related parties in respect to one of the available transfer pricing methods for determining an arm's-length result. In theory, this provision potential enables APAs to take place, although, to date, no formal APA application process has been established in Egypt.

Anticipated developments

The ETA announced that the Egyptian Transfer Pricing Guidelines will be issued as a series of parts, beginning with the part issued in November 2010. The first part focuses on providing guidance on primary transfer pricing concepts and issues, including the arm's-length principle, comparability analysis, transfer pricing methods, and documentation requirements.

The next parts of the Egyptian Transfer Pricing Guidelines are expected to address other more advanced issues, such as the application of the arm's-length principle to transactions involving intangible property (IP), intra-group services, cost contribution arrangements (CCAs), and advance pricing agreements (APAs).

Moreover, the ETA plans to issue separate regulations regarding the tax treatment of permanent establishments (PE), including the pricing of transactions between a head office and a PE.

29.

Estonia

Introduction

Estonian transfer pricing regulation relies strongly on the principles stated in the Organisation for Economic Co-operation and Development (OECD) Guidelines stipulating solid rules for implementing the regulation in practice.

Transfer pricing is becoming an increasingly important tax issue in Estonia. However, the Estonian transfer pricing practice is currently not very sophisticated, as both taxpayers and tax authorities are building their transfer pricing expertise.

Statutory rules

Application of the regulation

Estonian transfer pricing rules are stipulated in the Income Tax Act and in Regulation No. 53 issued by the Estonian Ministry of Finance on 10 November 2006. Estonian taxpayers are required to be able to demonstrate that both domestic as well as cross-border transactions with related parties were conducted at arm's length. Transfer pricing rules are applicable to all types of transactions.

Transfer pricing rules are applicable to inter-company transactions concluded between the following parties:

- An Estonian company and its related party.
- An Estonian sole proprietorship and its related party.
- An Estonian permanent establishment and its foreign head office.
- An Estonian permanent establishment and a party related to its foreign head office.
- An Estonian company and its foreign permanent establishment.

Related parties

Estonian tax legislation provides a rather broad definition of related parties. The following companies and individuals qualify as related parties:

- An Estonian company and its group company.
- An Estonian company and a direct shareholder that owns more than 10% of the share capital, number of votes or rights to the profits of the company.
- An Estonian company and two or more direct shareholders, which qualify as related parties to each other and own (on a combined basis) more than 50% of the share capital, number of votes or rights to the profits of the Estonian company.
- An Estonian company and another company that has a common shareholder, which owns more than 50% of the share capital, number of votes or rights to the profits of both of these companies.
- An Estonian company and another party that each separately own more than 25% of the share capital, number of votes or rights to the profits of the same legal entity.

- An Estonian company and another legal entity that have exactly the same members of their respective management boards.
- An Estonian company and its employees, members of management and supervisory board, and direct relatives of these persons.

Companies not covered by the above list of related parties may still be regarded as related parties if they have a mutual business interest or control. There is no administrative practice in place or guidelines issued by the tax authorities explaining the notion mutual business interest but in essence this is regarded as an anti-avoidance clause.

Transfer pricing principles

The Estonian regulation is based on the arm's-length principle, which requires the prices charged between related parties be equivalent to those that would have been charged between independent parties performing the same or similar functions under the same or similar circumstances. Should the transfer prices applied in the inter-company transactions not follow the arm's-length principle, any hidden distribution of profits is subject to Estonian corporate income tax (21/79 on net amount of profit distribution).

The Estonian transfer pricing regulation should generally be in line with the principles laid down in the OECD Guidelines. However, there are some Estonia-specific issues (e.g. preference of local comparables) that should be considered when applying the OECD Guidelines. Furthermore, sufficient attention should be paid to the present Estonian corporate income tax system, which taxes only direct and deemed profit distributions.

Under the present Estonian corporate income tax system, transfer pricing adjustments are treated as deemed dividend distributions subject to corporate income tax. Consequently, transfer pricing adjustments do not increase the taxable income of the taxpayer and are not treated as non-deductible for corporate income-tax purposes. Therefore, a transfer pricing adjustment assessed to a loss-making company triggers corporate income tax payable.

The Estonian transfer pricing regulation provides guidelines regarding comparability of the transactions in respect of the functional analysis and contractual terms of the transaction as well as economic circumstances and business strategies. The Estonian regulation also establishes guidelines for intellectual property, provision of intragroup services and cost-contribution agreements.

Transfer pricing methods

The Estonian regulation introduces five transfer pricing methods that are the same as those in the OECD Guidelines:

- Comparable uncontrolled price method.
- Resale price method.
- Cost-plus method.
- Profit split method.
- Transactional net margin method.

In addition, the taxpayer is entitled to apply its own method provided that it achieves a more reliable result.

Estonia

The Estonian regulation recognises the ‘best method rule’ for selecting the applicable transfer pricing method. As a result, each transaction or group of transactions must be analysed separately in order to determine the most appropriate method and that there is no priority of the methods. Furthermore, the regulation does not prescribe any obligatory method for certain types of transactions, and the taxpayer is entitled to apply only one method for calculating transfer price for a transaction.

Estonian corporate income tax system

Estonia has a rather exceptional corporate income tax regime that should be considered while applying the transfer pricing regulation. Under the Estonian corporate income tax regime, all undistributed corporate profits are tax-exempt. This exemption covers both active (e.g. trading) and passive (e.g. dividends, interest, royalties) types of income, as well as capital gains from sale of all types of assets, including shares, securities and immovable property. This tax regime is applicable to Estonian companies and permanent establishments of foreign companies that are registered in Estonia.

In Estonia, corporate profits are not taxed until the profits are distributed as dividends or deemed profit distributions, such as transfer pricing adjustments, expenses and payments that do not have a business purpose, fringe benefits, gifts, donations and representation expenses. Registered permanent establishments (including branches) are subject to corporate income tax only in respect of profit distributions, both actual and deemed, as defined in domestic law.

Distributed profits are generally subject to 21% corporate income tax (21/79 on the net amount of profit distribution).

The period of taxation is a calendar month. The combined corporate income tax and payroll tax return (form TSD with appendices) must be submitted to the local tax authorities and the tax must be paid by the tenth day of the month following a taxable distribution or payment.

Documentation

The Estonian transfer pricing regulation introduces documentation requirements applicable starting from 1 January 2007. As a general rule, all Estonian group companies and permanent establishments are obliged to prepare transfer pricing documentation to prove the arm’s-length nature of the intercompany transactions.

An exemption applies to small and medium-size enterprises (SME) unless they have conducted transactions with entities located in low-tax territories. A company or permanent establishment is deemed to be an SME, provided that the previous financial year consolidated results of an Estonian company or a permanent establishment together with its associated enterprises or head office meet all of the following criteria:

- Annual sales less than 50 million euros (EUR).
- Balance sheet less than EUR 43 million.
- The number of employees less than 250.

Although the formal transfer pricing documentation requirements do not apply to SMEs, they may still be required to prove the arm’s-length nature of their intercompany transactions to the tax authorities in the course of a tax audit. There are generally no

limitations and restrictions in relation to the form or type of evidence the taxpayer can submit to defend transfer prices.

The Estonian documentation requirements should generally follow the principles stipulated in the EU Council Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the EU. The master file and country-specific files, including supporting documentation, should be prepared by the taxpayer with due diligence considering the nature and extent of the controlled transactions.

The master file should contain a business profile of the group, a list of related parties with business profile descriptions, details of controlled transactions, a functional analysis, a list of intellectual property owned by the group, a description of the transfer pricing policy, and a list of any applicable cost contribution and advance pricing agreements. Country-specific files should include a business profile of the taxpayer, description of intragroup transactions, comparability analysis, and the selection of transfer pricing method and identified comparables.

Transfer pricing documentation should be submitted to the tax authorities within 60 days of their request. The transfer pricing documentation does not have to be in Estonian, but the tax authorities may ask the taxpayer for a translation.

Other than the formal transfer pricing documentation and general requirement to disclose the transactions with the related parties in the annual reports, there are no additional reporting requirements related to transfer pricing in relation to inter-company transactions.

Other regulations

Taxpayers and tax authorities are encouraged *expressis verbis* to apply the OECD Guidelines for interpreting and implementing the Estonian regulation except where they are not in agreement with the Estonian regulation.

In addition, the tax authorities have also issued guidelines of a general nature for the purposes of explaining the application of the regulation.

Legal cases

There have been few cases either resolved in the framework of administrative objection procedure or brought to court. The cases have concerned topics such as duplicative services, stewardship costs, selection of external comparables and consolidation of transactions.

Burden of proof

As a general rule, the burden of proof lies with the taxpayer, as the taxpayer is required to prove the arm's-length nature of the inter-company dealings. If the taxpayer has submitted proper documentation, the burden of proof is shifted to the tax authorities, who must demonstrate why the taxpayer's transfer prices are not at arm's length and support it with adequate documentary evidence in order to challenge the transfer prices of the taxpayer. Once the tax authorities have proposed an alternative transfer pricing method or comparables, the burden of proof again shifts to the taxpayer to defend the arm's-length nature of its transfer prices.

Estonia

Tax audit procedures

Estonian tax authorities have tax inspectors who specialise in transfer pricing. As a general rule, tax authorities do not perform special transfer pricing audits, but the pricing of inter-company dealings is reviewed in the course of a general tax audit where transfer pricing is audited simultaneously with other types of taxes.

The transfer pricing audit procedures must follow the general tax procedures established for tax audits. The tax authorities may request all relevant data, such as accounting records and other supportive documentation, and have interviews with the management and employees. Information may also be requested from third parties, including credit institutions.

The tax audit is usually finalised with the submission of a written report of the tax findings to the taxpayer. The taxpayer is entitled to file a written response accompanied by additional documentary evidence, if necessary. Any resulting transfer pricing adjustment is imposed by the appropriate local tax office of the tax authorities.

Revised assessments and the appeals procedure

Additional assessments and any penalties imposed by the tax authorities can be appealed by the taxpayer within 30 days of receipt of the tax verdict. The appeal may be submitted to the tax authorities, with review of the appeal occurring generally within 30 days. If the appeal is unsuccessful, the taxpayer is entitled to submit a new appeal to the court within 30 days of receiving the decision from the tax authorities. As an alternative, the taxpayer may submit an appeal directly to the court; appealing first to the tax authorities is not obligatory.

As a general rule, regardless of whether an appeal has been submitted, the taxpayer is required to pay the imposed tax within 30 days of receipt of the tax verdict. Under certain circumstances, the tax authorities or court may postpone the payment of tax until the dispute is resolved. Should the appeal be successful after the tax has been deposited by the tax authorities, overpayment of tax bears late payment interest amounting to 0.06% per day payable to the taxpayer.

Additional tax and penalties

Taxpayers are liable to self-assess the arm's-length nature of intercompany transactions. Any transfer pricing adjustment must be declared and the tax remitted monthly, as the period of taxation is a calendar month. The combined corporate income tax and payroll tax return (form TSD with appendices) must be submitted to the local tax authorities and the tax must be paid by the tenth day of the month following a taxable distribution or payment.

Tax arrears bear late payment interest (0.06% per day) and 21/79 corporate income tax will be levied on late payments' interest paid. In certain circumstances, transfer pricing adjustments may also trigger double taxation. There are no special transfer pricing penalties.

Tax returns are open for investigation generally for three years from the dates of submission. This statute of limitation can be extended for another three years if the authorities discover intentional non-payment of tax.

Resources available to the tax authorities

For the purposes of improving their transfer pricing expertise, transfer pricing trainings have been held for the tax inspectors. It is also understood that the tax authorities are able to use international databases such as Amadeus for performing benchmarking studies

Use and availability of comparable information

Comparable information is required in order to substantiate the arm's-length nature of the inter-company dealings and should be included in the taxpayer's transfer pricing documentation.

Estonian companies are required to make their annual reports publicly available by filing the copy with the local authority (i.e. Estonian Commercial Register). These annual reports can be used as comparables. In addition, taxpayers are entitled to use international comparables.

As a general rule, internal comparables are preferred to external comparables. In addition, local comparables are preferred to foreign comparables (e.g. pan-European or global). The use of secret or non-public comparables is not accepted.

Risk transactions or industries

Although administrative practice is inconsistent, sensitive areas are emerging such as loss-making companies, management services and financing.

Limitation of double taxation and competent authority proceedings

There is no special regulation to provide relief from double taxation of domestic inter-company transactions. The general procedure of refunding overpayments of tax may be insufficient for some cases and may trigger double taxation.

Relief from double taxation in cross-border inter-company transactions can be sought through the tax treaties concluded by Estonia that, in most cases, include provisions for a mutual agreement procedure. Estonia has also ratified the Arbitration Convention (90/436/ECC) that should provide relief from double taxation related to tax disputes inside Europe.

Advance pricing agreements (APAs)

Currently, there are no provisions enabling taxpayers to negotiate APAs with the tax authorities.

Anticipated developments in law and practice

We are not aware of any significant anticipated developments in law. It is expected that new transfer pricing law cases and more administrative practice should emerge in the close future.

Liaison with customs authorities

In Estonia, both tax and customs authorities are within the authority of the Estonian Tax and Customs Board. It is assumed that there is exchange of information between these departments but there is no prescribed approach for the use of

Estonia

certain information of one area in the other area (i.e. transfer pricing analysis for customs purposes).

OECD issues

Estonia is a member of the OECD and the taxpayers and Estonian Tax and Customs Board are *expressis verbis* encouraged to apply OECD Guidelines for interpreting and implementing the Estonian Regulation in situations where OECD Guidelines do not contradict the Estonian Regulation.

Joint investigations

In Estonia, the tax authorities have conducted joint investigations covering both taxation and customs of a taxpayer.

At this stage, we are not aware of any joint international transfer pricing tax audits conducted in cooperation with foreign tax authorities.

Thin capitalisation

There are no thin capitalisation rules in Estonia.

Management services

Estonia has not established any special transfer pricing regulation in relation to inter-company management services. As a result, taxpayers are entitled to follow the principles introduced in the OECD Guidelines for the purposes of establishing the arm's-length nature of inter-company management fees charged.

However, when auditing intragroup services, tax auditors tend to test whether the intragroup services have actually been provided, if the business services are related, and if the management fee meets the arm's-length nature. To prove the existence of the management service transaction, a management service agreement and an invoice as well as other documentary evidence to substantiate the provision of the services and its benefits to the recipient should be in place and maintained.

30.

Finland

Finland

Introduction

The bill containing legislation on transfer pricing documentation rules has been in effect from 1 January 2007. This has significantly increased the number of transfer pricing audits in Finland. Since January 2012 all transfer pricing issues are centralised to the Large Taxpayer's Office. Transfer pricing is one of the key areas of a tax audit and applies to Finnish multinationals as well as Finnish subsidiaries of foreign multinationals. It is estimated that the centralised transfer pricing project will increase the number of tax audits. Moreover, the tax administration has stated that monitoring of transfer pricing will be primarily done through tax audits instead of standard annual assessment.

Statutory rules

Transfer pricing adjustment

Article 31 of the Assessment Procedure Act (VML) prescribes the arm's-length principle for related party transactions. According to Art 31 VML, in the event a taxpayer and a related party have agreed upon terms or defined terms that differ from the terms that would have been agreed upon between independent parties and, as a consequence, the taxable income of the taxpayer falls below, or the taxpayer's loss increases, compared to the amount that the taxable income would otherwise have been, the taxable income may be increased to the amount that would have accrued in case the terms had followed those that would have been agreed upon between independent parties. Related party transactions are defined on the basis of direct or indirect control. The arm's-length requirement also applies to transactions between the company and its permanent establishment.

Documentation

The documentation rules are contained in Articles 14a-14c of the Assessment Procedure Act and provide that documentation establishing the arm's-length nature of transactions between related parties should be drafted on cross-border transactions. According to the rules, the Finnish transfer pricing documentation should include the following:

- Description of the business.
- Description of related party relationships.
- Details of controlled transactions.
- Functional analysis.
- Comparability analysis, including information on comparables, if available.
- Description of the pricing method and its application.

Finland

The description of the business should contain a general description of the business of the taxpayer and the group the taxpayer belongs to. The description could include recent history of the group, a description of the taxpayer's position on the market, and information on business environment and the taxpayer, any of which can be used to evaluate circumstances affecting the transfer pricing. It is separately stated in the government proposal concerning the transfer pricing legislation that it is important to describe the business strategy and changes to the business strategy. It should also be noted that the business description needs to be relevant to the transfer pricing of the company.

The description of the related parties should include information on related parties with whom the taxpayer has had business activities during the tax year, or whose business activities affect, directly or indirectly, the pricing of the transactions between the taxpayer and a related party. The information should include the basis for the related party relationship and the organisational structure of the group.

Details of controlled transactions should include the following information on intragroup transactions:

- Type.
- Parties.
- Value in euros (EUR).
- Invoicing flow.
- Contractual terms.
- Relationship to other transactions with related parties.

In addition, a list of relevant agreements (including copies of the most important agreements) should be included along with a list of cost allocation agreements, advance pricing agreements (APAs) and advance rulings, and any rulings issued by the tax authorities to the other party of the transaction.

The aim of the functional analysis is to analyse the transactions between related parties by taking into account the functions, assets and risks involved. Identifying the intangible property is extremely important. In addition, the risks of each party should be carefully analysed. It is stated in the tax authorities' guidance that a detailed description of both parties is required, as well as a characterisation of the entities.

The comparability analysis compares the related party transactions to unrelated party transactions. The analysis should include the factors affecting the comparability, including the functional analysis, the nature of the transferred assets or services, the terms and conditions, and the economical factors affecting the parties. Information on the search for comparables should also be included (i.e. information on the selection criteria, arguments, factors affecting the comparability and any adjustments made).

The description of the pricing method and its application should include the reasoning for the selection of the method, as well as a clarification of the method applied. The clarification should include calculations used to verify the arm's-length nature and details on adjustments made. Assumptions made and conclusions drawn should also be described.

Transfer pricing documentation should be submitted to the tax authorities within 60 days from a request. However, a taxpayer would not be required to submit transfer

pricing documentation earlier than six months after the end of the accounting period in question. Additional information requests should be complied with within 90 days of the request.

Based on the above, no contemporaneous documentation during the tax year would be required. However, the legislative proposal states that a taxpayer should monitor its transfer prices during the tax year, as it is not possible to amend the taxable income downward on a tax return in Finland. During the tax year it is possible to make an adjustment to bring pricing in line with the arm's-length principle; such an adjustment would be included in the calculation of taxable income.

A relief from the documentation requirement is being applied to small and medium-sized enterprises. These enterprises do not need to prepare transfer pricing documentation. The definition of small and medium-sized enterprises follows the European Commission recommendation 2003/361/EC. Consequently, the relief will, in principle, apply to companies belonging to a group with turnover of no more than EUR 50 million or balance sheet of no more than EUR 43 million and less than 250 employees. Employees include those employed in a group or company, full- or part-time workers, seasonal workers and owners who participate in managing the company. The number of employees is expressed in annual working units, where a full-time worker is one unit and the other workers are divided in partial units.

If the requirements of a small and medium-sized enterprise are exceeded during a year, the documentation requirements will not be imposed during that year.

According to the Finnish tax authorities, the requirements for transfer pricing documentation can be fulfilled with an EU transfer pricing documentation.

In terms of the language to be used in the documentation, the proposal for legislation states that a transfer pricing documentation should be accepted in Finland, even if it was drafted in English. A translation to Finnish or Swedish should be required only when it is necessary for the purposes of conducting the taxation of the entity in question.

Disclosure on tax return

Taxpayers are required to disclose on their annual tax return whether they have had related party transactions during the tax year in question and whether they are obliged to maintain transfer pricing documentation provided in 14a of the Assessment Procedure Act. Beginning from the tax year 2009, taxpayers who have the obligation to maintain the transfer pricing documentation are also required to file an additional tax return form (Form 78) describing the intragroup cross-border transactions and their volumes. However, Form 78 is not intended for explanations of transfer pricing methodology.

Other regulations

On 19 October 2007, the tax authorities published guidelines dealing specifically with documentation. The Organisation for Economic Co-operation and Development (OECD) Guidelines on transfer pricing, while not legally binding in Finland, are important in practice. Decisions of the Finnish courts, although they do not specifically refer to the OECD Guidelines, are compatible with them. Finnish legal commentary also follows the principles in the Guidelines.

Finland

Non-deductibility of economic support

It should also be noted that economic support given by a Finnish parent company to a loss-making foreign subsidiary has previously been deductible for tax purposes under certain conditions. An amendment to the business income tax act has abolished this opportunity. The amendment is applied to accounting periods ending on or after 19 May 2004.

According to the amended rules, costs incurred in improving the economic status of the related party company without counter-performance are non-deductible for tax purposes. According to the provision in the tax law, support given to a company is not deductible for tax purposes if the company giving the support or other companies in the same group or the above-mentioned companies together own at least 10% of the share capital of the company receiving the support.

Since only support without counter performance from the other party is non-deductible, our view is that, for example, market penetration support that fulfils the arm's-length criteria should be deductible for tax purposes. But although some tax authorities share our view, there are no published court rulings on the issue.

Legal cases

Several cases have been brought to court which establish some principles for dealing with transfer pricing and illustrate how the arm's-length rule can be applied in practice. Some of the rulings of the Finnish Supreme Administrative Court are set out below. However, to date there is no published legal case dealing with transfer pricing documentation.

Case 1990/483

A Finnish company paid penalty interest to its Swedish parent company in respect of payments made after the due date. The parent company had not paid penalty interest on similar late payments to the Finnish subsidiary. In these particular circumstances, the penalty interest was held to be a hidden distribution of profit as defined in Section 73 of the Assessment Act.

Case 1986/3441

A Finnish company that manufactured and marketed lures sold 90% of its products by exporting the majority to North America. In 1981 it established an Irish subsidiary. Two models in the product range were exported incomplete to Ireland, where they were finished and sold to the North American market. The Irish company benefited from favourable tax rates in the first 10 years of its activities.

In the next tax year, the parent company sold blanks to Ireland for FIM 916,488 and, after production costs of FIM 724,856, made a profit of FIM 191,632 or a gross profit margin of 20.9%. The Irish company finished these blanks and sold them in the North American market for FIM 4.3 million and, with associated costs of FIM 1.9 million, the Irish company made a profit of FIM 2.4 million or a gross profit margin of 55.8%.

The court held that the transfer price was different from what would have been agreed between two parties acting on an arm's-length basis. The taxable profit of the Finnish parent was increased by FIM 291,605 to take into account the hidden profit distribution to the subsidiary.

Case 1993/3009

A Finnish company, whose main activities were photographic development and wholesaling of photographic products, entered into a marketing services agreement with its US-resident parent company under which it received technical and marketing assistance in return for an annual fee. The fee was based on an apportionment of the parent company's marketing budget, split between the US and Finnish companies on the basis of their respective turnover. The agreement contained a clause limiting the maximum payment by the Finnish company to 1.5% of turnover.

In three consecutive years, the Finnish company paid marketing service charges equivalent to 0.59%, 0.44% and 0.33% of turnover. In return, it had received from the US parent access to a computerised quality control system, advice on the recovery of silver, various services for eliminating equipment defects and functional problems, and training planning services.

Based on the documentation presented, the Supreme Court found that it was necessary to have regard to the price that would have been paid to receive all of the services provided, if they could be obtained, and that it had not been proven that the agreement was on terms different from those that would have been agreed between independent parties. Consequently, the court overturned the additional assessments submitted by the tax authorities.

Case 1994/1847

A global group operated in 15 European countries in the business of manufacturing electrical fittings and special tools for computer-controlled automated systems. Its Finnish subsidiary imported wholesale products and distributed them in the local market. Under a licensing agreement, the company paid a royalty based on turnover to the US resident parent company. The tax authorities took the view that the activities of distributor and wholesaler did not justify paying a royalty. The company argued that the transfer price charged for goods did not take into account the research and development (R&D) costs that the parent incurred and therefore a royalty was justified. The company produced evidence that the lowest price paid by an unrelated dealer for the same products was significantly higher than the intragroup price plus royalty.

The court considered all of the services, rights and other benefits enjoyed by the Finnish company under the licensing agreement and the evidence provided by the company. It concluded that the authorities had not proved that the amount paid by way of royalties based on the principle of cost distribution between group companies was higher than it would have been between unrelated parties, or that the licence agreement contained terms that were not at arm's length. The additional assessments were rejected.

Case 1999/4219

A Finnish parent company had granted its Dutch subsidiary a licence to use its trademark. Under the licensing agreement, the Dutch subsidiary paid the Finnish parent a royalty of 2% of the net income of the group. The Finnish parent also received dividends from the Dutch subsidiary. The Dutch subsidiary had sublicensed the trademark to other group companies and received a royalty of 5% of the company's net income.

Finland

The tax authorities took the view that the terms of the licensing agreement between the Finnish parent company and the Dutch subsidiary were not at arm's length. Their view was that other Finnish group companies had paid a royalty of 5% to the Dutch company in order to enable the Dutch company to pay tax-exempt dividends to the Finnish parent company.

Since the company could not present adequate reasons for the difference between the level of the royalties paid from the Dutch subsidiary to the Finnish parent company and the royalties paid from the other group companies to the Dutch company, the court held that the Finnish parent company and the Dutch subsidiary had in their licensing agreement agreed on terms that differed from the terms used between unrelated parties. The taxable profit of the Finnish parent was increased by FIM 5 million of the dividends paid by the Dutch subsidiary.

Case 2010/73

The Finnish Supreme Administrative Court ruled that the interest rate on an intragroup loan cannot be determined based on the average interest rate on the group's external lending, in the situation where the debtor company's creditworthiness and other circumstances would have made it possible for the debtor company to receive external debt financing at a lower interest rate.

The Finnish company in question had, before a refinancing of the whole group, two separate loans (total value of EUR 36 million) from a third-party financial institution at the interest rates of 3.135% and 3.25%, and collateral given by the company was equivalent to EUR 41 million. At the refinancing, the company repaid its third-party loans and took a loan (EUR 38 million) from a Swedish group company at an interest rate of 9.5%. In addition, the company gave collateral worth EUR 300 million for the benefit of other group companies. The interest rate comprised different interest rates from bank loans, risk loans and loans from shareholders. The average interest rate of the external financing of the whole group was 7.04%.

The Supreme Administrative Court ruled that the interest paid by the Finnish company to the Swedish group company clearly exceeded the amount which would have been paid between unrelated parties. The amount of tax deductible interest could not have been defined on the basis of the average interest rate of the group's external financing (7.04%) in the case where the creditworthiness of the Finnish company and other circumstances would have made it possible to receive financing at a significantly lower interest rate. The difference between 9.5% and 3.25% (amounting to total of EUR 845,354) was considered as non-tax-deductible interest and was added to the taxable income of the Finnish company.

The Supreme Administrative Court's ruling was based on the following grounds:

- The interest paid by the company to the related party clearly exceeded the amount that would have been paid between independent parties.
- According to the information received, the company in question did not receive any financing services from the group's financing company or elsewhere that needed to be considered when evaluating the arm's-length interest rate.
- It was not in accordance with the arm's-length standard to determine the amount of deductible interest by reference to the average interest rate of the external financing of the whole group in a situation where the company's own financial

position and other circumstances would have made possible financing at a lower interest.

Burden of proof

The burden of proof is said to reside with the party that can best provide the required evidence. Generally, however, the burden of proof rests with the taxpayer. Consequently, where the authorities have questioned whether transactions between related parties have taken place at arm's-length prices, the taxpayer, who in any event is the party best able to provide the evidence required, must prove his or her case.

Tax audit procedures

Selection of companies for audit

Transfer pricing may be just one of the topics considered in the course of an ordinary tax audit, or the tax authorities may just perform a transfer pricing audit. As a general rule, the authorities try to audit the largest companies at least once every five years. Also as a general rule, the companies are selected to be audited based on their line of business or specific tax risk criteria developed by the tax authorities. The tax authorities are interested in high risk companies but the tax authorities have stated that also medium-sized companies will be one of the focus areas of the transfer pricing project. However, the tax authorities do not disclose information concerning their tax risk analysis process.

As of the 2009 tax year, taxpayers are required to file a tax return form (Form 78) describing the intragroup cross-border transactions and their volumes. This Form 78 will be used as background information for audit selections.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The tax authorities may request all data, material and property that they believe is necessary to audit the tax return or to agree on an assessment or appeal, such as books and records, other documents, etc. Information may also be requested from third parties, and certain entities such as banks, and investment and insurance companies, must disclose information on request.

The audit procedure

A tax audit would usually include a visit to the company's business premises and interviews with personnel, including examination of correspondence on issues arising during the audit.

While the taxpayer has a right to be heard in the audit process, this does not amount to actual negotiation. The tax auditors make a decision as to the amount of the assessment, based upon the facts they have gathered from the taxpayer and other sources. The tax auditors would normally present a preliminary report, against which the taxpayer may give a written response, after which the report is finalised. The final report, against which the taxpayer may also give a written response, may include a proposal for an adjustment. An adjustment is imposed by the local tax office as appropriate.

Assessments and the appeals procedure

An appeal may be lodged against any adjustment in the same way as against an ordinary assessment. A taxpayer has the right of appeal to the Adjustment Board in the

Finland

first instance. The appeal must be made no later than the end of the fifth year following the year of assessment, but in every case, however, within 60 days of receiving notification of the assessment. An appeal against a decision of the Adjustment Board may be made to the administrative court and must be made within similar time limits. Appeals against the decision of the administrative court must be made to the Supreme Administrative Court within 60 days of the decision, and only if the court grants permission to do so. Leave to appeal to the Supreme Administrative Court would be granted on the basis of the following criteria:

- The appeal has an important bearing on similar cases or would secure uniformity of legal practice.
- An error in procedure or other error has taken place in the case, which by virtue of law requires the decision to be reversed.
- There are other weighty grounds for granting permission to appeal.

Additional tax and penalties

A failure to comply with the documentation requirements could result in a tax penalty being applied. In case the required documentation or additional information is not submitted in a timely manner, or if the information submitted is essentially incomplete or incorrect, a tax penalty of a maximum EUR 25,000 could be imposed.

Penalties may be charged where an additional assessment is made. They are charged either by way of administrative fines or by imposition by the criminal courts. Administrative fines are levied in cases of deliberate or negligent returns and for failure to file returns on time. The administrative fines may amount to up to 40% of the increase of the taxable income, usually being between 5% and 10%. Penalty interest is charged at the market rate on any unpaid tax. Penalties, tax increases and penal interest on income tax paid in Finland are not tax deductible.

Use and availability of comparable information

No comprehensive Finnish databases containing third-party comparable information are available. However, the tax authorities have subscribed to common commercial databases, which are used for the purposes of obtaining comparable third-party data. This data is regularly used as a basis for suggested assessments.

According to the transfer pricing legislation, a comparability analysis should include the factors affecting the comparability; for example, the functional analysis, the nature of the transferred assets or services, the terms and conditions and economical factors affecting the parties. Finnish transfer pricing documentation need not include a benchmark study for external comparables. In practice, this means that no documentation penalties are levied, even though the transfer pricing documentation does not include a benchmark study. However, unless the company provides comparables to support its transfer pricing, the tax authorities are likely to perform a search during their audit.

It is stated in the legislative proposal that, in accordance with the EU Code of Conduct on European transfer pricing documentation, pan-European comparables searches should not be disregarded offhand. However, in practice European-wide comparable searches are regularly challenged in cases where the tax authorities have succeeded in finding comparable data on Finnish or Nordic companies.

Risk transactions or industries

There is no tendency to single out any one business sector. It is clear, however, that in the past there has been a tendency to examine service fees and royalties, rather than the transfer price of goods.

For the moment, financial transactions, valuation of intangible assets, royalty payments and business restructuring, especially, seem to be scrutinised by the Finnish tax auditors.

Tax auditors have recently paid attention to the group's internal financial arrangements. In many tax audits the arm's-length interest rate of intragroup loans or cash pool has been questioned. Furthermore, in some cases cash pool receivables or liabilities have been re-characterized as long-term receivables or liabilities. Financial transactions may draw the tax auditors' attention if domestic subsidiaries' interest expenses are considerably high, interest incomes are very low or the intragroup loans are not interest bearing. In some cases, a holding company structure has been challenged and business reasons for the structure have been requested.

Valuation of intangible assets is being scrutinised by the Finnish tax auditors, especially in cases of business restructurings when the intangible assets are being transferred from Finland to a foreign group company. In addition, practical experience shows that tax auditors quite often question both the justification of royalty payments for intangible property and the amount of royalty paid. In particular, royalties for trademarks have been questioned in several cases.

Furthermore, the current practise shows that transfer pricing audits related to permanent establishments have been increased and the allocation of profits to the permanent establishment has been questioned.

Limitation of double taxation and competent authority proceedings

Finland has created a reservation to the OECD Guidelines concerning the use of the competent authority process. This does not mean that the process will not be used at all, but rather that it will not automatically be used. In fact, Finland has concluded several tax treaties that include competent authority clauses.

In practice, competent authority cases have been rare. The most common source of complaint is the question of whether or not a permanent establishment exists in Finland; there have been only a few issues concerning transfer pricing. It is difficult to estimate the probability of obtaining relief in transfer pricing issues through the competent authority process, and there have been cases where relief has been refused. In practice it has been difficult to obtain relief and the process has been very slow.

Advance pricing agreements (APA)

Since 1 January 1997, amendments to the Assessment Procedure Act came into force, introducing a new system of advance notice available to the taxpayer from the tax administration. This procedure will also cover transfer pricing matters, valuation issues and questions relating to tax-avoidance legislation.

At present, in accordance with Section 84 of the Assessment Procedure Act, advance rulings on the tax consequences of proposed transactions can be given by the Central

Finland

Tax Board (Board). An advance ruling is given only on application by the taxpayer and in cases where the Board finds there is a point of importance either to the taxpayer personally or as a precedent. The Board may indicate the tax consequences of the proposed action but it will not issue advice as to the best way to minimise tax. In practice, the Board does not give advance rulings on valuation issues or tax avoidance legislation, both of which are relevant for transfer pricing.

At the moment Ministry of Finance is preparing a legislative proposal for an APA program. The Ministry of Finance has also requested clarifications for the APA procedure from the Large Taxpayer's Office. It is expected that the number of APA procedures will increase in the future as a result of the more effective transfer pricing monitoring as well as new APA legislation.

Anticipated developments in law and practice

The Ministry of Finance is currently preparing a proposal for APA legislation. However, the Ministry of Finance has not announced any schedule for the expected timeline to launch the APA program.

Liaison with customs authorities

There has been no general exchange of information between the income tax and customs authorities to date, although particular information may be exchanged at the specific request of the other party.

OECD issues

As an OECD member, Finland has approved the OECD Guidelines. The tax authorities follow the OECD Guidelines and other guidance approved by the OECD very carefully. However, issues may arise as to how to interpret the OECD guidance.

Joint investigations

It is possible that Finland could join with another country to undertake a transfer pricing audit. This has happened before, especially with other Nordic countries.

31.

France

Introduction

Statutory rules on transfer pricing adopt the arm's-length principle for cross-border related party transactions. In addition, a considerable number of court cases deal with issues relevant to transfer pricing, which aids in the interpretation and application of the legislation. In parallel with increased resources within the tax administration, recent legislative developments emphasise the focus of the French Tax Administration (FTA) on transfer pricing issues through new rules for documentation as well as tax measures against tax evasion.

Statutory rules

The following main statutory rules address transfer pricing:

- Section 57 of the French tax code (*CGI – Code Général des Impôts*).
- The concept of *acte anormal de gestion* (an abnormal act of management) also allows the FTA to deny tax deduction for expenses which are not related to normal acts of management or could not be deemed to have been incurred for the benefit of the business. The courts decide whether this concept applies by comparing the commercial practices of the company under review with what they judge to be 'normal' acts of management.
- Sections L 13 AA, L 13 AB and L 13 B of the tax procedure code, which set out transfer pricing documentation requirements.
- Section L 188 A of the tax procedure code.

The FTA also released a transfer pricing guide dedicated to small and medium enterprises in November 2006.

In theory, the tax authorities may choose whether to apply Section 57 or the concept of *acte anormal de gestion* when questioning a transfer pricing policy. In reality, this element of choice is likely to be removed by the limitations of each regulation. Section L 13 B reinforces the French Revenue powers of investigation by imposing information requirements in case of a tax audit involving transfer pricing. This law facilitates the application by the French Revenue of Section 57. Section L 188 A extends the statute of limitations when the French Revenue requests information from another state under the exchange of information clause of the applicable tax treaty.

Section 57 – Indirect transfer of profits

Section 57 was introduced into the French tax code on 31 May 1933, and has been regularly updated since this date.

Section 57 provides that 'To determine the income tax owed by companies that either depend on or control enterprises outside France, any profits transferred to those

France

enterprises indirectly via increases or decreases in purchase or selling prices, or by any other means, shall be added back into the taxable income shown in the companies' accounts. The same procedure shall apply to companies that depend on an enterprise or a group that also controls enterprises outside France'.

It may be applied only in relation to cross-border transfer pricing issues. Enforcement of Section 57 requires the tax authorities to prove that a dependent relationship existed between the parties involved in the transaction under review and that a transfer of profits occurred. However, it is not necessary to prove dependency when applying Section 57 to transfers between entities in France and related entities operating in tax havens.

Dependency can be legal or *de facto*. Legal dependency is relatively easy for the tax authorities to prove. It is defined as direct control by a foreign entity of the share capital or voting rights of the French entity under review. It can also mean dependency through indirect control, such as through common management. *De facto* control results from the commercial relationship that exists between two or more enterprises. For example, where the prices of goods sold by A are fixed by B, or where A and B use the same trade names or produce the same product, there does not have to be any direct common ownership. However, the fact that a large proportion of two or more companies' turnover results from transactions conducted between themselves does not necessarily mean that there is *de facto* dependency. The Tax Administrative Court of Paris ruled on 13 February 1997 that there was *de facto* control in the following situation: One French company in charge of the distribution of books published by a Swiss corporation was using personnel and equipment provided by a subsidiary of the Swiss entity, had the same management as the Swiss entity, and had authority on the choice of books to be distributed.

A transfer of profits may be inferred where, for example, transactions occur at prices higher or lower than prevailing market prices. This includes all types of transactions, including commodities, services, royalties, management services or financing.

Acte anormal de gestion

This concept, which derives from Section 39 of the CGI, was developed by the *Conseil d'Etat* (CE), the French supreme tax court in charge of corporate income tax issues.

For the determination of taxable income, expenses are tax deductible only to the extent that they are incurred for the benefit of the business or within the framework of normal commercial management.

To invoke the concept of an *acte anormal de gestion*, it is necessary to prove that a transfer of profits has taken place and that there was a deliberate intention to move profits or losses from one taxpayer to another. It may be applied to domestic and international transfer prices as well as to corporations or branches.

Under this concept, a tax deduction may be refused for charges not incurred for the benefit of the business or not arising from normal commercial operations.

Section L 13 AA – Transfer pricing documentation requirements

The Amended Finance Act for 2009, passed on 31 December 2009, introduced into French law new requirements for transfer pricing documentation. Following the adoption of the new documentation requirements, the FTA recently released specific

guidance to clarify the transfer pricing documentation law (Regulation 4 A-10-10). The new general transfer pricing documentation requirements apply to tax years beginning on or after 1 January 2010 and to any one of the following types of entities located in France:

- a. With turnover or gross assets on the balance sheet exceeding 400 million euro (EUR).
- b. That hold directly or indirectly more than 50% of capital or voting rights of a legal entity mentioned in (a).
- c. With more than 50% of their capital or voting rights held directly or indirectly by a legal entity mentioned in (a).
- d. That benefit from a ruling granting a worldwide tax consolidation regime.
- e. That are part of a French tax group in which at least one legal entity of the tax group meets one of the requirements mentioned under (a), (b), (c) or (d).

The regulations state that the permanent establishments are also within the scope of the transfer pricing documentation requirements.

The new law requires formal and compulsory transfer pricing documentation, including the following information:

- General information on the group:
 - General description of the activity, including changes occurred during the audited years.
 - General description of the legal and operational structures forming the group identifying the related companies engaged in the intragroup transactions.
 - Description of the functions performed and of the risks borne by the related companies to the extent they have an impact in the audited company.
 - Identification of main intangible assets having a link to the audited company (e.g. patents, trademarks, trade names, know-how, etc.).
 - Broad description of the transfer pricing policy.

According to the administrative regulations, such general information should allow the FTA to understand the economic, legal, financial and fiscal environment of the group. The main entities of the group must be presented, with a level of detail depending on the importance of their activity within the group, but also depending on how much their functions and assets impact the group's transfer pricing policy.

- Specific information on the audited company and on the transfer pricing policy. In particular, the following elements should be provided:
 - Description of its activities, including changes that took place during the audited period.
 - Information on operations carried out with related parties, including nature and amount of flows (global flows per category of transactions; this covers royalties in particular).
 - List of cost-sharing agreements, advance pricing agreements (APAs) and rulings obtained having an impact on the results of the company.
 - Description of the transfer pricing policy with an explanation on the selection and application of the retained method, in compliance with the arm's-length principle and with the analysis of the functions performed, of the risks borne and of the assets used by the audited company.

France

- Where relevant, an analysis of the comparability elements taken into account in the application of the retained transfer pricing method.

According to the regulations, such specific information should allow the FTA to assess whether the transfer pricing policy applied is compliant with the Organisation for Economic Co-operation and Development's (OECD) arm's-length principle.

The audited company may also provide any other relevant documents.

The complete set of documentation should be maintained and provided immediately upon request (which could be the first day of a tax audit). The regulations, however, provide for a 30-day extension if the documentation is not available or incomplete, with a possible additional extension of 30 days.

The FTA may assess a maximum penalty of 5% on the transfer pricing adjustment in the case of missing or incomplete documentation, with a minimum of EUR 10,000 per audited year. If there is no transfer pricing adjustment, the penalty imposed is EUR 10,000 per audited year for missing or incomplete documentation.

Therefore, it is advisable for companies within the scope of the new regulations to maintain contemporaneous documentation in anticipation of tax audits considering the stricter deadlines and penalties.

Companies outside the scope would remain subject to documentation requests during tax audits. Even if penalties are lower and deadlines not so strict, these companies would still be at risk of arbitrary reassessments for not having transfer pricing documentation in place.

Section L 13 AB

Operations that are conducted by French companies with an associated entity situated in a non-cooperative state or territory are subject to an additional documentation obligation. The French company must notably provide the financial statements of the associated entity.

Section L 13 B

Because of the new documentation requirements, Section L13 B is now applied mainly to small and medium businesses (SMBs). The Economic and Financial Act, published on 13 April 1996, contains procedures for transfer pricing examinations. This legislation gives the FTA a clear right to request information on the taxpayers' transfer pricing policy in the course of a tax examination when it has evidence upon which to presume that an indirect transfer of profits abroad has occurred, as defined by Section 57 of the French tax code. This procedure applies only in the course of a normal examination.

Four types of information may be requested under this procedure:

- The nature of the intercompany transactions.
- The method for determining prices for transactions.
- The activities of the foreign enterprises, companies or joint ventures.
- The tax treatment of the intercompany transactions.

Requests shall include a notification of the expected response time to the audited enterprise. The time allowed for response, which shall be no less than two months, may be extended upon justification to a total of no more than three months.

If an enterprise has responded inadequately, the administration may demand additional information within 30 days with a formal notice. This notice shall specify the desired additional information and mention the penalties in case of non-response. Thereafter, the sanctions imposed on the taxpayer will be twofold:

- A EUR 10,000 fine for each period under audit.
- The right for the FTA to reassess the taxpayer's profits on the basis of the information at its disposal. (This procedure, however, remains controversial. The burden of proof of the dependence and of the non-arm's-length character of the transactions rests with the FTA).

On 23 July 1998, the FTA published a regulation commenting on the provisions of Section L 13 B. This regulation specifies in particular that resorting to Section L 13 B is neither obligatory nor systematic – it takes place only if the tax inspector has not been provided with sufficient explanations during the tax audit.

Regarding the transfer pricing method used, any method invoked by the enterprise can be considered acceptable, provided that it is justified by contracts or internal memos describing the method, extracts of the general or analytical accounts, economic analyses (notably on the markets), the functions fulfilled, the risks assumed and the comparables retained. The FTA still broadly interprets elements required to justify the transfer pricing method.

Section L 188 A

Section L 188 A provides for an extension of the statute of limitations and is open to the authorities when they request information from foreign tax administrations before the end of the initial statute of limitations. The new statute of limitations expires at the end of the year following the year when the information requested is obtained or, failing response, at the end of the fifth year following the year that is audited. For example, if the financial year corresponds to the calendar year, intragroup transactions conducted in 2001 may, in principle, be investigated within the framework of the authorities investigating a company, up to 31 December 2004. If a request for information is put to a foreign tax authority in December 2005, these transactions may remain open to reassessment for the years 2006 and 2007.

The extension of the statute of limitation applies if there is a request for information bearing on intragroup transactions or on entities established in countries with favourable tax regimes (French tax code Section 209 B), but also in cases of requests for information with relevance to the foreign assets, credits, income or activities of a French taxpayer.

Other regulations

In addition to the legislation specific to transfer pricing described above, the following texts and regulations are relevant to the issue:

- The terms of various tax treaties.

France

- Sections of the French tax code that deal with related issues such as transactions with entities in tax havens.

Section 238 A limits the deductibility in France of commissions and other payments paid to entities located in tax havens. A company is deemed to benefit from a privileged tax regime when the difference between the foreign corporate tax and the tax that would have been paid in France exceeds 50%.

Under Section 209 B, income which is transferred under certain conditions to a controlled foreign company (CFC) or a permanent establishment (PE) which enjoys a privileged tax regime has to be recaptured in France and is subject to corporate income tax. These French CFC rules may not be applied if the foreign company is located in a member state of the European Union (EU) and if the arrangement in question is not an artificial arrangement set up only to obtain a tax advantage. In its regulations, the FTA makes a reference to the ICI and Cadbury Schweppes ECJ cases to explain the meaning of 'artificial arrangements' mentioned in the EU safeguard clause (Administrative regulation: 4 H-1-07).

French CFC rules do not apply to foreign-controlled entities which carry on an active trade or business in a non EU country where they benefit from a privileged tax regime. For fiscal years ending on 31 December 2012, and thereafter, the burden of the proof rests with the taxpayers.

- Sections of the French tax code that deal with specific measures against states or territories considered to be non-cooperative:

As from 1 January 2010, new Section 238 0-A defines, from a French perspective, non-cooperative states or territories (NCST) as a country or territory that:

- is not a member of the EU
- has been reviewed and monitored by the OECD Global Forum on Transparency and Exchange of Information
- has not concluded at least 12 administrative assistance agreements/treaties that allow a complete exchange of information for tax purposes, and
- has not concluded such an agreement/treaty with France.

The NCST list is updated annually to take into account, in particular, the effective implementation of the tax information exchange agreements.

As of 1 January 2012, NCST are the following states or territories: Botswana, Brunei, Guatemala, Marshall Islands, Montserrat, Niue, Philippines, and Republic of Nauru.

Withholding tax on passive income is increased to 50% for operations with NCST. Amounts paid to entities located in an NCST may also not be tax deductible for French corporate income tax purposes.

- The first pure transfer pricing regulation was issued on 4 May 1973, in the form of a note. This regulation is the main element of the FTA doctrine, and in April 1983, the tax authorities finalised and published this commentary on their interpretation of the transfer pricing legislation once the Section 57 was amended to cover transactions with tax havens.

- A new regulation published on 23 February 2006, on bilateral and EU mutual agreement procedures.
- Regulations published on 7 September 1999, on bilateral advance pricing agreements and 24 June 2005, on unilateral advance pricing agreements.
- The tax authorities' commentary on legal cases involving transfer pricing, which has been issued over the years in the form of administrative regulations¹.

Legal cases

Several cases over the years have established important principles for dealing with transfer pricing issues. These are summarised below:

Parent-subsidiary relations: expenses invoiced by a foreign parent company

SA Borsumij Whery France, CAA (Cour Administrative d'Appel) Paris 11 February 1997

The administration considered that the reimbursement of such a charge represented a transfer of profits abroad 'insofar as the French company has not substantiated the reality of the services, invoiced in a vague manner for services which the French company could perform itself'. The submission of 'incomplete documents of a general nature' was deemed to be insufficient. This analysis was then confirmed by the French Supreme Tax Court.

Parent-subsidiary relations: partnership

SA Cogedac, CE 23 November 2001

A parent company and its subsidiary incorporated a partnership in which the subsidiary contributed its purchasing platform. Ninety percent of the benefits were attributed to the parent company. In the absence of a significant contribution from the parent company to the activity of the partnership, and considering the lack of commercial interest for the subsidiary to enter into the partnership convention, the *Conseil d'Etat* ruled that the conclusion of the partnership convention by the subsidiary was constitutive of an abnormal act of management.

Reality of services

SA Bossard Consultants, CAA Paris 17 March 1998

A subsidiary company, which paid royalties for a licence of a trademark to its parent company, could not deduct part of the sums paid as a temporary increase of the royalties by one point because it could not justify the reality of the public relations and promotion activities in respect of the trademark that the temporary increase was purported to cover.

Date to use when appraising a transfer pricing transaction

CE Ford France 16 March 1990 and CAA Paris 4 October 1994

The transaction must be appraised on the basis of facts known (or facts that could have reasonably been known in the circumstances) at the time the contract was made. The use of hindsight is not permitted.

¹ The French Revenue has merged all its regulations in a new database since 12 September 2012. We will modify in our next update the previous references.

France

Comparable searches

Société Pharmatique Industrie, CAA Paris 12 July 1994; CE Galerie Vercel 28 September 1988; SARL Solodet, CE, 21 February 1990; Reynolds Tobacco, CAA Paris, 20 November 1990; Lindt et Sprungli CE, 4 December 2002; Novartis Groupe France SA, CAA Paris, 25 June 2008; Man Camions et Bus, CAA Versailles, 5 May 2009; Microsoft France, CAA Versailles, 16 February 2012; Eduard Kettner, CAA Paris, 29 March 2012

The Pharmatique Industrie case illustrates the type of comparison that the courts require from the FTA and taxpayers. The tax authorities used five products of similar commercial reputation, distributed by three companies operating in the same pharmaceutical sector with comparable turnovers, as comparable evidence in a transfer pricing dispute.

The CE is very careful when examining comparable situations. For example, the CE, on 28 September 1998, refused to consider that situations were comparable when the FTA was relying on isolated French-based transactions when the situation under audit involved a long-lasting relationship between a French entity and its US subsidiary.

In Solodet, the comparison was rejected because the comparable products were sold in Germany rather than in France. It was judged that both the prevailing market conditions and the end use of the products in Germany were different, and that therefore the companies identified by the tax authorities were, in fact, not comparable to the French company under review.

In Reynolds Tobacco, the 2%-3% commission received by the French entity was deemed by the courts to be an arm's-length amount, even though competitors were receiving about 8% for providing similar services. This was decided on the basis that the services provided by the French company were sufficiently, if only slightly, different, and this justified the lower rate charged.

In Lindt & Sprungli, the CE approved the position taken by the FTA, even though the FTA did not support its position by reference to independent comparable data, but rather through facts and circumstances of the case at stake.

In the Novartis Groupe France SA case, the court stated that if the FTA intends to use prices existing between other companies or a profit split approach by considering the global margin realised on one product at group level to reassess the French entity, it must demonstrate that the price invoiced to the French entity by a related company does not comply with the arm's-length principle with a relevant and exhaustive economical analysis. In this case, the court notably criticized the fact that the FTA did not perform a comparable search.

In Man Camions et Bus, the Court of Appeals stated that a comparability study performed by the FTA has to be based on independent comparables acting in similar conditions and markets. In this case, the FTA did not establish that foreign European markets were similar to the French market and therefore rejected the pan-European comparable study performed by the FTA. The fact that the French entity has been loss-making for years is not, in isolation, sufficient to prove the existence of a transfer of benefit out of France.

In the Microsoft case, the distribution activity of a French subsidiary of an American group was transferred to its Irish sister company. The French subsidiary was then converted into the sales agent of the Irish subsidiary. The Commission rate earned by the French subsidiary was reduced from 25% to 18%. The French tax authorities, taking into account the previous 25% commission rate, considered that it should not have been reduced and reinstated the corresponding income into the French company's taxable income. To support their position, the French tax authorities conducted a benchmarking study. However, the Court of Appeals ruled that the mere fact that the commission rate has been reduced does not demonstrate the transfer of profits abroad. Moreover, the Court confirmed that the transfer of profits abroad was not proved due to the irrelevance of the methods used and of the comparables found by the French tax authorities. The companies were not suitable for comparison because they were not in the same market as Microsoft France and that some of them were not independent companies.

Regarding the provision of intragroup services, in the Kettner case, the Paris Administrative Court of Appeals considered that, in order to demonstrate a transfer of profits abroad, the French tax authorities have to make a comparison with independent companies in order to show to what extent the fees paid for the services did not meet the arm's-length principle.

Concept of group interest

n° 2372, CE, 24 February 1978; Sovifram, CE 3 June 1992; Société Nord Eclair, CAA Nancy, 6 March 1996; SA Rocardis, CE 26 September 2001;

The French courts consistently have supported the tax authorities in refusing to accept the idea of the interests of the group as a whole serving as sufficient justification for a particular intragroup transfer pricing policy. However, charges at cost were accepted by the courts when the charges were invoiced by a parent entity to a subsidiary, according to the 24 February 1978 CE decision.

In the 1992 decision, the CE ruled that selling at a loss imported wines by a French subsidiary to its foreign parent company is constitutive of an abnormal act of management if the French company does not obtain any counterparty. The mere facts that the French subsidiary was its parent company's exclusive provider or that the French subsidiary benefited of its parent company's clientele was not deemed to constitute a sufficient counterparty.

In a 6 March 1996 decision, the Nancy appeals court expressly accepted an invoicing of charges at cost between two sister entities. This conclusion may derive from the fact that the FTA was challenging the flow of invoices and suggested that the invoicing should have gone through the parent company, so that the loss would have been incurred by the parent entity rather than one of the sister entities. In the Rocardis decision in 2001, the CE accepted the concept of group of interest between the members of a distribution network. The CE did not adhere to the general group concept approach, but the French court reckoned with the specificity of functioning of this specific distribution network.

France

Economic or commercial benefit

Boutique 2 M, CE 27 July 1988; CAA Nancy, SAS Mc Cormick France, 8 December 2011

In a number of cases over the years, the courts have accepted taxpayers' arguments that their transfer prices satisfied the arm's-length principle because even if they were at first sight higher or lower than what would have been expected (i.e. standard market prices), they resulted in some economic or commercial benefit for them. For example, their prices increased market share.

For example, in the SAS Mc Cormick France case, products were sold by a French company to a related foreign company at a price lower than the market price and the manufacturing cost. The court considered that there was no counterpart in a situation where the considered company could not justify the alleged new clients brought by the group, free loans, and financial contributions received from the group.

In all instances where this argument is put forward, the deemed benefit must be specific and reasonable in relation to the loss or reduced revenue recognised by the French company. Where the taxpayer has been able to prove only a potential benefit, the transfer pricing policy has been adjusted.

In such cases the burden of proof lies with the taxpayer. Various court decisions have established that this applies whether the tax authorities are attempting to enforce Section 57 of the tax code or the concept of *acte anormal de gestion*.

Legal protection of the intangible licensed as royalty payment

Bentone Sud, CAA Paris 15 June 1999

Despite the fact that the patents were no longer protected and there was a lack of actual transfer of know-how, the Appeal Court of Paris accepted the deductibility of a licence fee covering patents and know-how, in addition to a trademark and a regular supply of equipment. The court judged that the access to the trademark and the right to access products made by the licensor were a valid justification for the payment of royalty. This decision is unique.

Decisions such as the above-mentioned Lindt & Sprungli confirmed that the lack of legal protection is a critical factor for the courts in appraising the arm's-length nature of a royalty flow.

Existence of a written agreement

Electrolux, CE 23 October 1991; Barassi, CAA Lyon 1 February 1995

The court ruled in Electrolux that the lack of a written agreement signed prior to transactions taking place was not relevant to the transfer pricing policy under dispute because the ongoing trade between the related companies under review supported the transfer price as described to the tax authorities.

Once an agreement has been signed, the parties must abide by it. If circumstances change and the terms no longer apply, it must be amended.

Despite the above court decision, a contemporaneous written agreement is advisable in all instances.

Sale of assets

N°17055, CE 21 November 1980; Berri Ponthieu, CE 21 June 1995

In Berri Ponthieu, the court decided that the sale of shares in a listed entity at book value, which was lower than the prevailing market value, was a non-arm's-length transaction, even though the sale was a group reorganisation.

Similarly, the acquisition of shares at a price exceeding the market value is also a non-arm's-length transaction, unless there are special circumstances.

Sale of goods or services

SARL Rougier-Hornitex, CE 26 June 1996; SNAT, CE 31 July 1992; Rouleau, CAA Bordeaux 27 December 2001; Etablissements Georges Legros, CAA Lyon, 29 October 2010; SAS Unilever France, CAA Versailles, 5 December 2011; Nestle Entreprises, CAA Versailles, March 27, 2012

The sale of products or services to related parties at a price below prevailing domestic or international prices is not considered an arm's-length transaction.

In Rougier-Hornitex, the CE decided that a sale at a loss of services by a subsidiary to a parent company during the subsidiary's first two financial years was not an abnormal act of management. The price of the services, even though generating operating losses, was not below the market price and therefore was considered an arm's-length transaction.

In the Rouleau case, the court ruled that the tax authorities did not establish an *acte anormal de gestion* by only referencing that the sales of goods and services were below the market price of uncomparable products and below a cost price determined retrospectively and including charges linked to the fact that the company was working at under-capacity.

In the Etablissements Georges Legros case, the Court of Appeals decided that setting an intragroup currency conversion rate different from the market rate can constitute a transfer of profits as defined by the Section 57 of the French tax code if it results in a price increase. In this case, such an increase in the prices was not justified by economic reasons.

In the SAS Unilever Case, a French manufacturing company was remunerated on a cost-plus basis. The company, which was in a situation of under-activity, invoiced to a foreign-related company not its actual costs (higher than for other factories of the group) but lower theoretical costs corresponding to a possible more efficient functioning. It has been judged that the resulting negative margin did not justify a reassessment. The judge considered that the French tax authorities did not prove that the transfer prices were not market prices.

Recently, the Versailles Administrative Court of Appeals ruled against the taxpayer in the following case. A French affiliate sold mineral water to a Japanese related company. The transfer pricing method resulted in a net margin of 33% for the Japanese related company deemed to be too high by the French tax authorities. They took into account the fact that in Japan, a bottle of mineral water distributed by the Japanese related company was sold to end customers at a EUR 2.5 price while the highest market price in a country where the related distributor recognised a routine 6% margin was EUR 0.78, i.e. 3.2 times lower; the net margin in Japan should have been limited

France

accordingly to 6% times 3.2, i.e. 19% according to the French tax authorities. The taxpayer argued that the Japanese related company was not a routine distributor, but a co-entrepreneur. The court however considered that it did not bring enough evidence for such a statement, and the transfer pricing adjustment was confirmed by the court.

Commission

n°39049 and 29805 CE, 26 June 1985**Vansthal France, CAA 11 March 1993**

A number of court decisions address situations where companies used related intermediaries whose activities did not justify the level of commission or remuneration paid to them. For example, the decision of the Court of Appeal in Nancy on 11 March 1993 disallowed a transfer pricing policy under which a 20%-40% mark-up was added to payments to a Swiss entity because in its capacity as a billing centre it bore no risk.

However, where taxpayers have been able to justify the nature and value of the services provided, the courts have invariably accepted the commission paid. For example, a 5% commission was found to be acceptable between A and B, where B was assisting A with promoting its exports to Italy (CE 26 June 1985).

Royalties

Caterpillar, CE 25 October 1989 ; Cap Gemini, CE 7 November 2005

In Caterpillar, a 5% royalty was judged to be an arm's-length rate for the manufacturing and assembling operations. In this case, the court refused to accept that there should be different rates for the two different activities.

In Cap Gemini, the French tax Supreme Court stated that the FTA did not demonstrate the indirect transfer of benefit in the absence of a comparability study. The criticised transaction consisted of a royalty-free licence of the Cap Gemini trademark and logo. The court considered that the fact that French subsidiaries were charged with a 4% royalty, whereas European and American subsidiaries were charged no or lower royalty, was not relevant. The court considered that the value of a trademark and logo may differ depending on each situation and market. Different situations may request different royalty rates. In its ruling, the Conseil d'Etat reaffirmed that a transfer pricing reassessment must be based on solid evidence.

Commissionaire and permanent establishment (dependent agent)

Zimmer Limited, CAA Paris 2 February 2007, CE 31 March 2010

In Zimmer Limited, the Administrative Court of Paris stated that a commissionaire of a UK principal company constituted a permanent establishment of that company in France. The French company, Zimmer SAS, distributes in France the products for Zimmer Limited and was converted into a commissionaire (acting in its own name but on behalf of Zimmer Ltd.) in 1995. The FTA considered that Zimmer SAS constituted a permanent establishment of Zimmer Limited in France because the French entity had the power to bind its UK principal in commercial transactions related to its own activities. Zimmer Limited should, therefore, be taxed on the profits generated in France according to Section 209 of the FTC and Article 4 of the double-tax convention between France and the United Kingdom.

The court concluded that Zimmer SAS constituted a permanent establishment of Zimmer Limited in France and that, accordingly, the taxation in France of the profits attributed to such permanent establishment for the years under audit was fully justified.

Following the conclusions of the ‘Rapporteur public’, Ms. Julie Burguburu, the High Court (CE 31 March 2010) nullified the earlier decision of the Paris court and agreed with the taxpayer. The High Court reconfirmed that a company has a permanent establishment in a state if it employs a person who has the authority to bind the company in a business relationship and that person is not independent vis-à-vis the company. Two criteria, therefore, need to be met in order to be qualified as a permanent establishment. The two criteria are dependence and the authority to engage.

The High Court does not address the issue of dependence, which was not debated in this case because the dependency was already established.

Concerning the authority to engage, the High Court quotes article 94 of the Commerce Code included in article L-132-1 of the new code and notes that the commissionaire acts in its own name and cannot conclude contracts in the name of its principal. It underlines that the commissionaire does not legally bind its principal because of the nature of the contract. The High Court concludes that a commissionaire cannot constitute a permanent establishment of the principal. However, the High Court also sets certain limits by stating that when it derives from either the terms and conditions of the commissionaire’s contract or any element identified during the examination of the case that the principal is personally bound by the contract agreement concluded by the commissionaire with third parties, and the commissionaire then constitutes a permanent establishment of the principal.

Cross border business restructuring

Société Nestlé Finance International LTD, TA Paris, 11 May 2011

In the Nestlé case, a French company transferred its cash pooling activity to a related Swiss entity. The cash pooling function had been purely administrative, carried out exclusively for the benefit of parties related to the French company. The French company did not receive any compensation for the transfer of the cash pooling activity. The Administrative Court concluded that the transfer of an internal administrative function to a foreign entity – even if the function only involved other affiliated companies ‘captive clientele’ – required the payment of arm’s-length compensation.

This decision has been appealed and therefore could be superseded by a subsequent decision of the Administrative Court of Appeals or the Supreme Administrative Court.

Financial charges and revenue

Interest charges

N° 75420 and n° 77533, CE, 16 November 1988; Société Arthur Loyd, CAA Paris 1 February 1994; Montlaur Sakakini, CAA Lyon, 25 October 1995; SNC Immobilière GSE, CE, 7 September 2009; France Immobilier Groupe, CAA Paris, 29 September 2009; Société d’acquisitions immobilières, CE, 22 January 2010.

The interest rate charged to a subsidiary by a French entity must be comparable with the interest rate the French entity would receive from a third party bank for an investment similar in terms and risk. The interest rate used by the courts as a reference in Montlaur Sakakini is the rate that the lender could have obtained from a third party bank.

In the France Immobilier Group decision, the Court of Appeal considered that the level of the interest rate should not be assessed by reference to the debts contracted by the

France

lender, but should be based on the financing conditions that the lender could have obtained from a third-party bank.

In the *Société d'acquisitions immobilières* decision, the High Court decided that the cash advance granted by a sub-subsidiary to its 'grandmother' in difficulty with which it had no business relations, even accompanied by the payment of interest, could constitute an abnormal act of management if the amount lent is clearly disproportionate to the creditworthiness of the borrowing company.

In practice, when an interest rate has to be set up, reference should be made to the rate that would be obtained by the borrower (stand alone approach), which is in line with the rules set by Article 212 of the French Tax Code (*see below*).

Deferral of payments

Baker International, CAA Bordeaux, 6 April 1994

Payment deferral: If interest is not charged in respect of deferrals of payments granted to a related company, it is considered either an abnormal act of management or is subject to Section 57 of the tax code.

Absence of charges for guarantees

Soladi, CAA Nancy 30 April 1998; Carrefour, CE, 17 February 1992

It is deemed to be an abnormal act of management to provide an explicit financial guarantee free of charge, unless direct actual benefit for the entity providing this support can be justified. In a decision of 17 February 1992, the French Supreme Court considered as arm's length a rate of 0.25% for this service, while the FTA was seeking 1%. The remuneration asked for this service should be commensurate with the risk incurred as well as with the market value of this service, irrespective of the actual cost.

Debt waivers

SA Les Editions JC; CE 11 February 1994; Télécoise, CE, 16 May 2003; Guerlain, CE, 23 April 2008; Beauté Créateurs SAS, CAA Paris, 12 May 2010; Société Générale, CAA Versailles, 29 June 2010; Delpeyrat Chevalier, CAA Bordeaux, 15 March 2011

The arm's-length principle also applies to debt waivers. France-based entities may waive all or part of outstanding loans to related foreign entities to the extent that they can justify some own benefit as a result of this financial assistance.

In *Télécoise*, the High Tax Court determined that a French company is allowed to deduct a provision for bad debt in relation to its foreign branch whenever the debt is related to its foreign business operations carried out through the branch. However, the French company must establish that the operation has a direct commercial benefit on the business activities carried out in France.

In the *Guerlain* decision, a French company waived its receivables towards two foreign branches in Australia and Singapore of its Hong Kong subsidiary. The judge made a reference to the consolidated results of the subsidiary (including those of the two branches), which were positive despite the financial difficulties of the branches; this was one of the arguments put forward by the judge to reject the deductibility of the waiver of the receivables in France.

In the Beauté Créateurs SAS case, the Court of Appeals applied the principle settled in the Télécoise and Guerlain cases. In this case, the court permitted the deduction of the debt waiver granted to its foreign branch by the headquarters in France because the branch provided services for the benefit of the French headquarters which increased the sales in France and thus developed the business in France.

In the Société Générale case, the parent company granted an advance to a foreign subsidiary to face its financial difficulties and to meet the capital ratio requirements demanded by the local authority. The parent company granted a debt waiver to its subsidiary. The court ruled that such a debt waiver of a financial nature did not constitute an abnormal act of management if it allowed the parent company to avoid suffering a negative impact on its reputation from the bankruptcy of its subsidiary, even where the subsidiary in question is a small one.

In the Delpyrat Chevalier case, in order to refuse the deductibility of the debt waiver, the Court of Appeals took into account the turnover generated by the operations conducted with the foreign subsidiary, which was very limited.

Choice of the financing mode of a company's operations

SA Andritz, CE 30 December 2003, n° 23-3894; Banca Di Roma, CAA Paris, 16 December 2010

The terms of Article 57 of the French Tax Code (FTC) do not have the purpose, nor the effect, of allowing the administration to assess the 'normal' nature of the choice made by a foreign company to finance through a loan, rather than equity, the activity of an owned or controlled French company, and to deduce, if the need arises, tax consequences (cf. Article 212 of the FTC – thin capitalisation).

In the Banca di Roma case, the Court of Appeals reiterated that the FTA is not allowed to decide whether a business is to be financed through debt or equity.

Management charges

Allocation of charges

N° 2372, CE 24 February 1978; Société Office Dépôt France SNC, TA Montreuil, 5 January 2012

Management charges must be shared among all of the group entities benefiting from the corresponding services. Not allocating charges among all receiving group companies is considered to be an *acte anormal de gestion*.

Management charges should generally be allocated on the basis of a detailed analysis, taking into account which of the services the company received. However, when such a breakdown would be a cumbersome exercise unlikely to result in an accurate allocation, the charges may be allocated on the basis of a less detailed calculation, such as turnover.

In the Société Office Dépôt France SNC case, a US company recharged to its French subsidiary a portion of audit costs relating to a report meant to check the efficiency of internal control within the group, in compliance with the Sarbanes-Oxley legislation. The judge considered that such costs were incurred in the interest of the US company only, and were accordingly not tax deductible in France.

France

Justifying the services

Gibert-Marine, CAA Bordeaux 12 December 1995; Société Labouchède, CE, 22 June 1983; SA Mat transport, CAA Nancy 5 July 2001

The basis of fees paid for management services will be examined in a tax audit. The taxpayer will have to provide evidence about the nature, content, and value of the services rendered by the supplier to justify the fees paid and to receive a tax deduction for them. In this context, an invoice alone is not sufficient proof.

Payments for seconded executives

n°52754, CE, 30 March 1987; Oudot Ministerial commentary, 7 September 1987

It was considered that the costs of an executive seconded from a French company to a Swiss subsidiary should be charged to the Swiss company, unless the French entity could demonstrate a commercial or economic benefit from not doing so.

Burden of proof

As a rule, the burden of proof lies with the tax authorities, unless the transfer of profits concerns a tax haven, in which case the burden of proof is transferred to the taxpayer.

However, there is now a legal requirement for taxpayers to provide documentation supporting their transfer pricing policies. Although in theory the burden of proof lies with the tax administration, in practical terms, the burden of proof has always fallen on the taxpayer where the tax authorities have deemed a profit shift to have taken place or inappropriate transfer pricing to exist.

Tax audit procedures

Selection of companies for audit

Generally speaking, transfer prices are audited as part of a formal tax audit on all issues. There are no rules as to which companies come under investigation. Major companies are audited every three to four years, unless in a loss-making situation in which the statute bar limitation rules for corporate income tax are less crucial to the tax administration. Nowadays, almost all sectors are audited, including French wholly owned entities and subsidiaries of non-France-based groups.

The audit procedure

Tax audits are generally carried out through the following procedure:

- Written notice is sent to the taxpayer informing of the date of the auditor's first visit and the particular taxes and years under investigation. The taxpayer may use a professional advisor to assist during the investigation.
- The auditor's site visits take place at the taxpayer's main premises, either the registered offices or the main place of operations. The auditor's on-site presence can last from a few days to several months, depending on the size of the taxpayer's business and the number and complexity of issues under review. There is no maximum limit to the time the auditor may spend on-site. The auditor may be assisted by information systems or specialists taken from a dedicated group within the tax administration, as well as by FTA transfer pricing experts.
- Throughout the auditor's visit(s), regular dialogue takes place between the taxpayer and the tax inspector.

- On-site investigations by the tax inspector cease when the inspector is satisfied that all outstanding questions have been answered. At this point, written notice of any underpayment is sent to the taxpayer.
- The taxpayer must provide a written response to the notice within 30 days of receipt. In the response, the taxpayer must either accept or reject the proposed adjustment. If s/he chooses to contest the reassessment, the taxpayer must set out detailed and convincing arguments to support his/her case. At this point, the taxpayer may ask to meet the tax inspector's superior. Such a request is generally not denied. After this meeting the taxpayer may then also request a meeting with the local head of the tax audit division (i.e. the appeals officer or *Interlocuteur départemental*).
- After considering the written arguments of the taxpayer (and generally only after the meetings described above have taken place), the tax authorities either reaffirms or amends their initial position in a letter. There is no time limit within which the tax authorities must provide their response.
- In their final response, the tax authorities are obliged to offer the taxpayer the opportunity to take his/her case to the *Commission Départementale*. This body consists of representatives of the taxpayer and the tax authorities and is responsible for reviewing technical, as opposed to legal, tax issues. Both parties are entitled to submit reports to the commission, which hears both arguments before issuing a decision. The decision, however, is not binding on the FTA.
- The tax authorities are allowed to raise an assessment to collect the tax only once the Commission has reached its final decision, at the latest within three years from the date of the assessment notice (unless an application for mutual agreement procedure has been filed – see *mutual agreement procedure paragraph below*).

Revised assessments and the appeals procedure

If the taxpayer still wants to appeal against the revised assessment, then s/he may submit a *réclamation pré-contentieuse*, a claim prior to court action, to the tax authorities. If there is no response from the tax authorities within six months of the claim submittal, then the taxpayer may elect to take the case to court. Otherwise, s/he can wait for the tax authorities to release their decision, after which the taxpayer has two months from that date to take the case to court.

The first court in which the case may be heard is the *Tribunal Administratif* (TA). Arguments are submitted in writing, although either or both parties may be called to the actual court hearing. Like the *Cour Administrative d'Appel* (CAA), the TA may appoint an independent expert to review the facts presented by both parties before giving its judgment.

Either party may appeal the TA's decision; this appeal would be heard by the CAA. The plaintiff has two months from the announcement of the TA's decision in which to make an application to the CAA.

In very limited circumstances, either party may ask the CE to hear the case. The CE is the supreme corporate and income-tax court, and once it has heard the case it will either issue its own final ruling or instruct the CAA to review the initial ruling decision reached by the TA.

France

Depending on the provisions of the tax treaty that applies, a taxpayer may at any time decide to pursue a competent authority claim instead of litigation. It is also possible to pursue both routes at the same time.

Additional tax and penalties

Interest at the rate of 0.40% per month, or 4.8% per year, is charged for late payment or underpayment of corporate income tax. These amounts are not deductible for the corporate income-tax basis.

If the good faith of the entity is challenged, which tends to be frequent when transfer pricing issues are scrutinised, a penalty of 40% or even 80% of the tax avoided is levied (*pénalités pour manquement délibéré*). This extra charge is obviously not deductible from the corporate income-tax basis.

In addition, a transfer pricing adjustment may lead to VAT and *taxe professionnelle*, or local tax on business activity, as well as a deemed dividend issue, depending on treaty provisions.

Resources available to the tax authorities

The resources available to the tax authorities to devote to transfer pricing investigations are increasing. Major multinational entities are audited by the *Direction des Vérifications Nationales et Internationales* (DVNI or National and International Audit Administration).

The DVNI is responsible for auditing all companies with a turnover in excess of EUR 152.4 million for industrial companies or in excess of EUR 76.2 million for service companies.

With 30 auditing teams divided by sectors, the DVNI's level of industry-specific knowledge is high. General tax auditors may be assisted by tax inspectors specialised in transfer pricing (30ème Brigade). They can also use dedicated teams in charge of computer-assisted audit or audit of tax credits for research and development expenses.

Use and availability of comparable information

Various databases are available that contain the financial accounts of most of the companies, whether or not listed on the stock exchange. These include InfoGreffé, Diane and Amadeus databases.

The FTA has extensive access to Diane and Amadeus. The inspectors specialised in transfer pricing commonly use these tools to check taxpayer's benchmarks or produce their own alternative comparable studies. The DVNI is increasingly inclined to accept or even perform pan-European benchmarks.

Risk transactions or industries

Conversion schemes with a transfer pricing element are currently scrutinised in audit situations.

The legal cases listed above illustrate that other sectors, such as retail, may also occasionally be investigated. In addition, it is worth noting that the DVNI's transfer pricing and financial inspectors recently have been put together on the same team to enhance efficiency in transfer pricing audits involving valuation issues.

Limitation of double taxation and competent authority proceedings

The FTA does not publish data on competent authority proceedings.

Advance pricing agreements (APAs)

French tax regulations provide for official APA procedures. Between 1999 and 2004, only bilateral APAs were accepted. The rectifying Finance Bill of 2004 (Article 20) codifies the legal basis for APAs and extends their scope to unilateral APAs. The APA procedure is now included in the tax procedures code (*see Article L. 80 B 7° of the Livre des procédures fiscales*). Previously, the only domestic authorisation was through a 1999 FTA regulation. In addition, an APA procedure requesting limited documentation and simplified monitoring is now available to small- and medium-size enterprises.

Bilateral APAs

In a regulation issued on 7 September 1999, the tax administration defines the conditions under which it would be willing to grant a bilateral APA. This may be initiated only with states that have signed a treaty with France containing a section equivalent to Section 25.3 of the OECD model treaty. This regulation is a fundamental change from the prior opinion expressed by the central tax administration, where they saw an APA procedure as a breach of the principle of equality. Under this regulation, the application process can be initiated in France or in the other state. The application may cover all transactions or only certain transactions, covering all or part of the companies' operations (product, function, type of transaction or line of business). Through preliminary meetings with the FTA, the exact scope of the information (tax, financial, legal, industrial, commercial, etc.) to be provided is defined. A formal request may then be addressed to the FTA. Within two months of this application, the same application must be submitted to the other tax administration. An indicative list of information to be provided is included in this regulation, but the basic idea behind this list is to establish constant debate and exchange of information with the FTA as part of the review of the application. Once the review is completed, a draft ruling is issued for final approval by the taxpayer.

The ruling defines the parties, transactions, transfer pricing method(s) elected, assumptions used, revision formula, date of application of the ruling and its duration (three to five years), and contents of the annual report to be issued by the taxpayer. The ruling may not have a retroactive effect, except within the limit of the financial year during which the application is made.

Unilateral APAs

Unilateral APAs, which until the rectifying Finance Bill of 2004 were not authorised in France, may now be accepted by the French administration. However, in a regulation issued on 24 June 2005, the FTA made it clear that it would still favour the conclusion of bilateral APAs. Unilateral APAs could be granted in cases such as:

- If the bilateral tax treaty does not provide for a MAP.
- If, despite the MAP provided in the bilateral tax treaty, the foreign competent authority refuses to conclude an APA.
- For simple issues such as management fees and allocation key issues.

France

Small- and medium-size (SME) enterprises: simplified APA procedure

As the standard APA procedure can be burdensome, a simplified APA procedure for SMEs is available as from 28 November 2006. The simplified procedure proposed by the FTA includes the following:

- Less transfer pricing documentation is required for the APA request. The documentation is limited to a legal chart of the group, the list of transactions and prices between related parties, functional analysis, description and justification of the transfer pricing method, and the financial statements of the foreign companies involved in the transactions.
- The FTA assists in the preparation of the functional analysis and in the choice of the appropriate transfer pricing method.
- An economic analysis is also requested. During an experimental period, the FTA may perform the benchmarking analysis at the request of the SME.
- Simplified content of the annual compliance report requested in the follow-up years of the APA (e.g. details of the computation of the remuneration and a statement on the substantial changes to the activity conditions described in the APA request, such as activities, functions performed, risks borne, legal/de facto dependence, assets used, accounting methods).

Only SMEs that meet the following two criteria are eligible for the simplified APA procedure:

- SMEs with (1) fewer than 250 employees, and (2) a net turnover of less than EUR 50 million or with assets that do not exceed EUR 43 million.
- 25% or more of the capital or voting rights are not owned by one enterprise, or jointly by several enterprises that do not meet the conditions of the previous paragraph.

To determine whether the criteria are met, reference should be made to the financial year preceding that in which the request to initiate the procedure is submitted.

Mutual agreement procedure (MAP)

The rectifying Finance Bill of 2004 (Article 21) suspends the collection of taxes when, following a notice of reassessment, a competent authority procedure is undertaken by the taxpayer to eliminate double taxation (*see Article L. 189 A of the Tax Procedures Code, Livre des procédures fiscales*). Prior to this amendment, after issuing a notice of reassessment the FTA had three years to issue a notice of collection, notwithstanding the taxpayer's undertaking of a competent authority procedure. In this situation, given the average length of a competent authority procedure in France (three years and seven months), the FTA had to collect the taxes before the outcome of the competent authority procedure. After receipt of the notice of collection, the taxpayer could, and still may, request to benefit from deferral of payment of taxes if appealing to domestic remedies. However, under the deferral of payment procedure, the taxpayer incurs interest for late payment from the date stated in the notice of collection.

Under the new tax collection regime, the three-year statute of limitation (relating to issuance of the notice of collection) is suspended starting from the opening date of the competent authority procedure. The suspension holds until the end of the third month following the date of the notice given to the taxpayer that states the outcome of the competent authority procedure. Suspension of tax collection applies to

competent authority procedures pursuant to the relevant tax treaty and the European Arbitration Convention.

The suspension of tax collection is applicable to competent authority procedures opened as from 1 January 2005.

In February 2006, the French revenue issued a new regulation regarding MAP. This detailed regulation provides guidance pertaining to the scope, conditions and implementation of the MAP in France. It also aims to apply the recommendations encapsulated in the code of conduct elaborated by the EU Joint Transfer Pricing Forum with respect to the implementation on the EU Arbitration Convention.

Binding permanent establishment (PE) ruling

The rectifying Finance Bill for 2004 (Article 19) extends the tax ruling procedure to PEs (Article L. 80 B 6° of the Tax Procedures Code, *Livre des procédures fiscales*). Under the extended procedure, foreign companies may request a ruling from the FTA stating whether their business activity in France constitutes a PE or a 'fixed place of business', according to the bilateral tax treaty between France and the parent company's country of residence. Not only may the ruling apply to subsidiaries, but also it can relate to agents, regardless of whether they are independent (*see Article 5 §6 OECD Model Convention*), or branches, regardless of whether their only purpose is to hold and deliver the parent company's goods (*see Article 5 §4 OECD Model Convention*). When a request for a ruling is sent, the FTA has three months to reply. If the FTA does not reply within that time period, the request is automatically approved. The French subsidiary of the foreign company is, therefore, not deemed a PE in France, and the group is not liable for corporate income tax in France, consequently avoiding double taxation.

The approval binds the FTA, which may not issue tax reassessments for periods prior to the ruling. This new procedure is, however, limited exclusively to taxpayers acting in good faith (*contribuables de bonne foi*), that is, taxpayers having provided all the useful elements to decide whether a business constitutes a PE and has not provided wrong or incomplete information. The tax authorities may change their decision regarding periods after the ruling, as long as the taxpayer is informed of that change. This procedure is applicable as from 1 January 2005 (*see Decree of 8 September 2005*).

Liaison with customs authorities

The tax authorities have the authority to use information gathered by the customs authorities when challenging a transfer pricing policy.

OECD issues

The French tax authorities have not published a formal interpretation of transfer pricing guidelines issued by the OECD. Indeed, there has not yet been any commentary on the guidelines issued in July 1995. At various times, however, such as at public seminars, the tax authorities have indicated that they do refer to the OECD principles during audits and settlement procedures.

An explicit reference to the OECD principles was made for the first time in the regulation of 23 July 1998. Reference to these principles is also made in the APA and transfer pricing documentation regulations referred to above.

France

The courts tend to use the OECD's principles as guidelines (Fisons, TA Lyon, 25 April 1990).

Joint investigations

There is little information about joint investigations, although it is generally thought that the tax authorities participate more in these now than in the past. In particular, the French authorities tend to join forces with their counterparts in the United States, Germany, Belgium and the United Kingdom.

Interest deductibility

Thin capitalisation

To counter thin capitalisation situations more efficiently, the French 2006 Finance Bill adopted a new system, applicable from January 2007. The scope of the old thin capitalisation rule had been limited by two major decisions of the French Supreme Court on December 2003 (*Conseil d'Etat, Andritz SA and Correal Gestion*) and by a regulation dated 12 January 2005.

The 2007 provisions provide for the repeal of the existing thin capitalisation legislation and replacement by an entirely new set of rules, which cover the interest rate charged and thin capitalisation. These new thin capitalisation rules apply to all types of financing granted to a French entity by any French or foreign-related party.

Interest rate limitations

Under the revised Article 212 of the CGI, the tax deduction of interest paid to related parties is limited to the higher of (1) the average annual interest rate charged by lending institutions to companies for medium-term (two years or more) variable-rate loans, or (2) the interest that the indebted company could have obtained from independent banks under similar circumstances.

The arm's-length criterion mentioned in (2) is a new feature for France. This provision is likely to shift the burden of proof to the taxpayer, as the French tax authorities, in practice, likely will seek to apply the average annual interest rate. Once companies have passed this interest rate test, French indebted companies must pass a second test, namely the debt ratio.

Debt ratio

In addition, the new thin capitalisation rules provide that a portion of interest paid to related parties, which is deductible under the interest rate test, may be disqualified as a deduction if it exceeds all of the three following limitations during the same financial year:

- Interest relating to financing of any kind granted by related parties within the limit of 1.5 times the net equity of the borrower.
- 25% of the adjusted net income before tax 'résultat courant avant impôt', defined as operating income increased by financial income), before related party interest, amortisation and certain specific lease payments.
- Interest income received from related parties (there is no limitation on thin capitalisation grounds when the enterprise is in a net lending position vis-à-vis related entities).

The portion of interest that exceeds the above three limits may not be deducted in the accounting period, unless it amounts to less than EUR 150,000.

For these purposes, 'related parties' are defined as (1) a parent company and a subsidiary whose capital is held more than 50%, directly or indirectly, by the parent company, or which is de facto controlled by the parent company, or (2) two companies which are controlled, directly or indirectly, by a common parent company.

The 2010 Finance Bill brought all financings (including bank loans) secured by a 'related party' within the scope of the thin capitalisation limitations. Thus, any financing in respect of which a related party grants a guarantee or security is treated as related party debt.

Carry-forward of excess interests

That portion of the interest expense that is not immediately deductible by the French enterprise in the accounting period in which it is incurred may be carried forward without a time limit for relief in subsequent years, provided that there is excess capacity in the subsequent years, based on the second limitation mentioned above. However, the excess amount is reduced by 5% each year, from the second accounting period following that in which the interest expense was incurred.

Exceptions

The new provisions provide for several exceptions.

These new rules do not apply to interest payable by banks and lending institutions, or to certain specific situations (e.g. interest in connection with intragroup cash pools or in connection with certain leasing transactions).

In addition, the thin capitalisation rules do not apply if the French indebted company can demonstrate that the debt-to-equity ratio of the worldwide group to which it belongs exceeds its own debt-to-equity ratio.

Also, deductibility of interest is facilitated within a French tax-consolidated group. The new thin capitalisation rules apply to each enterprise member of the group taken on a standalone basis.

However, any excess interest incurred by such an enterprise may not be carried forward by that enterprise. Instead, it is appropriated at the group level. Subject to certain limitations, the consolidating company may deduct extra 'disqualified' interest. Any remaining excess interest may be carried forward for possible deduction at the group level in future accounting periods, less the 5% rebate.

The FTA issued an administrative regulation regarding these new complex rules on 31 December 2007 (Administrative regulation: 4 H-8-07). The guidelines provide the French tax authorities' interpretation of Section 212 of the French tax code relating to thin capitalisation rules. They clarify the legal provisions and provide practical guidance on the computation of the three tests.

In particular, the guidelines state that Section 212 is applicable to PE of foreign companies. It provides clarification on how the debt-to-equity ratio would be applied in the case of PEs where the entities do not have a share capital, per se.

France

The guidelines also detail the exclusion of ‘treasury centre’ and ‘leasing agreements’ from the scope of the thin capitalisation rules, and they describe the specific conditions under which the thin capitalisation rules would allow deduction at a tax group level (Section 223B of the French tax code) for those interests that have failed the three tests at the level of a subsidiary on a standalone basis.

Carrez amendment

On 1 January 2012, new tax rules entered into force with regard to the deductibility of interest and other expenses from share acquisitions (section 209 IX of the French tax code).

Under this new legislation, the deduction of interest expenses incurred in France by a company for purposes of the acquisition of shares qualifying for the French participation exemption regime is subject to restrictions, unless the French acquiring company can prove that the decisions relating to such shares are being taken by it and where the group exercises control (or influence) over the acquired company, such control (or influence) is exercised by the French acquiring company or one of its affiliates established in France.

If the French company fails to provide such evidence, the company owning the shares is required to recapture a part of its financial expenses incurred during each financial year running over the eight-year period following the year during which the acquisition took place. This rule applies retroactively to acquisitions made as far back as 2004, but deductions disallowances can be applied only starting from a company’s 2012 fiscal year.

2013 Finance bill

Under the current French tax system, interest expenses are fully deductible from the tax base for the calculation of the corporate income tax, subject to certain limitations.

The Bill proposes to limit the deduction of interest expenses for companies. Companies will be allowed to deduct:

- 85% of the total amount of deductible interest paid in 2012 and 2013.
- 75% of the total amount of deductible interest paid as from 2014.

However, the restriction will only apply if over EUR 3 million of interest is deducted by a company.

32.

Georgia

Introduction

Certain transfer pricing concepts have been included in the Georgian tax legislation since 1993 (Law of Georgia on Corporate Income Tax). Although specific provisions related to transfer pricing are very limited, some general transfer pricing rules were added to the Georgian Tax Code on 13 June 1997.

Similar provisions were incorporated into the latest tax code, effective from 1 January 2005. In particular, Article 22, *Principles of Determining the Price of Goods (Services) for Taxation Purposes*, and Article 23, *Interrelated Parties*, provide the basis for transfer pricing control by the tax authorities.

Specific transfer pricing regulations have become effective from 1 January 2011. Even though the Tax Code enlists applicable pricing methods, the law is not detailed, and the government's position on issues such as compensating adjustments, documentation, burden of proof and safe harbours will not be known until implementing rules are issued. Generally, however, the law follows recognised the Organisation for Economic Co-operation and Development (OECD) principles, so it is reasonable to expect that an analysis based on OECD Guidelines will prove acceptable in Georgia.

The Tax Code stipulates that, in accordance with the Ministry of Finance instructions (inexistent for the moment), the tax authority may recalculate the taxes if they can prove that the prices applied by related parties of transactions differ from market prices.

Statutory rules

Scope

The Georgian tax authorities may evaluate transfer pricing involving the following types of transactions:

- Controlled transactions involving various jurisdictions between related parties.
- International controlled transactions.
- In the following cases, transfer pricing regulations may apply:
- Controlled transaction between Georgian companies.
- Independent parties' transaction if one of the parties is a tax haven resident or registered in Free Industrial Zone (FIZ).

Basis for transfer pricing adjustments

The tax authorities may apply transfer pricing regulations in the following cases:

- Transactions between related parties, unless their relationship does not affect results of the transaction.

Georgia

- Transactions in which the tax authorities can prove that the price declared by the transacting parties differs from the actual price.

Related parties

The definition of 'related parties' is found in Article 19 of the new tax code effective from 1 January 2011. Parties are recognised as related if their relationship could affect the conditions or economic results of their activities. For example:

- Persons are founders (participants) of the same enterprise if their total share amounts to no less than 20%.
- One person has direct or indirect participation in another person's enterprise, where such market share is not less than 20%.
- Individual controls enterprise.
- One natural person is under subordination of another natural person in terms of his/her business position.
- One person is under direct or indirect control of the other person.
- Persons are under direct or indirect control of a third person.
- Persons, directly or indirectly, jointly control a third person.

Pricing methods

The following transfer pricing methods can be used for evaluating whether the prices are arm's length:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Net profit margin method.
- Profit split method.

If the cost plus method is chosen, the law indicates that the mark-up should be benchmarked against similar transactions between non-related parties. However, the tax legislation does not provide any additional information with this regard, and it remains to be seen how the government will seek to implement the benchmarking requirement, particularly given the limited data that is likely to exist in Georgia.

Other regulations

Not applicable.

Legal cases

No applicable.

Burden of proof

Currently the burden of proof remains with the taxpayer to confirm acceptability of the prices in place.

Tax audit procedures

Georgian tax authorities are allowed to conduct tax audit procedures only once a year, unless there is reliable information for a more frequent audit because of tax evasion. No specific regulations related to transfer pricing tax audits are provided in the tax code.

Revised assessments and the appeals procedure

Currently, the appeals procedures for any tax-related matters involving significant amounts are slow and may result in a change in the initial assessment based on available evidence. At this time, the court system is not a viable alternative.

Additional tax and penalties

There are no specific penalty regulations for the violation of transfer pricing rules. However, transfer pricing adjustments made by the tax authorities during a tax audit that would increase the taxable revenue of the taxpayer may be subject to tax underpayment administrative measures.

Specific measures include but are not limited to the following:

- Profit tax – at 15% rate.
- VAT – at 18% rate.
- Possible excise tax – depending on the nature of the goods.

Please note that current tax legislation also imposes fines for the underreporting of income and the late payment of interest.

Resources available to the tax authorities

Information on market prices is to be obtained from official sources, which may include the database of government bodies, information submitted by taxpayers or other reliable information. Under certain circumstances, the tax authorities have relied on information from other outside sources. In one case, the Council of Tax Appeals obtained needed information directly from the foreign customs authorities.

Use and availability of comparable information

Based on experience, the mostly common procedure used by the tax authorities is to rely on information collected themselves from other similar taxpayers and/or information published by the State Statistics Committee. Revenue Service started negotiating with private companies to obtain access to commercial transfer pricing databases. In isolated cases tax authorities are successful in obtaining information from their foreign counterparts.

Currently, Georgian tax authorities try to obtain extensive information from other similar markets worldwide.

Risk transactions or industries

Manufacturing and export/import.

Limitation of double taxation and competent authority proceedings

No well-developed procedures are in place.

Advance pricing agreements

Any taxpayer may apply for an advance ruling. The ruling must be issued within 60 days of application and is binding on the tax authorities, but only for the taxpayer for whom it is issued.

Georgia

Anticipated developments in law and practice

Rules and instructions for submitting transfer pricing documentation to the tax authorities should be determined by the order of the Ministry of Finance. However, such instructions have not been published yet.

Liaison with customs authorities

The tax and customs authorities have recently been merged into one body that is overseen by the Ministry of State Revenues. It is too early to determine how much coordination will take place between the departments; however, a new, unified database was introduced recently that makes import and export information easily available to the tax authorities.

OECD issues

The Georgian transfer pricing law follows recognised OECD principles and there are no provisions in the law to suggest that non-OECD positions will be taken. Consequently, it is reasonable to expect that an analysis based on OECD Guidelines will prove acceptable in Georgia.

Joint investigations

No such procedures are known to be taking place.

Thin capitalisation

Thin capitalisation rules became effective from 1 January 2011. Interest expense is disallowed on any debt in excess of three times the equity of a company. The law does not indicate how debt and equity are measured.

The rules do not apply to:

- financial institutions
- entities that have gross income of less than GEL 200,000
- entities with interest expense that is less than 20% of their taxable income before deducting that interest expense.

The maximum rate for which interest may be deducted is 24% in 2011, as defined by the Minister of Finance of Georgia.

Management services

Although the Georgian Tax Code does not specify transfer pricing regulations with regard to management services, such transactions may be scrutinised for elements of transfer pricing, given that they are provided or received in one or more of the following manners:

- By related parties.
- On a free-of-charge basis.
- As part of a barter transaction.

The more significant issue with management services is that such services generally have a source in Georgia under the tax code, and therefore would be subject to 15% withholding tax unless exemption is available under a relevant tax treaty.

33.

Germany

Introduction

The German legislation stipulates in Section 1 of the Foreign Tax Act the arm's-length principle as the norm for related party transactions. Accordingly, the prices for those transactions have to be settled on these grounds applying, if possible, the traditional transfer pricing methods. The appropriateness of the transfer prices have to be laid out in a documentation, which is regularly requested as part of routine tax audits. The approach of the tax authorities to transfer pricing issues, in particular to acceptable pricing methodologies and competent authority proceedings, is undergoing continual change in response to international developments in these areas.

Statutory rules

The statutory rules on transfer pricing are not found within one integrated section of the legislation but in several provisions in different statutes. However, in the meantime the legislative body has developed the Foreign Tax Act or *Außensteuergesetz* (AStG) as the main source for transfer pricing guidance. Section 1 AStG contains rules on:

- Definition of the arm's-length principle, including the notion that also unrelated parties would have knowledge on all relevant facts and circumstances of the transaction and would act as prudent and diligent business managers. This definition is supplemented by the hypothetical arm's-length principle that shall be applied if the set of comparables does not meet limited comparability requirements.
- Definition of related parties, which means an ownership of 25% or more.
- Establishment of the preference of traditional transaction based methods; and the limitation of profit based methods to cases where the three traditional methods are not appropriate.
- Emphasis on the adjustment of transfer pricing ranges; if no fully comparable data exists, transfer pricing ranges need to be narrowed. When a taxpayer selects a transfer price outside of the range, the adjustment will be made to the median of the range.
- Introduction of the Transfer of Function rules, which leads to the establishment of an exit taxation, if certain functions, risks, assets, and opportunities are relocated.
- General authority to adjust transfer prices that do not meet the arm's-length requirement, including a price adjustment mechanism that allows for adjustments within a ten-year period.

Other important provisions are:

- Section 90, Paragraph 3 of the General Fiscal Code or *Abgabenordnung* (AO) – Documentation requirements for cross-border transactions with related parties, including permanent establishments (PE).

Germany

- Section 162, Paragraph 3 of the AO – Consequences of inadequate or missing documentation (assumption of need for profit adjustment, income estimation by use of least favourable point in a price range).
- Section 162, Paragraph 4 of the AO – Penalty of 5% to 10% of profit adjustment (with certain ceilings/restrictions) in case of non-compliance with documentation requirements.
- Section 146, Paragraph 2b of the AO – Penalty of euro (EUR) 2,500 up to 250,000 in case of failure to cooperate with the tax authorities.

The 2008 legislation revised Section 8a of the KStG regarding thin capitalisation rules. These rules have been replaced by a general limitation on interest deductions. The thin-capital rules that restricted the deduction of interest on shareholder loans have been replaced by an interest deduction limitation rule. Under the new rules, the allowable net interest expense is restricted to 30% of taxable income before interest, taxes on income, depreciation and amortisation. There is no limitation on the deductibility of interest in the following circumstances:

- Where the net interest expense is less than EUR 1 million.
- Where the company is not part of a group and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.
- Where the company is a member of a group, but its borrowings do not exceed the borrowing ratio (as shown by the financial statements under a common accounting convention such as International Financial Reporting Standards or US generally accepted accounting principles) by more than 1% and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.

Similar principles apply to corporate holdings in partnerships and there are related party and right-of-recourse rules for shareholders to catch back-to-back financing and other perceived abuses. Any net interest expense that has been disallowed on a given year because it exceeds the 30% threshold may be carried forward for relief in future years. The net interest expense is then treated as a net interest expense of the year concerned, with the same conditions applying.

In addition to the adoption of formal statutes by Parliament, the authorities are authorised to issue so-called ordinances (*Rechtsverordnungen*) on specific matters, which need to be approved by the Upper House and have statutory character in that they are binding for taxpayers and tax courts. With respect to transfer pricing documentation, an ordinance was published in 2003, providing guidance and binding interpretation on the type, contents and scope of the documentation required (*Gewinnabgrenzungsaufzeichnungsverordnung – GAufzV*). With respect to Section 1, Paragraph 3 of the Foreign Tax Act, the authorities issued an ordinance specifying further details regarding the transfer pricing rules on cross-border transfer of functions (*Funktionsverlagerungsverordnung – FVerlV*). The ordinance covers details on (1) the terminology of Section 1, Paragraph 3 of the Foreign Tax Act, (2) the valuation to be used with respect to the so-called transfer package, and (3) retroactive price adjustments.

Administration principles issued by the tax authorities

The tax authorities do not have the authority to issue legally binding regulations on transfer pricing matters. They are, however, authorised to promulgate general regulations, decrees on special topics, proclamations, etc. on any issue as considered

appropriate, including transfer pricing matters. All such promulgations are binding only on the tax authorities, and this tool is used extensively by the authorities to promote their interpretation of statutory law and court decisions. Accordingly, these promulgations indicate the position of the tax authorities and thus have considerable relevance in tax practice.

From a transfer pricing perspective, the regulations set out below are of particular interest.

On 23 February 1983, the Federal Minister of Finance published the Principles relating to the Examination of Income Allocation in the Case of Internationally Affiliated Enterprises (administration principles). These principles contain the general rules on the international income allocation where related parties are involved as well as an extensive discussion on the rules of law governing income allocation. Also included are positions on various types of intercompany transactions. The original version of the administration principles also contained guidelines on cost-sharing arrangements, methods of adjustment and related procedural aspects, but these sections have been replaced by new regulations (*see below*).

The administration principles generally follow the 1979 Organisation for Economic Co-operation and Development (OECD) Guidelines. They have been under revision for some time to incorporate developments since 1979 and, in particular, to catch up with the current OECD standards.

The 1983 administration principles were changed or amended by the following additional principles:

The revised principles on cost-sharing arrangements published in 1999, the new chapter on international secondments published in 2001, and the revised principles on procedural aspects published in 2005, incorporate the tax authorities' interpretation of questions regarding the documentation of the facts and circumstances that relate to relevant transfer pricing arrangements. Importantly, these principles refer to the requirements to document the appropriateness of transfer prices. Taxpayers' documentation of the appropriateness of transfer prices must be exclusively oriented towards the arm's-length principle and is the core of the administration principles on procedures.

On 13 October 2010, the German Federal Ministry of Finance issued the administration principles relating to the Examination of Income Allocation between Related Parties in case of Cross-Border Transfer of Functions (administration principles on transfer of functions). These principles explain the view of the German tax authorities with respect to terms and definitions as well as examples on how the arm's-length price 'exit charge' for a transfer of function should be calculated. According to the administration principles on transfer of functions, the determination of an exit charge should follow a capitalised earnings or discounted cash flow evaluation, all based on generally accepted evaluation methods. Furthermore, the evaluation has to be performed for each of the two parties involved in the transaction, based on an indefinite capitalisation period, using discounted rates calculated as specified in the principles and setting the transfer price at the median of both evaluation results. If the taxpayer's approach deviates from this general approach, the burden of proof is shifted to the taxpayer. The principles also describe the three main 'escape clauses'. However, it may be difficult to actually apply them in practice as the requirements are set at a high level and

Germany

the burden of proof for the fulfilment of these requirements is with the taxpayer. In addition, documentation requirements are detailed and non-compliance with these requirements does allow the tax authorities to deviate from the transfer price applied, which may result in significant additional taxes. The administrative principles include some helpful clarifications, e.g. on the shift of a single customer order, centralised order allocation to group entities, replacement of 'old' by 'new' products (and shift of manufacturing tasks for 'old' products to an affiliate), or consequences where the other party terminates an agreement by giving notice. Even if the administrative principles are effective from fiscal year 2008 onwards, they state that that part of the regulations is for clarification only and, therefore, will be applied by the German tax authorities to all open cases irrespective of the fiscal year they relate to.

Court cases

Transfer pricing issues historically were settled by compromise or negotiation long before they reached the courts; hence, there have been very few court cases on the subject.

There are two levels of courts, and all cases that are heard by the courts may last several years before a final decision is reached by the Federal Tax Court or *Bundesfinanzhof* (BFH) (i.e. the higher court). Decisions by the BFH establish a binding precedent on the lower tax courts on a particular subject. However, the German tax authorities do not always accept BFH decisions as binding for all similar cases and thus may publish instructions that a certain court case is not to be applied by the tax authorities on other cases.

Most published court cases on transfer pricing issues deal with the interpretation of the arm's-length principle and the tax consequences resulting from a violation of this principle. In substance, the courts typically verify whether transactions between affiliated parties are based on upfront (written) agreements and result in an income allocation comparable to that arising from transactions between third parties. The test question commonly asked by the court to establish this is whether a prudent and diligent manager (*ordentlicher und gewissenhafter Geschäftsleiter*), in exercising the required professional diligence, would have applied similar conditions on third party transactions.

One of the most important transfer pricing cases decided by the BFH in the past decades is the judgment on 17 February 1993 (I R 3/92), which was published in the Federal Tax Gazette 1993 II p. 457. This case established an important principle that was summarised by the court itself as follows:

'... an orderly and diligent manager will, for the corporation managed by him, introduce to the market and distribute a new product only if he can expect, based on a prudent and pre-prepared economic forecast, a reasonable overall profit within a foreseeable period of time with due consideration to the predictable market development'.

The decision covers a variety of aspects, including the treatment of marketing expenses and the permissible scope of start-up losses. In many respects, the decision is significant for German distribution affiliates of international groups, which are in a continual overall loss position. Such a loss-making affiliate should anticipate

encountering difficulties in convincing tax auditors that losses incurred over several years would have been accepted in dealing with true third parties.

This decision covered the market introduction of a new product by an already established company and stated that typically a market introduction phase, where losses are acceptable, should not be longer than three years. In contrast to this, a BFH decision dated 15 May 2002 stated that a start-up loss phase resulting from market influences of a newly founded company can be substantially longer on a case-by-case basis. The typical start-up phase of three years is, consequently, regularly extended in case of newly founded companies.

An even higher impact on German transfer pricing practices and procedures results from the BFH decision of 17 October 2001 (I R 103/00, published in the Federal Tax Gazette 2004 II p. 171). Not only does this judgment refine principles established in the case on 17 February 1993, but also it provides substantial guidance on procedural issues, such as the judicial revision of data introduced by the tax authorities, of (secret) comparables, the burden of proof, the consequences of lacking cooperation by the taxpayer, the scope of transfer pricing documentation requirements, as well as the determination of arm's-length transfer prices within acceptable ranges. Further references to this judgment will be made in the following sections. It needs to be understood that the German legislature reacted to this decision, in particular, by introducing statutory transfer pricing documentation requirements in Section 90, Paragraph 3 of the AO and promulgating penalties in cases of non-compliance with these obligations in Section 162, Paragraphs 3 and 4 of the AO. To this extent, the principles of the BFH decision dated 17 October 2001 are no longer unrestrictedly applicable to the years 2003 onwards. However, it should be emphasised that even after the introduction of statutory documentation requirements, the burden of proof for transfer prices not being at arm's length is still with the tax authorities, and that the other findings of the BFH in its 17 October 2001 decision remain in force.

Within its decisions of 27 August 2008 – reconfirmed by the decision of the BFH dated 29 April 2009 – the BFH interpreted the term 'business relationship' under Section 1 of the Foreign Tax Act. A business relationship between related parties shall not exist if a parent company does not sufficiently capitalise its subsidiary but provides the subsidiary with free 'capital replacements', which a third party would not have provided (such as an interest-free loan or a binding letter of comfort). If the subsidiary is not able to perform its business operations without the capital replacements, the provision of such capital replacement is not qualified as a business relationship between related parties and, hence, is not subject to income adjustments according to Section 1 Foreign Tax Act.

One of the regional tax courts, the tax court of Cologne, rendered an important decision on 22 August 2007 on the need of upfront (written) agreements for intercompany transactions. The court states that German national law clearly requires having such agreements in place in order to avoid income adjustments. However, the court also clearly acknowledges that Germany will not be able to uphold such a formalistic position under a double-tax treaty where the emphasis is put on whether – irrespective of the fulfilment of formalities such as written agreements – transfer prices are arm's length. The decision is mostly meant to underline the fact that the German tax authorities generally will not be able to attack transfer prices solely for the lack of intercompany agreements. It is interesting to note that the tax authorities have not appealed the court decision and seem, consequently, to acknowledge its findings.

Germany

Nevertheless, in practice it remains advisable to enter into upfront agreements with respect to intercompany transactions.

Another regional tax court of Münster rendered an important decision on 16 March 2006 on the allocation of location savings. According to the court the savings should be shared between the location of a contract manufacturer that operates in an environment with a lower wage level and the entrepreneur.

Burden of proof

As a matter of principle, the taxpayer has to prove compliance with German tax law for all business transactions, including transfer pricing matters. In its aforementioned decision of 17 October 2001, the BFH provides guidance on the allocation of the burden of proof. The taxpayer has to prove the underlying facts of a transaction, which includes presentation of the functions and risks and a description of how the transfer price for the transaction was determined. This also includes, however, an explanation on the appropriateness of the transfer prices applied. Nevertheless, the onus is on the tax authorities to prove that the transfer price is, or is not, arm's length. If the taxpayer does not fully comply with his/her obligation to present all facts, the tax authorities may conclude that the pricing has been determined by the affiliation of the parties; however, the latter does not in itself allow the tax authorities to conclude that the transfer price is not arm's length, and the authorities must still determine the proper pricing by means of a comparability study or an appropriate estimation.

The 2003 legislation has introduced a rebuttable assumption that, in the absence of appropriate documentation, the actual income from intercompany transactions is higher than the income declared. If the taxpayer is not able to refute this assumption, the tax authorities may have to estimate the arm's-length result, and if in this case the income can be determined only within a certain price range, the authorities may use the least favourable end of the price range. This mechanism represents one of the penalty elements for non-compliance with documentation rules, which is a potentially heavy detriment for a taxpayer who has not fulfilled his/her legal documentation obligation. Otherwise, one would benefit from the 17 October 2001 BFH decision, which still provides the right to use the most favourable end of the price range in case of an estimation. From 2008 onwards, however, even in these cases a correction could be made, at least to the median of a range, if the taxpayer had agreed on prices outside of the appropriate range.

However, in this respect even the administration principles on procedures dated 12 April 2005 do not allow the taxpayer to generally choose the most favourable value in a range of transfer prices or margins in the frame of an estimation. The tax authorities require that this exploitation of the range in the sense of the most favourable value for the taxpayer depends on the degree of comparability of the respective third-party data. For this purpose, the tax authorities may narrow the range to the detriment of the taxpayer if an unlimited comparability of all third-party data within the range is not given.

The above rules apply only to the regular price determination process. However, in criminal prosecutions, the case is handed to the prosecution arm of the tax authorities or from there to the State Prosecutor, which will have to prove that the conditions of tax fraud or other criminal offence are met, including the taxpayer's criminal intent.

Tax audit procedures

The German tax authorities do not normally perform tax audits specifically for transfer pricing issues, rather they examine transfer pricing during the normal tax field audits, which are performed at regular intervals. With the exception of small business entities, German enterprises are generally subject to regular tax field audits, which usually cover three to five consecutive years. Almost all tax audits are focusing on transfer pricing, and tighter investigations by tax auditors into transfer pricing issues are occurring in light of extensive new rules and a nationwide transfer pricing programme for tax auditors.

Since the introduction of legal documentation requirements, companies should be prepared to provide the documentation of their cross-border transfer prices within the limits of Section 2, Paragraph 6 of the GAufzV already on receipt of the official advance notice (*Prüfungsanordnung*) of the tax audit. The time limit of 60 days (respectively, 30 days for so-called extraordinary transactions) for submitting this documentation starts in these cases with this official advance notice. However, an unspecified flat request for documentation is not allowed; companies should consider objecting if confronted with such an unspecified flat request.

Duty of taxpayer to cooperate with the tax authorities

The tax authorities may request any information considered relevant to all transactions throughout the audit period, and the taxpayer is obliged to cooperate with the authorities. Where the investigation concerns cross-border transactions, German taxpayers are under an increased obligation to cooperate. Information on foreign affiliated parties must be provided if requested as far as the taxpayer has factual and legal access to the requested data. Where the requested data is not provided, even though the German taxpayer would have had the possibility to obtain such information, the tax authorities are entitled to estimate 'appropriate' transfer prices based on simplified methods, which may result in an adjustment of taxable income.

The 2008 legislation introduced the notion that, if foreign related parties will not disclose information that is relevant for the transfer prices of a German entity, the transfer prices of the German entity can be estimated at the end of the range that is most unfavourable for the German taxpayer.

Documentation requirements

The German rules request documentation as to type, contents and scope of cross-border transactions with related parties, including the economic and legal basis for an arm's-length determination of prices and other business conditions. Documentation must be prepared within a reasonably short period (i.e. within six months after the end of the business year) for extraordinary transactions, such as corporate restructurings as well as material long-term contractual relationships.

Documentation for all types of transactions must be presented to the authorities upon their request, typically in the course of a tax audit. The time limit for presentation is 60 days following the request (respectively, 30 days in case of extraordinary transactions); extensions may be granted for special reasons.

Field audits in practice

Field audits, in most cases, are carried out at the premises of the taxpayer. The tax auditor notifies the taxpayer of the intended visit and the scope of the audit typically

Germany

some weeks before the audit commences. Depending on the size, complexity and availability of information, an audit may take between a few days and many months, or even years. Effective in 2002, special procedures have been established to allow spontaneous VAT audits with no warning to the taxpayer. Depending on the results, such a special audit may be continued as a regular tax audit covering other taxes, including transfer pricing.

As of 2002, the tax authorities are entitled to access the electronic records of taxpayers, who are required to make their data available. At their election, the authorities may take direct access or may request that the taxpayer process and evaluate data at their specification. Finally, the authorities may also require copies of all data in a form suitable for further processing.

As a result of the field audit, the tax auditor summarises the findings and any tax adjustment considered necessary in a written report. It is common tax audit practice that the tax auditor, before finalising the report, continues to correspond with the taxpayer or his/her advisors to try to settle all the issues of concern. Regularly, a final meeting is held between all parties involved to evaluate the material findings. It should be noted that negotiation is an important element of most tax audits and that in most cases a final settlement is reached by compromise.

In case of internationally affiliated companies, the examination of cross-border transfer prices is increasingly the focus of tax audits. Hence, the tax risks resulting from transfer prices not being at arm's length should not be underestimated, in particular against the background of respective sanctions that may apply in such cases. In this respect, the quality of the documentation of the appropriateness of transfer prices is of particular importance, as it may result in minimising the risk of income corrections. Simply said, the better the documentation of transfer prices with regard to their arm's-length character, the lower the risk of income corrections. In addition, solid transfer pricing documentation may help to shorten the duration of a tax audit.

Revised assessments and the appeals procedure

The tax auditor is not authorised to issue revised assessments for the years under audit. The final report, including suggestions for any tax adjustment, is presented to the local tax office where the revised tax assessments are prepared, usually in accordance with the recommendations of the tax auditor.

The taxpayer may appeal against the revised assessments. If the appeal is denied by the appeal's department of the respective tax office, the taxpayer may appeal at court. Such appeals would be heard first by the regional tax court and then, if admitted, by the Federal Tax Court.

Additional tax and penalties

Any unfavourable transfer pricing adjustment will result in an increase of taxable income, which generally leads to the treatment as hidden dividend distribution. This is taxed with the corporation tax rate of 15% (through 2007, 25%) as well as the trade tax (unless balanced by tax loss carry-forwards). To the extent a transfer pricing adjustment will be treated as a hidden dividend distribution, additional withholding taxes may become due; even if double-tax treaties or supranational law (e.g. the EU Parent-Subsidiary-Directive) provide for reduced withholding tax rates, such reduction may be achieved only by a formal application.

Penalties other than interest charges are generally unknown under the present laws as part of the taxation process and may be an issue in criminal proceedings only. However, with respect to transfer pricing documentation, a penalty regime has been implemented with effect from 2004. In strict legal terms, a surcharge (no penalty for criminal misconduct) between 5% and 10% of a profit adjustment must be raised, with a minimum of EUR 5,000. In case of late presentation of appropriate documentation, the maximum surcharge is EUR 1 million, with a minimum of EUR 100 for each day after the 30/60 days time limit is exceeded. Furthermore, in the course of the audit procedure penalties may be assessed in case of undue cooperation.

Resources available to the tax authorities

Central authority for all international tax matters, including transfer pricing, lies with the Federal Tax Office (*Bundeszentralamt für Steuern*). The Federal Tax Office collects all information and data of relevance for international taxation and transfer pricing issues. This central extensive statistical information is confidential and is available to the tax administration only. In local tax audits, matters of international importance may be presented by the local tax auditor to the Federal Tax Office for review, and expert auditors of the Federal Tax Office with specialisation in transfer pricing or other international tax matters may assume responsibility for respective segments of local tax audits. The Federal Tax Office relies entirely on internal expertise rather than on outside consultants or other experts.

In recent years, the German Revenue has identified transfer pricing as a strategic area of the highest importance, and considerable efforts are being made to strengthen this area, both from a manpower/experience and an organisational point of view. Internationally affiliated taxpayers are being increasingly investigated by tax auditors with special cross-border experience, and that experience includes transfer pricing. The responsibility for larger companies (which typically have international group affiliations) also lies with special regional tax offices, which have an increasing transfer pricing expertise.

Use and availability of comparable information

In determining an arm's-length price, Section 1, Paragraph 3 Foreign Tax Act advises to primarily use the traditional transactional pricing methods: comparable uncontrolled price (CUP) method; resale price method (RPM); and cost plus (CP) method. Profit-related transfer pricing methods are also generally accepted in tax audit practice and their use is supported by the administration principles. The administration principles on procedures explicitly acknowledge that, under certain conditions, the use of other methods may be appropriate. Specifically, the use of the profit split method (PSM) or the transactional net margin method (TNMM) is mentioned for specific cases; the latter can generally be applied if (1) no standard method is applicable, (2) an enterprise carries out only routine functions, and (3) at least a limited comparability exists based on comparable data.

The administration principles also allow companies to apply profit based transfer pricing methods to the extent that useful comparable data cannot be determined on the basis of the traditional methods. However, the application of the comparable profit method (CPM) is explicitly rejected (i.e. transfer pricing methodology must be strictly transactional).

Germany

The application of the transfer pricing methods depends inter alia on the structure of the company under review. The German tax authorities differentiate between three categories of companies:

- Companies with routine functions and no considerable contribution to the value chain – allowed methods: standard methods and TNMM; companies with an entrepreneur-type structure (so-called strategy leaders) – allowed methods: standard methods with respect to its affiliates; PSM between companies of the same structure.
- Companies exercising more than routine functions, without having the profile of an entrepreneur – allowed methods: standard methods, determination of transfer prices based on internal planning data with arm's-length profit forecasts.
- Companies having an entrepreneurial profile – allowed methods: any method that leaves in principle the residual profit with the entrepreneur.

Hence, Germany follows the international trend of using profit based transfer pricing methods for the determination of arm's-length transfer prices; however, certain restrictive conditions must be fulfilled. This happened inter alia against the background that it is becoming more and more difficult in competent authority or arbitration proceedings to reject profit-related pricing methods where other countries are applying such methods.

The 2008 legislation describes the concept of the hypothetical arm's-length test when no comparables are available. This concept has originally been established by German courts: Applying the hypothetical arm's-length test, a transfer pricing range is typically seen to be between the minimum price for one party in the transaction and the maximum price for the other party, with the price expectations of the parties based on the net present value of forecasted future income. If no other value can be substantiated by the taxpayer, the mean of the range is taken as the arm's-length price.

Availability

With regard to the availability of published financial data such as company accounts, except for publicly traded entities, few German corporations are inclined voluntarily to publish any meaningful financial data or to comply with general European publication requirements. Owing to the lack of penalties for non-compliance in the past, only a relatively small percentage of German corporations fulfilled the publication requirements. However, an increasing number of German companies have started to publish their financials in databases. Hence, databases have a larger quantitative basis and their meaningfulness for comparability studies is increasing. At the same time, databases contain more detailed company information so that database-supported comparability studies are gaining importance in defending appropriate transfer prices to the tax authorities. However, the administration principles on procedures require that the search process of a database analysis be comprehensible and examinable for a tax auditor. It must not be limited to a mere database screening but requires a manual or qualitative screening. The overall guiding principle is 'quality is more important than quantity of comparables'. Only under these circumstances will the tax authorities accept database-supported comparability analyses.

Secret comparables

In the past, the German tax authorities have relied entirely on self-collected information. However, reflective of the evident international development, they have started to use information available on publicly accessible databases. Still, to the

extent the tax auditor resorts to other taxpayers' data for examining the arm's-length character of transfer prices, the taxpayer is not entitled to be informed of this data for reasons of taxpayer confidentiality. As a result, this data has a reduced value of proof regarding income corrections in a tax audit.

Limitation of double taxation and competent authority proceedings

Competent authority provisions are an integral part of the extensive German treaty network, and proceedings normally follow the pattern of Article 25 of the OECD Model Tax Convention. Retroactive adjustments arising from transfer pricing issues, which may result in a reduction of German taxes, may be allowed even where tax assessments have become final and would not, in accordance with domestic tax law, otherwise be allowed. Depending on the complexity and/or importance of the subject matter, a competent authority proceeding may take between a number of months to several years.

The administration principles on procedures explicitly mention that in case of an imminent double taxation caused by transfer pricing corrections of a foreign or national tax authority, the opening of a mutual agreement or EU arbitration procedure may help to remove this double taxation by means of corresponding counter-income corrections. For this purpose, in case of a transfer pricing correction intended by a national tax audit, the company must be immediately informed of this correction so that it can turn to the foreign tax authority and discuss the possibility of a corresponding counter-correction with them. Should the foreign tax authority not agree to such a correction, the taxpayer may apply for a mutual agreement or to the EU arbitration procedure.

Further details on mutual agreement and EU arbitration procedures are set out by the tax authorities in a circular letter of 13 July 2006.

In case of an imminent transfer pricing correction intended by the foreign tax authorities, the German taxpayer is obliged to inform the German tax authorities. Should German transfer prices change correspondingly, such changes would have to be documented. Should the German tax authorities not see themselves in a position to effect the corresponding counter-correction, the company has the opportunity to apply for a mutual agreement or EU arbitration procedure in order to avoid double taxation. In case of a foreign transfer pricing correction, the company must submit all documents relevant to this correction to the German tax authorities.

It should be noted that, although the success of competent authority proceedings depends on the voluntary consensus of both tax authorities involved, the German authorities are unlikely to reject a compromise. In addition, Germany has begun to include in the negotiation of a new tax treaty the position that mutual agreement procedures should contain an arbitration element (i.e. that they cannot end without a binding and final decision to avoid double taxation).

Like all other EU Member States, Germany observes the European Arbitration Convention on Transfer Pricing Matters. The EU Arbitration Convention is based on the Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Transfers of Profits between Associated Undertakings.

Germany

Advance pricing agreements (APAs)

The attitude of the Federal Ministry of Finance on APAs is generally positive, insofar as the Ministry actively welcomes and supports APAs for transfer pricing purposes in Germany. This has to be seen against the background that the determination of arm's-length transfer prices in an APA serves the avoidance of lengthy disputes between the participating authorities in treating cross-border transfer prices. A further benefit of an APA is that it may considerably shorten the length of tax audits because the transfer pricing system as such is not challenged. In addition, APA reporting requirements and documents of an APA can be used to fulfil German transfer pricing documentation requirements.

However, it should be emphasised that the Federal Ministry of Finance is typically not prepared to grant unilateral APAs in transfer pricing issues because unilateral APAs have no binding effect on the other country concerned. Therefore, the German tax authorities are instructed to grant APAs only on a bilateral or multilateral basis. This necessitates the respective other country to participate in the APA procedure and effecting APA proceedings on the legal basis of Article 25 OECD Model Tax Convention in the sense of a (anticipated) mutual agreement procedure.

Germany also has APA guidelines in the sense of formal regulations on how to apply for, negotiate and grant an APA. On 5 October 2006 Germany's Federal Ministry of Finance released a circular on bilateral and multilateral APAs which was designed to facilitate the processing of APAs and to establish more certainty for taxpayers.

Within the Federal Ministry of Finance, the competence for APA applications and for granting an APA has been centralised in one department and is no longer allocated over several state-specific departments. This centralised department is located within the Federal Tax Office in Bonn. It has to be considered that in addition to the Federal Ministry of Finance, the local tax office (including the tax auditor) is regularly involved in an APA procedure. In addition, expert auditors for international tax issues from the Federal Tax Office may be involved in the proceedings.

In 2007, Germany introduced the following fees for its APA programme:

- In general, the fee for an APA amounts to EUR 20,000 (basic fee), which becomes due if an APA is not issued as set out in the application process. In case of multilateral APAs, the fee incurs for each country involved.
- The fee for an extension of an already existing APA amounts to EUR 15,000 (extension fee).
- Amendments to an APA application incur a fee of EUR 10,000 (amendment fee).
- Reduced fees are possible in cases concerning small enterprises.

Finally, the German tax authorities closely examine any unilateral APA granted by a foreign tax authority that has detrimental tax effects in Germany, unless the German tax authorities themselves actively participated in the APA process.

Anticipated developments in law and practice

Law

The German government intends to extend the application of Section 1 Foreign Tax Act (e.g. application of the arm's-length principle, hypothetical arm's-length principle, transfer of functions regulations) to permanent establishments and partnerships. In

this context, it is also intended to implement the Authorised OECD Approach (AOA) for permanent establishments in Section 1 Foreign Tax Act Furthermore, the government is also working on additional ordinances.

The German tax authorities are also continuing their work on a revision of the administration principles following international developments. The administration principles have been revised regarding Chapters 7, 8 and 9 via new decrees. In a future step, the government intends to revise Chapter 5 (intangible assets). As can already be seen from the administration principles on procedures dated 12 April 2005, it is expected that in a continuing revision of the 1983 administration principles, Chapter 3 – which deals with the supply of goods and services – will support the application of profit based methods for the determination of transfer prices under certain circumstances. Here, German tax authorities increasingly follow international trends.

Practice

Further changes can be observed in the approach of the German tax authorities to transfer pricing issues. As practical training and experiences of tax auditors are increasing, the profile of transfer pricing issues in tax audits is raised. At the same time there is a noticeable trend that the tax authorities are developing their own ideas, such as the concept of the hypothetical arm's-length principle, the application of the exit tax concept, or the limited use of comparable data.

These trends together with the increasing number of transfer pricing audit has led to an increasing number of competent authority, arbitration proceedings and APAs.

Liaison with customs authorities

In the past, income tax and customs authorities normally worked independent of each other, with little or no communication or exchange of information. However, this is gradually changing, and it can no longer be excluded that transfer pricing adjustments may result in a reassessment of customs duties, or vice versa.

OECD issues

Germany is a member of the OECD and has approved the OECD Guidelines on transfer pricing despite having previously expressed reservations on certain sections of the guidelines, such as those dealing with profit based pricing methods.

Joint investigations

The tax treaty provisions and additional EU provisions on the exchange of information, competent authority, arbitration and consultation proceedings provide a procedural framework for the German tax authorities to join another country in a joint investigation of a multinational group for transfer pricing purposes. For practical reasons (e.g. lack of manpower and language problems), such simultaneous audits are likely to be restricted to exceptional cases. Currently, there is close communication with other EU Member States and the US Tax Administration on issues of mutual interest, and this will impact on alliances for joint audits.

34.

Greece

Introduction

Since 1994, provisions under the Greek tax law (Article 39 of L. 2238/1994, the Income Tax Code) have enabled the Greek tax authorities to make adjustments to intercompany transactions that have not been conducted on an arm's-length basis. However, this law has been rarely applied in practice, and, consequently, companies operating in Greece have historically paid little attention to developing formal transfer pricing policies or preparing documentation to support the pricing of their intercompany transactions.

That situation changed in late 2008 when L. 3728/2008, relating to market control and supervision, was issued by the Ministry of Development. Although the purpose of this legislation was ostensibly to implement measures to control consumer prices, the legislation adopted Organisation for Economic Co-operation and Development (OECD) style transfer pricing principles as one of the tools with which to accomplish consumer price controls. Accordingly, Article 26 of L. 3728/2008 confirms the application of the arm's-length principle to intercompany transactions and establishes a formal transfer pricing documentation requirement for all Greek taxpayers. Subsequently, detailed regulations in support of Article 26 of L. 3728/2008 were also promulgated by the Ministry of Development under Decision R. 2709/2008, with further clarifications by Decision A2-2233.

Prompted to action by the Ministry of Development's legislative advance in transfer pricing, the Ministry of Finance enacted its own documentation requirements for tax purposes in mid-2009. These requirements are incorporated into the Greek tax law under Article 1 of L. 3775/2009, which amended the existing Article 39 and added a new Article 39A to L. 2238/1994. Additionally, Article 13 of L. 3842/2010 has incorporated further amendments to the aforementioned Article 39A. These last amendments have differentiated the two transfer pricing regimes in terms of documentation requirements and penalties for non-compliance (which may now rise up to 20% on the non-arm's-length amounts). Accordingly, this chapter addresses the Greek transfer pricing environment from both perspectives.

The provisions of Article 26 of L. 3728/2008 are effective for fiscal years ending after the date of enactment of the law (i.e. 18 December 2008), while the provisions of Articles 39 and 39A (as amended by the abovementioned legislative provisions) are effective for tax returns filed from 1 January 2011 and thereafter (i.e. fiscal year 2010 onward). However, as the Ministry of Development has the power to refer a taxpayer to the Ministry of Finance if it discovers evidence of non-arm's-length pricing in the course of an audit under Article 26 of L. 3728/2008, the practical position is effectively that documentation is also required for tax purposes from fiscal years ending 18 December 2008 onward.

The introduction of two pieces of transfer pricing legislation by two different government bodies within such a short time period is a clear indication that transfer pricing is now a key focus of the Greek government. Moreover, the Greek tax authorities have historically been relatively aggressive in conducting tax audits, with taxpayers rarely avoiding some level of adjustment. Given this history, it is inevitable that audits involving transfer pricing issues are likely to become a regular feature of Greek tax practice in the future.

Statutory rules

Transfer pricing adjustment

The power of the Greek tax authorities to make an adjustment for transfer pricing purposes is contained within Articles 39 and 39A of L. 2238/1994. By virtue of Article 39 of L.2238/1994, when purchase of products or service agreements are entered into between domestic enterprises or between a foreign and a domestic enterprise with financial terms different than those which would have been agreed between unrelated parties, the profits that would have been achieved and were not because of these terms are considered profit of that company without affecting the validity of its accounting books and records.

Affiliated undertakings

According to Article 39 par. 3 of L. 2238/1994, Articles 39 and 39A of L.2238/1994 shall apply to all companies being associated by way of direct or indirect substantial managerial or financial dependence or control, due to either the participation of a company in the capital or in the management of another, or the participation of the same persons in the capital or the management of both companies.

Moreover, Article 39A par.3 of L. 2238/1994 explicitly stipulates that the transfer pricing documentation requirements also apply to both permanent establishments of foreign companies in Greece and permanent establishments of Greek companies established abroad.

Article 26 of L. 3728/2008 gives a narrower definition of affiliated undertakings by providing that the relevant regulations apply to all taxpayers engaging in transactions with companies associated with them – ‘associated’ being defined as under the Greek Corporate Law, namely Article 42e of L. 2190/1920. The latter provision states that companies associated with a taxpayer, known as ‘affiliated undertakings’, exist in the following circumstances:

- In parent/subsidiary arrangements, where:
 - the parent owns the majority of the capital or voting rights in a subsidiary, including securities and rights held by third parties on behalf of the parent
 - the parent controls the majority of voting rights in a subsidiary through an agreement with the other shareholders or partners of the subsidiary
 - the parent participates in the capital of the subsidiary and has the right, directly or through third parties, to appoint or remove the majority of the members of the management of the subsidiary, and
 - the parent has the power to exercise (or actually exercises) dominant influence or control over the subsidiary, or has the power to do so through another subsidiary under the common management of the parent.
- Where a brother/sister relationship exists, defined as the subsidiaries, or subsidiaries of subsidiaries, of the above parent/subsidiary relationships.

Greece

- In cases of indirect ownership, defined as the parent/subsidiary and brother/sister relationships above, irrespective of whether direct participation exists.
- Common management without capital participation, as defined in the Greek Corporate Law on consolidation (Article 96(1) of L. 2190/1920).

Documentation

Both legislative acts and specifically, Articles 39 and 39A of L. 2238/1994 and Article 26 of L. 3728/2008 provide that all Greek companies engaging in transactions with affiliated undertakings must conduct those transactions on an arm's-length basis, whether this principle is stated explicitly (for foreign transactions) or implicitly (for domestic transactions). Under Article 39A of L. 2238/1994 and Article 26 of L. 3728/2008, taxpayers are required to demonstrate the arm's-length nature of all intercompany transactions by preparing detailed transfer pricing documentation.

Additionally, under Article 26 of L. 3728/2008, within four and one-half months from the end of the fiscal year a taxpayer is required to submit to the Ministry of Development a list of all transactions with affiliated undertakings. As set out in Article 8 of Ministerial Decision A2-8092/2008, the list must provide the amount and nature of each transaction (e.g. sale of goods, provision of services), information about the counterparty (name, place of registration, tax registration number), and all intercompany deliveries invoiced through third parties (i.e. triangular transactions).

The Ministry of Development has issued specific regulations under Article 26 of L. 3728/2008, which provide further detailed guidance in relation to application of Article 26 of L. 3728/2008 and its documentation requirements (hereafter, Ministry of Development regulations). Although the Ministry of Finance has issued no regulations in relation to transfer pricing at this time, the Ministry of Development regulations are detailed and comprehensive and are based on the principles set out in the OECD Guidelines. Accordingly, the Ministry of Development regulations may be considered a guide as to what is likely to be contained within future regulations issued by the Ministry of Finance. Generally, the concept of the transfer pricing documentation follows the concept of the Master and Local Transfer Pricing File of the EU Transfer Pricing Code of Conduct.

Clarification of affiliated undertakings

The following transactions are explicitly confirmed as being covered by the definition of 'affiliated undertakings':

- Permanent establishments.
- Triangular transactions (i.e. intercompany transactions invoiced through a third party).

Exemptions from transfer pricing documentation requirements

Certain transactions or entities may be exempt from the requirement to prepare transfer pricing documentation according to legislation by both Ministry of Finance and the Ministry of Development and. More specifically, the exemptions provided differ between the two transfer pricing regimes; hence they are presented separately below:

Ministry of Finance regulations

- Transactions between related parties with a value of 100,000 euros (EUR) or less.
- Companies with annual turnover of EUR 1.5 million or less are subject to simpler and limited documentation requirements.

Ministry of Development regulations

- Transactions with an individual not acting as an entrepreneur.
- Transactions between related parties with a value of EUR 200,000 or less.
- Companies with annual turnover of EUR 1 million or less.
- Transactions where the object is the transfer of a company's shares.
- Transactions for the transfer of ownership and other property rights in real estate.
- Special auxiliary and supporting service entities established under the provisions of Greek tax law (Article 27 of L. 3427/2005).

Contents of documentation

For a Greek-headquartered taxpayer, Articles 39 and 39A of L. 2238/1994 and Article 26 of L. 3728/2008 require a 'Master Documentation File' to be prepared. For a Greek subsidiary of a foreign-owned company, both laws require a 'Greek Documentation File' to be prepared. In general, Greek transfer pricing legislation regarding the content of the transfer pricing files has accepted the EU Transfer Pricing Code of Conduct. Specifically, the content of transfer pricing files should include the following:

- Information regarding the group (Part A):
 - Organisational, legal and operational structure (including permanent establishments and partnerships).
 - Group corporate activities and strategy, including changes from the previous fiscal period.
 - Intercompany transfer pricing policy, if available.
 - Identification of intercompany transactions, including nature of transactions (e.g. sale of goods, provision of services), invoice flow, transaction amount and information about the related parties engaged in the transaction (e.g. their objectives, duration of trading activity, annual gross income, number of employees).
 - Functions, risks and assets of the related parties, including changes from the previous fiscal period.
 - Ownership of intangible assets and associated royalty payments to or from third parties.
 - Advance pricing agreements (APAs) between the companies of the group and foreign tax authorities.
- Information regarding the company (Part B):
 - Detailed report of the intercompany transactions covered by the documentation, including nature of transactions (e.g. sale of goods, provision of services), invoice flow and transaction amount.
 - A comparative analysis showing the characteristics of the intercompany transactions, a functional analysis of the relevant related parties, the contractual terms of the transactions, the economic circumstances surrounding the transactions, and any special corporate strategies.
 - Description of the transfer pricing method or methods adopted for the intercompany transactions, including the reasons why that method was considered most appropriate.
 - Information related to internal or external comparables, where available.
 - Other data or circumstances considered vital to the company preparing the documentation.

Given the background behind the introduction of Article 26 of L. 3728/2008 as described at the beginning of this chapter, the Ministry of Development regulations have a strong emphasis on documenting and supporting commercial aspects of the

Greece

intercompany transactions, with explicit references to corporate strategy, market changes and impact of competition, changes in product specifications or technological advancements, exclusivity rights, contractual deadlines for completion of transactions, and marketing strategies (market entry, discounting, promotional, etc.). It is not yet clear whether future Ministry of Finance regulations providing detailed guidance on the contents of transfer pricing documentation will have a similar focus.

The Master Documentation File and the Greek Documentation File must both be maintained in the Greek language and retained for the entire period of the statute of limitations (technically five years under Article 84 of L. 2238/1994; however, extensions may apply).

Transfer pricing methodologies

The Ministry of Development regulations outline the acceptable transfer pricing methodologies for Greek taxpayers. Fundamentally, these replicate the provisions of the OECD Guidelines; however, the Ministry of Development regulations place a priority on the comparable uncontrolled price method over other transfer pricing methodologies. In order of the hierarchy established by the Ministry of Development regulations, the following transfer pricing methodologies may be used:

- Comparable uncontrolled price method.
- Other traditional methods (i.e. resale price method and cost plus method) – Available only where the comparable uncontrolled price method cannot be applied.
- Other (non-traditional) methods (i.e. transactional net margin method and profit split method) – Available only if the three traditional methods cannot be used.

To apply a method lower on the hierarchy, the taxpayer must include in the documentation file a clear explanation of the reasons why a higher-placed method cannot be applied.

Note that no similar Ministry of Finance regulations have been issued yet. In this respect, Article 39A states that the content of the documentation files based on the Ministry of Development regulations should be taken under consideration in case of a tax audit.

Calculation of the arm's-length range

Pursuant to the Ministry of Development regulations, when calculating an arm's-length range from comparable company data, the average results of the past three years (as per the law requirements) shall be used. There is no mandated approach for calculating the arm's-length range, and any 'generally accepted calculation or statistical programmes can be used'. In addition, once a range has been established, there is a presumption that intercompany pricing falling within this range of comparable prices is at arm's length (assuming the selection of the comparable companies is considered appropriate).

However, although the Ministry of Development regulations provide for the above presumption and also state expressly that when conducting an audit the Ministry of Development must bear in mind that there is no single arm's-length price that should be considered acceptable and that a range of prices may be appropriate. Additionally, if a taxpayer falls outside the interquartile range, the Ministry of Development must confirm the median of that range as the arm's-length price.

On the other hand, as the Ministry of Development does not have the power to make an adjustment to taxable income, use of the median should not be considered binding on the tax examiners during an audit conducted under Articles 39 and 39A of L. 2238/1994 at this time. Although, based on their own analyses, the tax examiners may of course adopt the median as the arm's-length price in specific cases in the future.

Consequently, based on the current legislation and regulations, it is theoretically possible that a taxpayer falling outside the range of comparable prices could find themselves in the unenviable position of being assessed against two different arm's-length prices – subject to an adjustment to the median in the course of an audit by the Ministry of Development, yet adjusted to some other point in the range by the examiners during a tax audit.

Legal cases

Given that no assessments in relation to transfer pricing issues have arisen in Greece as yet, there are no particular legal precedents at this time.

Burden of proof

The burden of demonstrating compliance with the documentation requirements of Articles 39 and 39A of L. 2238/1994 and Article 26 of L. 3728/2008, introducing the obligation to file a transfer pricing file, an arm's-length pricing analysis and any extenuating circumstances justifying a deviation from such arm's-length pricing (such as a market entry business strategy) upon relevant request from the authorities, rests with the Greek taxpayer. However, once a taxpayer has demonstrated such *prima facie* compliance, the burden of rebutting and proving either (1) lack of compliance, (2) failure to meet the arm's-length standard, or (3) failure to sufficiently demonstrate extenuating circumstances rests with the Greek tax authorities.

Tax audit procedures and tax certificate process

Within the course of an ordinary tax audit the documentation file should be available; the taxpayer has in any case 30 days at his disposal to have the documentation file available to the tax authorities.

However, recent developments have occurred in Greece as regards to the tax audit procedure, the so called Tax Audit Certificate. Specifically, Greek companies with year-end closing after 30 June 2011 are obliged, in the course of their audit by Certified Auditors, to be audited also from a tax perspective. The audit programme of the Tax Certificate includes the fulfilment of the company's obligations with transfer pricing requirements set by the Tax Law – what has happened in essence is that the tax audit has been outsourced from the public domain to certified auditors after the latest developments of the Greek economy.

At least 9% of the total number of companies audited by individual Certified Auditors and audit firms for their tax compliance will be selected for an audit by the tax authorities. The criteria for selection are not set yet. These audits to be carried out by the relevant tax audit authorities should be completed no later than 18 months following the deadline for submission by the Certified Auditors and audit firms of the Tax Compliance Report in the relevant database. Apart from companies audited under the above conditions, the Ministry of Finance may choose to audit additional companies under certain conditions; *inter alia* violations related to transfer pricing

Greece

matters is one of the situations where the Ministry of Finance may choose to audit a company.

So, all regular audits, other than the exceptions mentioned in the paragraph below, are conducted within the aforementioned 18 month period. Exceptionally, regular audits carried out in cases where Articles 39 and 39 A of L. 2238/1994 is violated, the audit may be performed until the expiry of the statute of limitation for that fiscal period, which is five years.

To summarise, the above 18 months period implies that the audit company received an Unqualified Tax Certificate. Within 18 months from the issuance of the Unqualified Tax Compliance Report and provided that no tax violations have been identified through the sample based audits by the Ministry of Finance referred to above, the tax audit of this fiscal year is considered finalised.

In the event that transfer pricing violation has been deemed to occur, a mandate will be issued and the audit from the tax authorities may be performed until the expiry of five years statutory limitation, provided by Article 84 of L. 2238/1994.

On the other hand, the Ministry of Development regulation and specifically Article 9 of Ministerial Decision A2-8092/2008, stipulates that an audit of a taxpayer's documentation file by the Ministry of Development begins with a notification letter from the Ministry asking the taxpayer to submit such file within 30 days. Once the Ministry of Development audit has begun, the Market Supervisory Authority which conducts the audit may also request other data for review, such as the taxpayer's general ledger or trial balance, financial statements, an explanation of how the documentation file was prepared etc.

Audits conducted by officers of the Market Supervisory Authority may result in penalties for failure to comply with arm's-length pricing or for failure to prepare documentation, as stipulated in L. 3728/2008. However, these officers do not have the power to make an adjustment to taxable income if a transaction is considered to have been conducted other than at arm's length. In such cases, the Market Supervisory Authority refers the documentation files and other records to the Ministry of Finance so the tax authorities can review and make an assessment if considered appropriate.

The statute of limitation for these audits is equalised to the statute of limitation under the tax legislation (i.e. technically five years, although this may be extended as noted above).

Revised assessments and the appeals procedure

Under the Ministry of Development's transfer pricing legislation, a taxpayer must file a request to commence litigation within five working days from the date of notification of an assessment if it wishes to contest that decision. The Ministry has ten working days to respond to that request. If the request is rejected, the case is referred to the Administrative Court. The taxpayer must pay 20% of the fines or penalties assessed during the audit to the Administrative Court in advance. If the taxpayer's request for litigation is rejected by the Market Supervisory Authority or the tax examiners, the taxpayer can challenge this rejection by submitting a request for review to the Administrative Court within 60 days of the date of rejection.

Similar provisions are also included in the Ministry of Finance's transfer pricing regulations. A taxpayer has the possibility to contest the assessment of the Greek tax authorities and commence litigation within the deadline for submission of the relevant request to the competent Administrative Courts. In case a penalty exceeding EUR 50,000 is imposed, the taxpayer may engage the special Commission of Article 70A of L.2238/1994 competent for the administrative settlement of tax disputes.

If the request is rejected, legal proceedings may be commenced in the Administrative Court; however, the taxpayer must pay 50% of the fines or penalties assessed during the audit to the Administrative Court in advance. Although this 50% is refundable if the court rules in the taxpayer's favour, in case of appeals the Administrative Court will not accept the taxpayer's appeal if the 50% has not first been deposited.

To be noted that by virtue of the newly introduced provisions of L. 4079/2012, as from 20.9.2012 onwards, the deadline for the submission of recourses for tax issues before the Administrative Courts is reduced to 30 days upon notification of the relevant deeds.

Failure to comply with documentation requirements

In the case of the Ministry of Finance, failure to present or improper maintenance of the transfer pricing documentation instructed by Articles 39 and 39A of L. 2238/1994 entails a penalty of 20% on the total of intercompany transactions. Said penalty is different than the one imposed in case of non-compliance with the arm's-length principle (*please refer below*).

Failure to comply with the Ministry of Development transfer pricing documentation requirements (i.e. the list of intercompany transactions and transfer pricing documentation) results in a penalty equal to 10% of the intercompany transactions that were not documented or the documentation was not submitted on time.

Moreover, in case of not in due time submission of the list filing a fine equal to EUR 10,000 is imposed plus EUR 1,000 for any additional day of delay which is capped at EUR 100,000 (Article 26 par. 6 of L. 3728/2008, as amended by L. 4038/2012).

It is not yet clear whether a taxpayer could be penalised twice – by the Ministry of Development and the Ministry of Finance – for the same failure to provide transfer pricing documentation within the required time limits.

Failure to comply with the arm's-length principle

Under Articles 39 and 39A of L. 2238/1994, if the tax auditors conclude that a transaction is not being conducted at arm's length, they will make an adjustment to the taxpayer's taxable income. In this case, a penalty equal to 20% of the additional tax paid is also applicable.

Moreover, in the event that the Market Supervisory Authority concludes a particular transaction was not conducted on an arm's-length basis under the transfer pricing legislation and regulations of the Ministry of Development, a penalty of EUR 5,000 is imposed and the file shall be referred to the tax authorities (with the consequent potential for an adjustment to taxable income and penalties, as noted above).

More importantly, however, in the latter case the criminal sanctions of the Market Code also apply – namely a fine (no limit prescribed) and/or imprisonment of up to five years. Again, it is not yet clear whether the Ministry of Development will be

Greece

this aggressive in pursuing transfer pricing issues, and it is hoped that a measure of reasonableness will apply. However, taxpayers should certainly be aware that the possibility of criminal sanctions for transfer pricing failures does exist.

Resources available to the tax authorities

Ministries of Development and Finance continue to provide training in transfer pricing matters to its existing pool of tax auditors, and transfer pricing issues are therefore likely to be raised in future corporate tax audits. However, as with any country introducing transfer pricing legislation, a 'ramp-up' period during which the tax auditors gain experience in the area of transfer pricing is anticipated.

Furthermore, in May 2010, the Ministry of Development sent a large number of letters to many Greek taxpayers notifying them to file their transfer pricing documentation in order to be audited. Up to now, two of these audits have resulted in the imposition of onerous fines to subsidiaries of foreign MNEs.

Use and availability of comparable information

As the comparable uncontrolled price method has the highest status in the Ministries of Development and Finance legislations, evidence of internal and external comparable data should be included in the documentation file, if available. To demonstrate the comparability of such transactions with the intercompany transaction, the taxpayer must provide sufficient internal data, such as sales volume and units sold, for such an analysis to be made.

When reviewing comparable data provided by a taxpayer (including internal and external comparables, as well as comparables taken from databases), a detailed comparability analysis of the characteristics of the transaction being tested and the parties to the transaction should be provided. The factors considered important in this analysis are largely consistent with the comparability factors identified in paragraphs 1.19 to 1.35 of the OECD Guidelines.

The transfer pricing regulations permit the use of commercial databases to collect comparable data. In such cases, the Greek taxpayer must provide an accurate description of the database, the criteria and steps used to select the comparable companies, and a list of all the companies which were eliminated from the search (and the reasons for their elimination). It is understood that the Greek authorities of Ministries of Development and Finance have also licensed commercial databases themselves for the purposes of conducting comparable searches.

Risk transactions or industries

Based on our experience gained from the companies that have already received a notification letter from the Ministry of Development in May 2010 (please refer above), the targeted transactions or industries consisted of a wide range of activities (e.g. consumer goods, services).

Limitation of double taxation and competent authority proceedings

Greece has an extensive treaty network, including treaties with almost all its major trading partners. These treaties contain provisions to relieve double taxation through the use of mutual agreement proceedings (MAP); however, to date, it is not known whether Greece has conducted any such negotiations.

Technically, there are no restrictions on the commencement of an application for MAP following an audit assessment. Consequently, it is not necessary for the taxpayer to have exhausted its rights through the domestic appeals process of the Administrative Court in order to have the right to apply for MAP.

Advance pricing agreements (APAs)

Greece has no APA regulations at this time. However, as bilateral APA negotiations are theoretically covered by the MAP provisions of Greece's tax treaty network, it should be possible to apply for a bilateral APA between the Greek tax authorities and the tax authorities of a treaty partner. Nevertheless, along with the MAP mentioned above, it is not known if the Greek tax authorities have yet concluded an APA.

Anticipated developments in law and practice

The Ministry of Finance is expected to issue further regulations in the future.

Moreover, as Greek transfer pricing audit experience develops in the coming years, practical application of the new legislations is also likely to become clearer.

A recent draft bill, which is still subject to discussion and subsequent ratification by the Greek Parliament, provides for the taxpayers the ability to file an APA request.

Liaison with customs authorities

With the lack of transfer pricing focus in Greece in the past, there has historically been no liaison between the tax authorities and the customs authorities in this area. However, there is no administrative requirement that government bodies maintain taxpayer confidentiality between themselves, and as a result, it is possible that such liaison may develop in the future.

OECD issues

Greece is a member of the OECD, and the provisions of Articles 39 and 39A of L. 2238/1994, Article 26 of L. 3728/2008 and the Ministry of Development regulations are all largely consistent with the OECD Guidelines.

Joint investigations

No joint investigations have taken place between the Greek tax authorities and any other tax authorities to date. However, no law or regulation prevents Greece from conducting such a joint investigation in the future.

Thin capitalisation

The transfer pricing regulations apply to interest on intercompany loans. There are however specific thin capitalisation rules providing with a debt-to-equity ratio of 3:1.

Other regulations

Tax regime of L.3427/2005

L. 3427/2005 provides a specific advantageous tax regime for companies offering services to their parent companies established abroad.

Specifically, according to Article 30 L. 3427/2005 Greek companies or branches of foreign companies may be subject to this Regime provided that they offer exclusively the following services to their foreign parent company or affiliates:

Greece

- Consultancy services.
- Central accounting services.
- Production, product, process or services quality control.
- Drafting of studies, designs and contracts.
- Advertising and marketing services.
- Data processing.
- Collection and provision of information research and development.

Companies operating under the Regime of L.3427/2005 merely recharge all of their costs adding a predetermined mark-up and are taxed on their profits under the regular CIT rate. All costs recharged are considered as tax deductible. The mark-up on cost is preapproved by the competent department of the Ministry of Development, which examines a benchmarking study prepared by the Company for that purpose. The relevant decision is valid for 5 years. Companies operating under the said regime are excluded from the obligation to document compliance with the arm's-length principle.

Non cooperative States and States with preferential tax regime

By virtue of Article 78 of L.3842/2010 (applicable as of 1.1.2010), important limitations have been introduced on the tax deductibility of expenses paid to companies established in countries considered as 'non cooperating states' or 'states with preferential tax regime'.

Special attention should be paid as to the location of the company contracting with the Greek entity, since according to Greek tax legislation, payments of any kind, including payments for purchase of products and receipt of services, made by a company established in Greece to a company established in a non-cooperative state or a state with a preferential tax regime are, in principle, not recognised as tax deductible items, unless the tax payer proves that such payments relate to real and common transactions and do not result in the transfer of profits, income or capital for tax evasion purposes.

More specifically, according to the provisions of Article 51A par. 4 (as amended by L. 3943/2011), non-cooperating States are considered the States that are not EU Member States and which have not concluded agreements of administrative assistance in the tax sector with Greece or with twelve other States at least. Such States are enumerated in a Ministerial Decision published annually.

Moreover, par. 7 of the same Article stipulates that "a legal entity, irrespective of its legal form, is considered as being subject to a preferential tax regime in a country outside Greece, even if its residence, its registered or actual seat or establishment is in an EU Member State, in case:

- it is not subject to taxation in this state or is de facto not subject to taxation, or
- it is subject to tax on profits, income or capital, which is equal or lower than 60% of the tax rate that would have been due, in accordance with Greek tax legislation, should that legal entity were resident or had its registered seat or maintained a permanent establishment in Greece, in accordance with art.100 of the present Code".

Further, Ministerial Circular POL 1225/26.10.2011 has clarified that the comparison should be made between the statutory applicable Greek tax rates and the tax rates provided by the foreign tax legislation, without taking into account the effective tax rate of the recipient company.

However, the company established in Greece has the possibility to counter proof that the transactions under consideration are real and in the normal course of the company's business and also do not aim to tax avoidance or tax evasion. In such case the respective expenses should qualify as tax deductible items. Special attention should be paid in the documentation available in order to support that the respective transactions have been actually realised.

Triangular transactions

- By virtue of Article 30 par. 5 of L.2238/1994, in case goods sold by a Greek company to an individual or legal entity or representative or subcontractor of them having established their business in a non-cooperative State without the products having been delivered outside Greece and are subsequently sold to another Greek company at a price higher than the first sale, then the difference is considered as gross profit of the Greek selling company. Also, if a Greek company sells goods to an individual or legal entity or representative or subcontractor of them having established their business in a non-cooperative State or in a State with preferential tax regime at a lower price than the price it sells the same products to a domestic or foreign company, that lower price is not recognised and the difference is added back to the Greek company's gross profit.
- By virtue of Article 31 par 1c of L.2238/1994 the value of raw and ancillary materials and other goods (plus processing thereon) which is paid to an individual or legal entity, the role whereof consists exclusively of the invoicing of the transactions, while the delivery of goods or provision of services is conducted by a third party, are not deducted from the gross profits of companies. The practical consequence of this provision requires particular attention, in cases for example of multinational groups where invoicing is centralised.

35.

Hong Kong

Introduction

The increasing cross-border activities of Hong Kong businesses with those in mainland China and the expansion of the Hong Kong treaty network have made transfer pricing a real issue to contend with in Hong Kong. In April 2009, the Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 45 on Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments (DIPN 45). This was followed by the long-awaited DIPN 46 on Transfer Pricing Guidelines – Methodologies and Related Issues, published in December 2009. Both of these practice notes seek to provide taxpayers with greater guidance and clarity in the area of transfer pricing. In addition to DIPN 45 and DIPN 46, the decision made by the Court of Final Appeal (CFA) in July 2009 in the Ngai Lik case (Ngai Lik Electronics Company Limited vs. Commissioner of Inland Revenue), which is discussed in more detail later in this chapter, contains significant transfer pricing implications. In March 2012, the IRD issued DIPN 48 on advance pricing arrangements, which introduced the APA programme to Hong Kong taxpayers with guidance on the new regime. These developments have shaped the transfer pricing landscape in Hong Kong. Transfer pricing has become an increasingly important tax issue in Hong Kong.

Statutory rules

Section 20(2) of the Inland Revenue Ordinance (IRO) is the only statutory provision that can be considered as enacted to deal with transfer pricing issues in Hong Kong. This section applies where a resident person conducts transactions with a ‘closely connected’ non-resident person in such a way that if the profits arising in Hong Kong are less than the ordinary profits that might be expected to arise, the business performed by the non-resident person in pursuance of his or her connection with the resident person shall be deemed to be carried on in Hong Kong, and the non-resident person shall be assessable and chargeable with tax in respect of his or her profits from such business in the name of the resident person.

The main thrust of IRO Section 20(2) is to ensure that any transactions a Hong Kong resident has with a closely connected non-resident are conducted in a reasonable manner, as if transacting with a third party in accordance with the arm’s-length principle.

Section 20(2), however, has historically been perceived as having limited practical application. Advance Ruling Case 14 and Case 27 are rare examples that demonstrate how the IRD applies this section in practice. The IRD has often been more inclined to use other provisions in the IRO, including the general anti-avoidance provisions, to deal with transfer pricing issues, particularly if the potential amount involved was significant. For example, the IRD has historically sought to make transfer pricing adjustments by:

- disallowing expenses incurred by the Hong Kong resident under IRO Sections 16 or 17
- bringing the non-resident taxpayers into tax under IRO Section 14 (and thereby taxing both sides of the related party transactions), and
- challenging the entire arrangement under general anti-avoidance provisions such as IRO Section 61A (allowing the IRD to disregard or to counteract the mispriced transactions).

Disclosure requirements

To combat abusive tax schemes used by corporations with tax evasion/avoidance as the primary motivation, the key focus of the IRD is the identification and investigation of questionable transactions. The IRD achieves this through the scrutiny of the annual profits tax return, a statutory form specified by the Board of Inland Revenue under Section 86 for a taxpayer to fulfill his or her profits tax reporting obligation. Taxpayers are required to disclose in the annual profits tax return the following matters: (1) transactions for/with non-resident persons, (2) payments to non-residents for use of intellectual properties, (3) payments to non-residents for services rendered in Hong Kong, and (4) transactions with closely connected non-resident persons.

Other official guidance

The IRD releases Departmental Interpretation and Practice Notes to provide guidance to taxpayers on a variety of issues as well as clarifications of existing positions. These publications are not legally binding; they do, however, provide the IRD's view on the existing law and its administrative practices in its application of the law. The issuance of DIPN 45 and DIPN 46 was the first time that the IRD explicitly expressed its view in dealing with transfer pricing-related matters. Since these practice notes represent the existing view of the IRD, they are retrospective in nature and should apply to taxpayers' historical, current and future transfer pricing arrangements. DIPN 45 and DIPN 46 are summarised as follows:

DIPN 45

DIPN 45 provides guidelines on corresponding transfer pricing adjustments in double taxation arrangement (DTA) context. Hence, DIPN 45 applies adjustments only to transactions between a Hong Kong entity and an entity in a jurisdiction that has entered into a DTA with Hong Kong. DIPN 45 stipulates that if a taxpayer has a transfer pricing adjustment in one of the treaty countries that has led to double taxation, the IRD will consider allowing the taxpayer to make a corresponding adjustment in Hong Kong, provided the IRD considers the adjustment made in the other country is reasonable. To date,¹ 25 countries have concluded full-scope DTAs with Hong Kong (i.e. not restricted to airline and shipping income): Austria, Belgium, Brunei, China, Czech Republic, France, Hungary, Indonesia, Ireland, Japan, Kuwait, Liechtenstein, Luxembourg, Netherlands, New Zealand, Portugal, Spain, Switzerland, Thailand, United Kingdom and Vietnam.

DIPN 46

DIPN 46 outlines the IRD's views of the legal framework for the IRD to deal with transfer pricing issues, the methodologies that taxpayers may apply and the documentation that taxpayers should consider retaining to support their

¹ As at 14 September 2012, the DTAs with the following countries have been signed (but have not yet come into force): Jersey, Kuwait, Malaysia, Mexico and Switzerland.

Hong Kong

arrangements. DIPN 46 also provides some thoughts on transfer pricing-related issues, such as tax avoidance schemes, in particular:

- DIPN 46 explains the relevant provisions (Sections 16(1), 17(1)(b), 17(1)(c) and 61A) in the IRO and the relevant articles in DTAs that allow the IRD to make transfer pricing adjustments. Note that, contrary to the obiter (i.e. non-precedential) views expressed in the CFA judgment in the Ngai Lik case, to be discussed in the next section, the IRD believes that it can use the deductibility provisions of the IRO (Sections 16 and 17) to challenge transfer pricing arrangements, which creates a degree of uncertainty in this area.
- DIPN 46 explains the definition of an associated enterprise under the OECD (Organisation for Economic Co-operation and Development) Model Tax Convention, which is relevant for transfer pricing in a DTA context. It specifically states that no threshold (e.g. percentage ownership criteria) has been prescribed to define an associated enterprise from a Hong Kong transfer pricing perspective. As a result, taxpayers are advised to take a broad definition of associated enterprises when identifying and assessing related party transactions.
- DIPN 46 confirms that transfer pricing in Hong Kong applies to domestic and international-related party transactions. For transfer pricing adjustments made by or in respect of non-DTA countries and in respect of domestic-related party transactions, it is worth noting that no mechanism is currently in place to obtain double taxation relief.
- DIPN 46 explains the OECD Guidelines in the Hong Kong context, in particular the way the OECD transfer pricing methodologies would be applied in Hong Kong under the IRO. However, the IRD indicates a preference for the traditional transfer pricing methods in DIPN 46, whereas the latest draft OECD position² puts all transfer pricing methods on an equal footing. This may imply that transfer pricing documentation prepared based on the OECD Guidelines may not always be accepted by the IRD.
- DIPN 46 encourages the preparation of contemporaneous transfer pricing documentation. Although the IRO does not mandate the preparation of transfer pricing documentation, taxpayers are required to maintain sufficient documents to substantiate their compliance with the arm's-length principle under Section 51C of the IRO. DIPN 46 also provides guidance on the type of information that is useful to maintain.
- DIPN 46 provides guidance on services in a related party context. Generally, principles defined by the OECD are accepted by the IRD. However, DIPN 46 provides no guidance on safe harbours in respect of appropriate mark-ups for intragroup services and transfer pricing practices for cost-sharing arrangements.

Legal cases

Ngai Lik case

Though the Ngai Lik case was primarily an anti-avoidance case, the CFA's decision in the case has brought about transfer pricing implications for taxpayers engaged in offshore-related party transactions. The case involved a reorganisation scheme of the taxpayer's group. After the scheme, profits were shifted to related BVI entities that were newly set up and had related party transactions with the taxpayer. The IRD considered that the scheme was entered into by the taxpayer with the sole or dominant purpose of obtaining a tax benefit, contrary to the anti-avoidance provisions of Section

.....
2 Per 2010 OECD Transfer Pricing Guidelines.

61A, and assessed the profits of the BVI entities as those of the Hong Kong taxpayer under Section 61A. The CFA, however, held that the Section 61A assessments raised by the IRD in this case were not validly raised, because they were based on arbitrary amounts rather than counteracting the tax benefit obtained by the taxpayer from its transfer pricing arrangements. The CFA ordered that the assessments under Section 61A be raised on the basis of a reasonable estimate of the assessable profits that the taxpayer would have derived if it had hypothetically dealt with its related parties at an arm's-length price.

In addition, a clear but obiter part of the CFA judgment stated that the wording of the expense deduction sections of the IRO, Sections 16(1), 17(1)(b) and 17(1)(c), would not authorise the IRD to disallow the deduction of amounts expended for the purpose of producing chargeable assessable profits simply on the basis that the amounts are considered excessive or not at arm's length. Rather, adjustments to the deduction claims on the grounds that they are excessive could be challenged only by the anti-avoidance sections, in particular Section 61A of the IRO. There appears to be a clear argument based on these comments that, under the present provisions of the IRO, the only real basis on which transfer pricing arrangements can be challenged by the IRD is via the anti-avoidance provisions of the IRO, which is different from IRD's view in DIPN 46 that the use of Sections 16(1), 17(1)(b) and 17(1)(c) in the IRO is also applicable in the context of transfer pricing issues. This creates a degree of uncertainty as to whether IRO Sections 16(1), 17(1)(b) and 17(1)(c) are relevant to transfer pricing matters and perhaps require a further CFA case to clarify.

Burden of proof

In Hong Kong, the burden of proof lies with the taxpayer. Although the IRD does not intend to impose disproportionate compliance costs on enterprises carrying on business in Hong Kong, these enterprises are required to draw up their accounts truly and fairly and may be called upon to justify their transfer prices and the amount of profits or losses returned for tax purposes in the event of an enquiry, audit or investigation.

Tax audit procedures

Transfer pricing documentation is not mandatory under the IRO, and no specific details are provided in the IRO in relation to transfer pricing-focused audits. However, given that the statute of limitations in Hong Kong is seven years and the view of the IRD as expressed in the DIPN 46 can be applied retrospectively, taxpayers should keep good records to support the arm's-length nature of their related party transactions. Furthermore, to determine the accuracy of a tax return, the IRD may require any taxpayer to provide sufficient records that would allow the IRD to obtain full information in respect of the taxpayer's income. Such records are required to be maintained for a period of not less than seven years after the completion of the transactions, acts or operations to which the taxpayer has undertaken.

Additional tax and penalties

The IRO does not provide a specific penalty regime directed at a transfer pricing 'offence', nor does DIPN 46 comment specifically on penalties. Penalties may be imposed in accordance with the general penalty provisions. Taxpayers are potentially subject to penalties under Section 82A in the event that transfer pricing is successfully challenged by the IRD. In the absence of a 'reasonable excuse', and when the IRD successfully challenges transfer pricing arrangements under anti-avoidance provisions,

Hong Kong

penalties may apply. In Hong Kong, the IRD can potentially apply penalties of up to 300% of underpaid tax.

Resources available to the tax authorities

The topic of transfer pricing is still new in the IRD's agenda and, unlike in many other countries, the IRD currently has no specific unit devoted to deal with transfer pricing investigations. However, the IRD has created specific resources for its APA programme and hence is continuously building its expertise in the transfer pricing area by training its assessing staff as well as participating in technical knowledge sharing and exchange seminars with tax authorities in other jurisdictions.

Use and availability of comparable information

Although the IRO does not mandate preparation of transfer pricing documentation, DIPN 46 provides guidance on the type of information that is useful to maintain. Such information includes an analysis of the functions and risks undertaken by the taxpayer, and the methodology upon which it derived the transfer price through the use of comparables in the benchmarking analysis

Comparable information is generally available through various databases. No specific guidance is provided by the IRD on the sources of comparable data. We understand, however, that the IRD has subscribed to the Bureau van Dijk (BvD) Electronic Publishing SA's OSIRIS database.

Limitation of double taxation and competent-authority proceedings

There is currently no mechanism to obtain double taxation relief for transfer pricing adjustments made in a non-DTA context. In addition, the mechanism for double taxation relief in a DTA context requires agreement by the IRD on the transfer pricing adjustment made by the other side. This means that a corresponding adjustment made in a DTA context is by no means automatic

If there is no agreement on the IRD side, taxpayers may seek to resolve the issue with the competent authority of the other side through a mutual agreement procedure (MAP). However, MAPs contain no obligation for both sides to reach an agreement on resolving the double taxation that arises from transfer pricing adjustments.

Advance pricing arrangements (APAs)

DIPN 48 was issued in March 2012, providing guidance for taxpayers to apply for APAs in Hong Kong under the DTA framework. The APA programme is open to all residents and non-residents with a permanent establishment in Hong Kong, subject to profits tax and have related party transactions pertinent to Hong Kong. The threshold for an APA application is Hong Kong dollar (HKD) 80 million each year for sale and purchase of goods, HKD 40 million per annum for services, or HKD 20 million per annum for intangible properties. The IRD may, at its discretion, relax the eligibility criteria to allow an enterprise access to the APA process.

The Hong Kong APA process follows the five stages of (1) pre-filing, (2) formal application, (3) analysis and evaluation, (4) negotiation and agreement, and (5) drafting, execution and monitoring. In general, an APA will apply for 3 to 5 years. The Commissioner does not charge any fee on enterprises during the APA process on

the Hong Kong side. Although no APAs are yet concluded as the programme is newly introduced in Hong Kong, the tentative timeframe for concluding an APA is expected to be 18 months from the acceptance of the formal application

It is stated that the Commissioner is only prepared to consider bilateral or multilateral APA applications, at least at the initial stage of the programme, unless certain conditions for a unilateral APA apply.

Anticipated developments in law and practice

We can see that the IRD is putting more emphasis and resources to transfer pricing related matters. As DIPN 48 is new, it is yet to be seen how the APA programme develops in Hong Kong, and the attitude and reaction of IRD to the APA applications. Nonetheless, we have observed that many taxpayers are welcoming of and interested in the APA programme in order to obtain certainty on their transfer pricing issues.

OECD issues

Hong Kong is not a member of the OECD. The IRD, however, expresses its view in DIPN 46 that it would generally seek to apply the principles in the OECD Guidelines, except where they are incompatible with the express provisions of the IRO.

36.

Hungary

Introduction

Hungary became a member of the Organisation for Economic Co-operation and Development (OECD) in May 1996 and of the European Union on 1 May 2004.

Hungary introduced transfer pricing legislation in 1992, in Section 18 of the Corporate and Dividend Tax Act (CDTA). Section 18 of the Hungarian CDTA prescribes the use of the arm's-length principle (referred to as the customary market price) when setting the consideration associated with business contracts between affiliated companies.

Hungary as an OECD member state has acknowledged that the arm's-length principle as defined in Article 9 of the OECD Model Tax Convention is the international transfer pricing standard to be used.

The tools at the disposal of the tax authorities to monitor compliance include notification requirements, documentation and tax audits. In addition to the incremental tax that becomes payable, the costs of non-compliance with transfer pricing rules include tax penalties of 50% of the adjustment as well as interest on late payments of tax.

Statutory rules

On 1 January 2003, a new subsection introducing transfer pricing documentation requirements was added to Section 18 of the CDTA. This provision was followed by more detailed regulations contained in Decree No. 18/2003 of the Ministry of Finance.

On 16 October 2009, Decree No. 22/2009. (X.16) of the Ministry of Finance was published containing the changes of the documentation requirements pertaining to the determination of the arm's-length price (the Decree). The amended Decree came into effect as of 1 January 2010, and is first applicable to the transfer pricing documentations regarding the 2010 tax year.

These regulations require taxpayers to document each related party agreement with respect to the method in which the arm's-length price was determined, by the time the corporate income-tax return is filed. Such documentation needs to be updated for changes in the relevant circumstances that could cause unrelated third parties to renegotiate the pricing terms and conditions.

The penalty for non-compliance with the transfer pricing documentation requirements is detailed in Section 172 (16) Act XCII on the rules of taxation and is a default penalty of forint (HUF) 2 million per transaction per year, which significantly increased for repeated non-compliance to up to 4 million HUF for each register (combined register) in the case of repeated offenses. In the event of any repeat offense concerning the

keeping of the same register, a default penalty of up to four times the penalty imposed for the first offense may be imposed upon the taxpayer. The tax authorities have explained that non-compliance includes lack of documentation, 'barely prepared' documentation, or documentation that does not meet the requirements determined in the law and documentations prepared late. The documentation must cover each agreement, and the agreements cannot be consolidated unless the terms of supply or performance are the same under the agreements or their subject matter is closely related.

The basis of imposition of the default penalty is the subject of a continuing controversy on the issue of whether the correct interpretation of the Decree would impose the default penalty in respect of each absence of documentation of each agreement rather than per default identified in a tax audit. The tax authorities have stated they interpret the imposition of a default fine based on the number of agreements for which documentation is not in place, counting each instance as a default.

Content requirements for the transfer pricing documentations regarding the 2010 tax year are regulated by Decree No. 22/2009. As opposed to the provisions of the previous decree, Decree No. 22/2009 allows the preparation of two different types of transfer pricing documentation: a country-specific, or a combined transfer pricing documentation. Taxpayers are required to declare the option they choose in their corporate tax return.

The requirements regarding the country-specific documentation mostly correspond to those set out in Section 4 of Decree No. 18/2003 of the Ministry of Finance (i.e. details of the related parties and inter-company transactions, industry analysis, company and functional analysis, economical and financial analysis). According to the new decree, taxpayers are allowed to prepare a combined transfer pricing documentation that shall consist of two main parts:

- The core documentation.
- The country-specific documentation(s).

The core documentation should contain the following common standard information with regard to each member company resident in any member state of the European Union:

- The general description of business structure.
- The general description of the group in terms of its organizational, legal and operational structure.
- The general denomination of the related parties conducting controlled transactions with EU group members.
- The general description of the controlled transactions, as well as the functions performed and risks assumed.
- Information on the ownership of intangible assets, and on royalties paid and received.
- The description of the transfer pricing policy or system within the group.
- The cost-contribution agreements, transfer pricing resolutions, and court decisions regarding the arm's-length price.
- The date on which the documentation was prepared or amended.

Hungary

The elements of the country-specific documentation are generally similar in both cases. The country-specific documentation includes relevant data of the related parties involved in the controlled transaction; general description of the taxpayer's business enterprise and business strategy; description of agreements; benchmark analysis; and the description of comparable data.

Other regulations

Simplified documentation

According to Section 6 of Decree No. 22/2009, taxpayers may fulfil their documentation obligation with the preparation of a so called simplified documentation for low value adding services. The simplified documentation should contain the details of the related parties, the subject matter, date, terms and conditions of the underlying agreement, the arm's-length price (i.e. the mark-up between 3% and 7%), and the date when the documentation was prepared.

Low value adding services are defined as low-risk routine services between related parties that are incidental to the taxpayer's main activity (main services), and are not directly related to the recipient's main business activity; and the service represents economic or business value for the recipient. In addition, the following conditions have to be taken into account:

- The value of the transaction included in the contract at an arm's-length price (exclusive of VAT) does not exceed HUF 150 million in the tax year under review, 5% of the service provider's annual net sales revenue or 10% of the recipient's annual operating costs and expenses in the tax year.
- The taxpayer undertakes to determine the arm's-length price using the Cost Plus Method.
- A mark-up between 3% and 7% is applied for the services.
- The low value adding services are not provided to a non-related party, or received from a non-related party, under comparable circumstances in the given tax year or in the preceding two tax years, which would establish that the use of a mark-up between 3% and 7% would result in a non-arm's-length price.

The Decree specifies in Schedule No. 1 what kind of services qualify in particular as low value adding intra-group services: information technology services; real estate activities; professional, scientific, research and technical activities (e.g. accounting services); education services; administrative services; transport, transport agency, cargo handling, warehousing and storage services and some other services.

Exceptions

Taxpayers are not subject to the transfer pricing documentation requirement under the Decree among others:

- To transactions made by a resident taxpayer with its foreign branch or affiliate, if the resident taxpayer makes adjustments in its corporate tax base pursuant to international agreement so that it contains no income that is subject to taxation abroad.
- In connection with related-party transactions if the state tax authority has issued an APA resolution establishing the arm's-length price, for the period of validity of the resolution.

- If the consideration due for goods or services supplied as part of an activity that is incidental to the taxpayer's main activity is recharged in full to a related party.
- In the case of liquid assets transferred without consideration.
- If the value of the transaction included in the contract at an arm's-length price (exclusive of VAT) does not exceed HUF 50 million during the period between the date of the contract and the last day of the tax year. When determining the threshold (irrespective of the fact of consolidation), the aggregate value of the transactions included in the contracts that may be consolidated under this Decree must be taken into consideration.

The requirement for documentation does not apply to individuals, small or micro enterprises (as defined in Section 3, Act XCV of 1999), individuals and transactions conducted on the stock exchange or at an officially set price (however, cases of insider trading, fraudulent attempts to influence exchange rates or applying prices in breach of legal regulations are not exempt).

Legal cases

There has been little in the way of legal cases dealing with transfer pricing in Hungary.

Burden of proof

Since the introduction of transfer pricing documentation requirements, the burden of proof has passed on to the taxpayer. Taxpayers are required to support their related party transactions with specific documentation that has to be in place on the date a corporate income-tax return is filed.

As the documentation rules are clear as to the level of detail and approach required, taxpayers are faced with carrying out a detailed analysis of their related party transactions.

In the event that adequate documentation is in place, it is up to the tax authorities to demonstrate that the method selected, the search criteria and the uncontrolled comparables identified are not applicable. This assumes that the functions are correctly determined and the financial analysis and implementation of related party agreements are correctly disclosed.

Tax audit procedures

The number of transfer pricing audits has increased significantly in the previous years, and this trend is expected to continue in the future. During these audits, the tax authority reviews the formal elements and also the supporting analysis of the inter-company transactions from an arm's-length point of view. Standard tax audits have raised queries regarding the degree of compliance with the related party documentation regulations, with increasing numbers of questions regarding the transfer pricing methodology selection.

Facing budgetary pressures, the government has been under pressure to step up enforcement activities. At the same time, in recent submissions on creating a sustainable investment climate, the government has emphasised that it will also seek to address taxpayers' concerns of transparency in the enforcement of legislation. Regarding penalties, Hungarian tax authorities have been active in publicising that:

Hungary

- penalties should not be considered to be a one-time payment as an alternative to compliance; and
- taxpayers will now be held to due dates, which previously have not been strictly enforced.

The penalties were introduced to encourage taxpayer compliance with the legislation in the belief that the penalty would never have to be imposed. Non-compliance with the legislation in practice has resulted in the recent public campaign of the tax authorities to educate taxpayers about what is to come.

Revised assessments and the appeals procedure

Almost all Hungarian taxes are levied by self-assessment. In other words, the taxpayer must file the return and make any payment by the due date, without waiting for a formal assessment or payment demand from the tax authorities.

In Hungary, a tax authority audit can be started at any time during the five years following the end of the year in which the return was originally due. The statutory period of limitations for starting a tax audit is, therefore, six calendar years from the year-end date. The tax auditors generally make field visits to the taxpayer's premises lasting several weeks and covering a span of two to five years. Their findings are discussed with the taxpayer and its representatives.

The tax authority will issue minutes on its findings, and the taxpayer has 15 days to file their response to the minutes. The tax authority then issues its first-level resolution. Appeals against the first-level resolution have to be filed within 30 days to a higher authority within the tax administration. A second-level resolution may be issued by the tax authority following the appeal against the first-level resolution. The taxpayer can then submit appeals against the second-level resolution to the relevant court.

Additional tax and penalties

Failure to comply with the Hungarian transfer pricing documentation regulations is subject to a penalty of up to HUF 14 million (approx. USD 63,000) as detailed above.

Adequate and timely documentation should not be underestimated as an indicator of the taxpayer's good faith if transfer prices are queried. Good faith clearly will have a bearing on the resolution of a transfer pricing dispute.

Transfer pricing adjustments (assuming they are in favour of the tax authority) could not only increase the tax liability of the taxpayer but also result in a tax penalty of 50% on any additional tax payable plus interest on late payment of tax at twice the base rate of the National Bank of Hungary. As of 29 August 2012, the base rate of the National Bank of Hungary was 6.75%.

In addition to the above, there is also the risk of double taxation when a 'corresponding adjustment' is not accepted in the other tax jurisdiction involved.

These risks exist for qualifying agreements in any of the years open to scrutiny by the tax authority under the Hungarian statute of limitations, which is five years.

Resources available to the tax authorities

The tax authority set up a central transfer pricing unit in 2006 to carry out transfer pricing-specific audits and assist in local general tax audits when a transfer pricing issue is identified. This unit also works closely with the department of large taxpayers, which looks after the largest taxpayers in Hungary. As of 1 January 2007, the tax authority's directorate of high-importance taxpayers has sole jurisdiction in cases defined by law, as well as in cases involving taxpayers regarded as 'high importance' under separate legislation. It is also responsible for conducting centralised inspections.

According to the Decree No. 4/2012 (II.14.) of the Ministry of National Economics, high-importance taxpayers include credit institutions and insurance companies organised as joint-stock companies and (except for state entities, sole proprietors and private persons defined by the Personal Income Tax Act), taxpayers with tax obligations (i.e. all tax obligations of a company including those collected and payable by the company) of HUF 3,250 million or more, provided that they are not subject to bankruptcy, liquidation, or winding-up proceedings on the last day of the year preceding the tax year.

Use and availability of comparable information

The tax authority has introduced a number of external databases, which it uses to assist in its tax audits. The two major publicly available Hungarian databases are KJK-Kerszöv DVD Céghírek and IM Online, where public financial information can be downloaded on Hungarian companies. The tax authority also uses Bureau van Dijk's AMADEUS database and Bloomberg databases and has developed its own internal database on the basis of the financial information received during tax audits.

Risk transactions or industries

The tax authority has publicly stated that it considers entities that are either loss-making or show an accounting profit of less than 2% of gross revenue as the subject of particular attention in transfer pricing audits.

Advance pricing agreements (APAs)

Hungary adopted legislation regarding advance pricing agreements on 1 January 2007. The Decree No. 38/2006 of the Ministry of Finance details the procedure for making applications for advance pricing agreements. An application form is available at the Hungarian Tax Authority website (<http://www.nav.gov.hu>).

Procedure

The applications for advance pricing arrangements are lodged with the Tax Authority's Directorate of High Importance Taxpayers and are required to be co-signed by a tax advisor, a tax expert (a registered professional tax specialist in Hungary), a chartered tax consultant or a lawyer.

Fees

The fees are 1% of the arm's-length price determined by the authority with the following limits:

- HUF 500,000 but no more than HUF 5 million for a unilateral APA where traditional methods (CUP), resale price method (RPM), (CPM)) are applied.
- HUF 2 million but no more than HUF 7 million for unilateral APA where profit-based methods (TNMM, profit split method) are applied.

Hungary

- HUF 3 million for a bilateral APA but no more than HUF 8 million.
- HUF 5 million for a multilateral APA but no more than HUF 10 million.

The application should be accompanied by a copy of the receipt certifying payment of the application fee in full, duly signed by the issuing bank.

If an application for an advance pricing arrangement is dismissed, the tax authority will refund 75% of the application fee to the taxpayer within 15 days of the resolution on the dismissal of the application (usually 30 days after the issue of a resolution).

The application may be requested for three to five years and may be extended (once) or amended for an additional fee of 50% of the fee paid for the original proceeding.

The administrative time limit for these proceedings is 120 days, which may be extended on two occasions by 60 days.

Note: There is an Annex to Decree No. 38/2006 of the Minister of Finance that sets out the details to be included in the advance pricing agreement application.

Notification to the local tax office

All applications for an advance pricing arrangement are automatically notified to the local tax office dealing with the day-to-day tax affairs of the taxpayer.

Appeals

Appeals against the first instance resolution (ruling) must be addressed to the Chairman of the Tax Authority and filed with the Tax Authority's Central Office. If, following an unsuccessful appeal, the resolution (ruling) is not cancelled, amended, corrected, replaced or complemented as requested in the appeal, the decision on the appeal must be prepared and presented to the Chairman by a tax authority unit organisationally independent and separate from the unit that prepared the first instance resolution. This provides some comfort that there will at least be a peer review of unsuccessful appeals.

Bilateral and multilateral procedures

In bilateral and multilateral procedures, the taxpayer will not be involved in the exchange of information or multilateral procedure between the Hungarian Tax Authority and the foreign tax authority or authorities. The Hungarian Tax Authority does, however, have the right to request the applicant to supply, within eight days, any additional information at the applicant's disposal that is considered material for the purposes of assessing the APA application, or for clarifying new facts, data or circumstances, if any, that may emerge in the course of such procedures.

Advance pricing arrangement in practice

The Tax Authority requires information requested in the Decree to be supplied in advance of the submission of the application for advance pricing agreements and it is usual for a preliminary meeting to be held with the Tax Authorities to explain the background of the application and clarify any initial queries that the Tax Authority may have in respect of the information provided. The Hungarian Tax Authorities are in practice generally helpful in ensuring a smooth APA procedure for the taxpayer.

Anticipated developments in law and practice

The Hungarian transfer pricing legislation continues to develop as part of the general harmonisation with the EU legislation and directives and therefore taxpayers can anticipate significant developments in the future both in terms of the quality of the tax audits and legislative background. The last year has already seen an increase in the quality of tax audits and imposition of default penalties where documentation is either incomplete or not available. This is expected to be a continuing trend.

OECD issues

The Decree No 22/2009 of the Minister of Finance on Documentation states that it is based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and related protocols, which include the OECD Transfer Pricing Documentation Guidelines. Therefore the OECD transfer pricing developments should be seen to play a major part in the development of transfer pricing legislation and practice in Hungary.

Thin capitalisation

Under Paragraph j) in Section 8 (1) of the Hungarian Corporate Tax Act, interest on liabilities in an amount pro-rated to the portion of such liabilities that exceed three times the equity capital results in an increase to the corporate tax base.

For purposes of thin capitalisation, liability means the average daily balance of outstanding loans (with the exception of liabilities due from financial institutions) and outstanding debt securities, while equity capital means the average daily balance of subscribed capital, capital reserve, profit reserve and tied-up reserves.

Note: From 2012 interest free loans received from related parties also have to be taken into account, if the tax base was decreased with the arm's-length interest according to Section 18 of the Act LXXXI of 1996 on Corporate Tax and Dividend Tax.

37.

Iceland

Introduction

Iceland has no direct transfer pricing legislation but it is a member of the Organisation for Economic Co-operation and Development (OECD) and subscribes to the principles contained in the OECD Guidelines. However, there are no direct references in Icelandic tax law or in other legislation to the OECD Guidelines.

In recent years, Icelandic companies engaged in international trade have become increasingly aware of the needs and opportunities of a carefully structured transfer pricing policy.

Icelandic tax authorities are showing an increased interest in implementing rules and regulations on this issue, which will likely be based on the principles of the OECD Guidelines.

Statutory rules

Iceland has no collective statutory rules which are specifically aimed at transfer pricing. The statutory authority for addressing transfer pricing issues is found in the application of general legal concepts, such as the anti-avoidance rule. Article 57 of the Icelandic Income Tax Act No. 90/2003 (originally included in the tax code in 1971) contains a general anti-avoidance rule stating that business transactions between all parties should be based on the arm's-length principle. With reference to the general concept of this Article, tax authority can, in cases where transfer prices are not arm's length, adjust the taxpayers' revenues and expenses so as to reflect market value. These adjustments can be performed only within the domestic statute of limitation period (i.e. six years). Authorities have thus based its transfer pricing conclusions on Article 57.

The Income Tax Act includes several separate rules that can be identified as transfer pricing rules. However, those rules generally concern transactions between individuals rather than between companies (e.g. a rule that obligates employees who receive their wages in kind to account for them on their tax return based on market value).

The VAT Act also includes separate rules that can be identified as transfer pricing rules, as they address issues concerning how to price products when transactions between related parties occur.

Transfer pricing issues will not be addressed unless there is a statutory rule that can be built upon.

Other regulations

Double tax conventions

In addition to domestic legislation, transfer pricing principles are stated in all double tax conventions that Iceland has entered into with foreign countries. These principles are based on Article 9 of the OECD Model Tax Convention.

Regulations

Iceland has no published regulations relating to transfer pricing.

OECD Guidelines

Iceland is a member country of the OECD and has embraced the OECD Guidelines for transfer pricing purposes. In Iceland, it is expected that the OECD Guidelines and the newly confirmed Code of Conduct for transfer pricing documentation in the EU will likely have an impact in the future.

Legal cases

Several legal cases concerning transfer pricing have reached the State Internal Revenue Board. A few cases have also reached the District Courts and the Supreme Court of Iceland. No transfer pricing cases are currently being processed through the courts.

In some legal cases of a different nature, it has been established that transfer pricing issues can be addressed on the grounds of Article 57 of the Income Tax Act, even though the rule is considered a general anti-avoidance clause. These cases also established the arm's-length principle for transactions between related parties.

Burden of proof

The tax authorities carry the full burden of proof when trying to establish that a transfer pricing adjustment is needed.

Tax audit procedures

Tax audit procedures can be based on predetermined tax audit programmes or on a random inspection of tax returns.

The tax authorities can request any information on the taxpayer and the taxpayer must cooperate with the tax authorities on all tax audit procedures. The normal tax audit is performed by local tax offices located around the country, but sometimes a tax audit is performed by the Directorate of Internal Revenue and the Directorate of Tax Investigations. Tax audits can be performed only within the domestic statute of limitation period (i.e. six years).

Revised assessments and the appeals procedure

The taxpayer has the right to an appeal to the local tax office. This appeal must be set forth within 30 days from the decision date. If the taxpayer does not meet that deadline, then he or she can file a complaint to the Director of Internal Revenue. Tax authorities have two months to process the complaint. When a decision has been made, the taxpayer can appeal to the State Internal Revenue Board within three months or take the case to the courts. The taxpayer can also wait for the decision of the State Internal Revenue Board and then appeal it to the courts.

Iceland

Additional tax and penalties

Penalties in the range of 15%-25% on top of the tax base are applied where an adjustment is performed based on a transfer pricing tax audit or a general tax audit.

Resources available to the tax authorities

No special transfer pricing unit operates within the Icelandic tax authorities.

The tax authorities have employees who are able to review any of the transfer pricing transactions brought to its attention through tax audits or requests for binding rulings.

Icelandic tax authorities have participated in Nordic collaboration meetings on transfer pricing issues and are formal participants in a Scandinavian work group that is researching and developing rules on transfer pricing.

Use and availability of comparable information

No comprehensive databases containing third-party comparable information are available in Iceland.

The financial statements of all Icelandic companies are publicly available, and the financial information contained therein can be used in searching for comparable information.

There is no legal demand for documenting transfer pricing policies for Icelandic companies when determining its transfer prices, but there is a legal demand for all transfer pricing issues to be based on the arm's-length principle.

Risk transaction or industries

No particular transactions run a higher risk of being subject to investigation than others, although cases regarding inter-company loans and fees seem to be at the forefront.

Limitation of double taxation and competent authority proceedings

The tax authorities can reopen a tax assessment upon request if there has been a transfer pricing adjustment in a country with which Iceland has a treaty connection. Those issues are addressed in the mutual agreement procedure provisions in double taxation treaties aiming to avoid double taxation. Currently, tax authorities do not follow any formal procedures, but in general proceedings have worked well with a good flow of information between countries.

Advance pricing agreements (APAs)

No APAs have been entered into in Iceland and no formal procedure for obtaining such agreements exists. However, it is possible to obtain a binding ruling from the tax authorities or the Ministry of Finance according to Act 91/1998 in connection with a particular transfer pricing issue that has not yet been executed.

Anticipated developments in law and practice

No changes in law have been presented. Icelandic tax authorities are, however, showing an increased interest in implementing rules and regulations on this issue, which will likely be based on the OECD Guidelines.

Liaison with customs authorities

No formal cooperation exists between the tax authorities and the customs authorities on transfer pricing issues. However, these organisations may join forces if deemed necessary.

OECD issues

Iceland is a member country of the OECD and, as such, has embraced the OECD Guidelines for transfer pricing.

When dealing with transfer pricing issues in the past, Icelandic authorities have not based their decisions or referred to the OECD Guidelines.

The transfer pricing rule stated in all of Iceland's double taxation conventions is based on Article 9 of the OECD Model Tax Convention.

Joint investigations

Icelandic authorities have not participated in any formal joint investigations in connection with transfer pricing issues. However, it is not unlikely that they will do so with other Nordic countries in the future.

Thin capitalisation

Iceland has no statutory rules on thin capitalisation.

Management services

The general arm's-length principle applies for charging management fees to Icelandic companies.

38.

India

Introduction

A separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 (the Act) covers intra-group cross-border transactions which is applicable from 1 April 2001 and specified domestic transactions which is applicable from 1 April 2012. Since the introduction of the code, transfer pricing has become the most important international tax issue affecting multinational enterprises operating in India. The regulations are broadly based on the Organisation for Economic Co-operation and Development (OECD) Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements, and contain harsh penal provisions for noncompliance.

Statutory rules and regulations

The Indian Transfer Pricing Code prescribes that income arising from international transactions or specified domestic transactions between associated enterprises should be computed having regard to the arm's-length price. It has been clarified that any allowance for an expenditure or interest or allocation of any cost or expense arising from an international transaction or specified domestic transaction also shall be determined having regard to the arm's-length price. The Act defines the terms 'international transactions', 'specified domestic transactions', 'associated enterprises' and 'arm's-length price'.

Type of transactions covered

Section 92B of the Act defines the term 'international transaction' to mean a transaction between two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property; provision of services; cost-sharing arrangements; lending/borrowing of money; or any other transaction having a bearing on the profits, income, losses or assets of such enterprises. The associated enterprises could be either two non-residents or a resident and a non-resident; furthermore, a permanent establishment (PE) of a foreign enterprise also qualifies as an associated enterprise. Accordingly, transactions between a foreign enterprise and its Indian PE are within the ambit of the code.

An explanation having an inclusive list of transactions has been inserted in the definition of 'international transaction' by the Finance Act 2012, to specifically cover certain transactions/ arrangements such as purchase, sale, transfer, lease or use of intangible property, provision of guarantees, deferred payments or receivables, business restructuring or reorganisation etc. Intangible property has been explained to include marketing intangible, customer-related intangible, human capital intangible, location-related intangible, etc. These clarifications have been inserted retrospectively with effect from 1 April 2001.

Until financial year (FY) 2011-12, transfer pricing regulations were not applicable to domestic transactions. However, the Finance Act 2012 has extended the application of transfer pricing regulations to 'specified domestic transactions', being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds INR 5 crore:

- Any expenditure with respect to which deduction is claimed while computing profits and gains of business or profession.
- Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (Section 80-IA) and SEZ units (section 10AA).
- Any other transactions as may be specified.

This amendment will be applicable for FY 2012-13 and subsequent years.

Associated enterprises

The relationship of associated enterprises (AEs) is defined by Section 92A of the Act to cover direct/ indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations in which the same person (directly or indirectly) participates in the management, control or capital of both the enterprises.

For the purposes of the above definition, certain specific parameters have been laid down based on which two enterprises would be deemed as AEs. These parameters include:

- Direct/indirect holding of 26% or more voting power in an enterprise by the other enterprise or in both the enterprises by the same person.
- Advancement of a loan, by an enterprise, that constitutes 51% or more of the total book value of the assets of the borrowing enterprise.
- Guarantee by an enterprise for 10% or more of total borrowings of the other enterprise.
- Appointment by an enterprise of more than 50% of the board of directors or one or more executive directors of the other enterprise or the appointment of specified directorships of both enterprises by the same person.
- Complete dependence of an enterprise (in carrying on its business) on the intellectual property licensed to it by the other enterprise.
- Substantial purchase of raw material/sale of manufactured goods by an enterprise from/to the other enterprise at prices and conditions influenced by the latter.
- The existence of any prescribed relationship of mutual interest.

Furthermore, in certain cases, a transaction between an enterprise and a third party may be deemed to be a transaction between AEs if there exists a prior agreement in relation to such transaction between the third party and an AE or if the terms of such transaction are determined in substance between the third party and an AE. Accordingly, this rule aims to counter any move by taxpayers to avoid the transfer pricing regulations by interposing third parties between group entities.

Also, as per Section 94A of the Act, if a taxpayer enters into a transaction in which one party is a person located in a notified jurisdictional area, then all the parties to the transaction shall be deemed to be AEs, and any transaction with such party(ies) shall be deemed to be an international transaction. This regulation aims to specify countries

India

or territories outside India having lack of effective exchange of information as notified jurisdictional areas. To date no jurisdiction has been notified.

The arm's-length principle and pricing methodologies

The term 'arm's-length price' is defined by Section 92F of the Act to mean a price that is applied or is proposed to be applied to transactions between persons other than AEs in uncontrolled conditions. The following methods have been prescribed by Section 92C of the Act for the determination of the arm's-length price:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).
- Such other methods as may be prescribed.

In this regard, the Central Board of Direct Taxes has notified that the 'other method' for determination of the arm's-length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. The 'other method' shall apply to FY 2011-12 and subsequent years.

No particular method has been accorded a greater or lesser priority. The most appropriate method for a particular transaction would need to be determined having regard to the nature of the transaction, class of transaction or associated persons and functions performed by such persons, as well as other relevant factors.

The regulations require a taxpayer to determine an arm's-length price for international transactions or specified domestic transactions. It further provides that where more than one arm's-length price is determined by applying the most appropriate transfer pricing method, the arithmetic mean (average) of such prices shall be the arm's-length price of the international transaction or specified domestic transactions. Accordingly, the Indian regulations do not recognise the concept of arm's-length range but requires the determination of a single arm's-length price.

However, some flexibility has been extended to taxpayers by allowing a range benefit which would be notified by the Government, not exceeding 3%. Accordingly, if the variation between the arm's-length price and the price at which the transaction has actually been undertaken does not exceed the specified range of the latter, the price at which the transaction has actually been undertaken shall be deemed to be the arm's-length price. Therefore, the benefit of the range would be available only if the arm's-length price falls within the specified range of the transfer price. This, in turn, would have the effect of disallowing the benefit to a taxpayer where variation between the arm's-length price and transfer price of the taxpayer exceeds the specified range, leading to a transfer pricing adjustment even though the transfer price is only marginally outside the range benefit.

The government will notify the range benefit percentage from FY 2012-2013 and onwards which would be industry specific. For FY 2011-12, the government has continued with the 5% range which is available to all taxpayers.

In addition, transfer pricing provisions will not apply if the arm's-length price would result in a downward revision in the income chargeable to tax in India.

Documentation requirements

Taxpayers are required to maintain, on an annual basis, a set of extensive information and documents relating to international transactions undertaken with AEs or specified domestic transactions. Rule 10D of the Income Tax Rules, 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer. Such requirements can broadly be divided into two parts.

The first part of the rule lists mandatory documents/ information that a taxpayer must maintain. The extensive list under this part includes information on ownership structure of the taxpayer, group profile, business overview of the taxpayer and AEs, prescribed details (nature, terms, quantity, value, etc.) of international transactions or specified domestic transactions and relevant financial forecasts/estimates of the taxpayer. The rule also requires the taxpayer to document a comprehensive transfer pricing study. The requirement in this respect includes documentation of functions performed, risks assumed, assets employed, details (nature, terms and conditions) of relevant uncontrolled transactions, comparability analysis, benchmarking studies, assumptions, policies, details of adjustments and explanations as to the selection of the most appropriate transfer pricing method.

The second part of the rule requires that adequate documentation be maintained that substantiates the information/ analysis/ studies documented under the first part of the rule. The second part also contains a recommended list of such supporting documents, including government publications, reports, studies, technical publications/ market research studies undertaken by reputable institutions, price publications, relevant agreements, contracts, and correspondence.

Taxpayers having aggregate international transactions below the prescribed threshold of INR 10 million and specified domestic transactions below the threshold of INR 50 million are relieved from maintaining the prescribed documentation. However, even in these cases, it is imperative that the documentation maintained should be adequate to substantiate the arm's-length price of the international transactions or specified domestic transactions.

All prescribed documents and information have to be contemporaneously maintained (to the extent possible) and must be in place by the due date of the tax return filing. Companies to whom transfer pricing regulations are applicable are currently required to file their tax returns on or before 30 November following the close of the relevant tax year. The prescribed documents must be maintained for a period of nine years from the end of the relevant tax year, and must be updated annually on an ongoing basis.

The documentation requirements are also applicable to foreign companies deriving income liable to Indian withholding tax.

It should be noted that, with effect from April 2009, the Central Board of Direct Taxes (CBDT) has been empowered to formulate safe harbour rules. These rules will specify the circumstances in which the tax authorities will accept the arm's-length price as declared by a taxpayer, without detailed analysis. The basic intention behind the introduction of these rules is to reduce the impact of judgmental errors in determining the transfer prices of international transactions or specified domestic

India

transactions. To date, no safe harbour rules have been issued by the CBDT. However, the adaptation of these rules might help relieve taxpayers of the burden of carrying out detailed comparability analysis and benchmarking studies in support of their intercompany transactions.

Accountant's report

It is mandatory for all taxpayers, without exception, to obtain an independent accountant's report in respect of all international transactions between associated enterprises or specified domestic transactions. The report has to be furnished by the due date of the tax return filing (i.e. on or before 30 November). The form of the report has been prescribed. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. Furthermore, the accountant is required to certify the correctness of an extensive list of prescribed particulars.

The Authority for Advance Rulings (AAR)¹ has delivered a ruling in the case of Vanenburg Group B.V. and Dana Corporation, wherein it was held that the provisions relating to the determination of the arm's-length price are machinery provisions which would not apply in the absence of liability to pay tax, and accordingly, a taxpayer would not be required to comply with the transfer pricing regulations in respect of income that is not chargeable to tax in India.

Based on these rulings, a possible view exists that where it is established that the income is not subject to tax in India (under the provisions of the Act/ double taxation avoidance agreement), the taxpayer should not be required to comply with the regulations relating to the maintenance of transfer pricing documentation and furnishing of an accountant's report.

It is relevant to note that although the ruling is binding only on the applicant that had sought it, it does carry a degree of persuasive value.

In this context, it is important to note that entities enjoying a tax holiday in India still need to comply with transfer pricing provisions and would need to demonstrate that their international transactions have been carried out at arm's length. In addition, such entities would not be entitled to a tax holiday on any upward adjustment made to their transfer prices in the course of an audit.

Burden of proof

The burden of proving the arm's-length nature of a transaction primarily lies with the taxpayer. If the tax authorities, during audit proceedings on the basis of material, information or documents in their possession, are of the opinion that the arm's-length price was not applied to the transaction or that the taxpayer did not maintain/ produce adequate and correct documents/ information/ data, the total taxable income of the taxpayer may be recomputed after a hearing opportunity is granted to the taxpayer.

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¹ A scheme of Advance Rulings has been introduced under the Act in order to provide the facility to non-residents and certain categories of residents, of ascertaining their income tax liability, planning their income tax affairs well in advance and avoiding long drawn and expensive litigation, an Authority for Advance Rulings has accordingly been constituted. The non-resident/ resident can obtain binding rulings from the Authority on question of law or fact arising out of any transaction/ proposed transactions which are relevant for the determination of his tax liability.

Tax audit procedure

A certain percentage of tax returns are selected for detailed audit. A notice to this effect has to be statutorily dispatched to the taxpayer within six months from the end of the financial year in which the return is furnished. Such notice specifies the records, documents and details that are required to be produced before the tax officer.

Once an audit is initiated, the corporate tax assessing officer (AO) may refer the case to a specialist transfer pricing officer (TPO) for the purpose of computing the arm's-length price of the international transactions or specified domestic transactions. Such reference may be made by the AO wherever he or she considers it necessary. However, this can be done only with the prior approval of the Commissioner of Income tax. In accordance with prevailing internal administrative guidelines of the Revenue, all taxpayers having an aggregate value of international transactions or specified domestic transactions with AEs in excess of INR 50 million are referred to a TPO for detailed investigation of their transfer prices. The threshold of INR 50 million may be reviewed on an ongoing basis.

The TPO would then send a notice to the taxpayer requiring the production of necessary evidence to support the computation of the arm's-length price of the international transactions or specified domestic transactions. The prescribed documentation/ information maintained by the taxpayer in respect of its transfer pricing arrangements would have to be produced before the tax authorities during the course of audit proceedings within 30 days after such request has been made. The period of 30 days can be extended to 60 days at most.

The TPO would scrutinise the case in detail, taking into account all relevant factors such as appropriateness of the transfer pricing method applied and correctness of data. TPOs are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath and compelling the production of books of account and other relevant documents and information. Further, with effect from 1 June 2011, TPOs have been empowered to conduct surveys for spot inquiries and verification for subsequent investigation and collation of data. In addition, TPOs have been instructed to seek opinions of technical experts in the relevant field to enable them to analyse technical evidence in complex cases.

After taking into account all relevant material, the TPO would pass an order determining the arm's-length prices of the taxpayer's international transactions or specified domestic transactions. A copy of the order would be sent to the AO and the taxpayer. On receipt of the TPO's order, the AO would compute the total income of the taxpayer by applying the arm's-length prices determined by the TPO and pass a draft order within the time limit prescribed for completion of scrutiny assessments.

Normally, scrutiny assessments are required to be completed within an upper time limit of 36 months from the end of the relevant tax year. However, scrutiny assessments involving transfer pricing audits would have to be completed within 48 months from the end of the relevant tax year. It is important to note that India completed its seventh round of transfer pricing audits in October 2011.

Appeals procedure

A taxpayer that is aggrieved by an order passed by the AO may appeal to the Commissioner of Income Tax, also called the Appellate Commissioner, within 30 days

India

of the date of receipt of the scrutiny assessment order. The office of the Appellate Commissioner is a type of quasi-judicial authority, where the taxpayers make representations in support of their claims to rebut the order passed by the AO. The decision of the appellate commissioner is reflected in an appellate order.

An alternative dispute resolution mechanism has been instituted by the Finance Act (2009) to facilitate expeditious resolution of disputes in all cases involving transfer pricing and foreign company taxation. It has introduced the concept of draft assessment orders, which would be issued by the AO pertaining to the order of the TPO that is prejudicial to the taxpayer. In cases involving foreign companies or companies suffering transfer pricing adjustments, the AO is required to forward a draft assessment order to the taxpayer which would ordinarily include the order of the TPO. A dispute resolution panel (DRP), comprising a collegium of three Commissioners of Income Tax, is constituted to which the taxpayer would have recourse on receiving the draft assessment order from the AO.

At this stage, the taxpayer has two choices: It could either accept the draft order as it is, or seek to refer the matter to the DRP. The taxpayer has to communicate its decision to the AO within 30 days of the receipt of the draft order. If the order is accepted by the taxpayer as it is, the draft would be finalised by the AO and served to the taxpayer. If the matter is referred to the DRP, the panel would have nine months from the time of referral to decide the matter taking into consideration the draft order of the AO, the order of the TPO and the taxpayer's objections and evidence. The draft assessment order would be finalised after the DRP has rendered its decision to the AO. If the taxpayer does not communicate its decision to refer the draft order to the DRP within 30 days, the AO would finalise the assessment order without modification of the draft assessment order.

However, an order of the AO that is based on the direction of the DRP would be appealable directly to the Income Tax Appellate Tribunal (Appellate Tribunal). All orders passed by the AO before 30 June 2012 pursuant to the directions of the DRP were binding on Revenue. However, with respect to objections filed on or after 1 July 2012, the Revenue can appeal against the direction passed by the DRP.

It is also clarified that the taxpayer would have to decide whether to opt for the dispute resolution mechanism based on the draft assessment order or file an appeal in the normal course with the appellate commissioner against the assessment order. Thus, the order of the AO can be agitated before the appellate commissioner in the ordinary course (i.e. if it is not referred to the DRP).

Taxpayers that still feel aggrieved by the order of the appellate commissioner or, as the case may be, the order of the AO passed in conformity with the directions of the DRP have the right to appeal to the Appellate Tribunal, thereafter to the jurisdictional High Court, and finally to the Supreme Court. A similar right to appeal also rests with the Revenue, in cases where objections before the DRP have been filed on or after 1 July 2012.

Additional tax and penalties

The following stringent penalties have been prescribed for noncompliance with the provisions of the transfer pricing code:

- For failure to maintain the prescribed information/document: 2% of transaction value.
- For failure to furnish information/documents during audit: 2% of transaction value.
- For failure to disclose any transaction in Accountant's report: 2% of transaction value.
- For adjustment to taxpayer's income: 100% to 300% of the total tax on the adjustment amount.
- For failure to furnish an accountant's report: INR 100,000.

Further, taxable income enhanced as a result of transfer pricing adjustments does not qualify for various tax concessions/holidays prescribed by the Act.

Advance pricing agreements (APAs)

The Indian authorities have introduced unilateral, bilateral and multilateral APAs with effect from 1 July 2012. There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible for applying for an APA. However, the APA mechanism is not available for specified domestic transactions. The validity of an APA (once entered into) shall not exceed five consecutive years and shall be binding on the taxpayer as well as the Revenue authorities in respect of the international transactions for which the APA is sought. APA fees would range between INR 1 million to 2 million, based on the value of international transactions. There are four phases in an APA which is in line with global practice, as follows:

- **Pre filing phase:** The process of an APA would start with a pre-filing consultation meeting. This meeting will be held to determine the scope of the agreement, understand the transfer pricing issues involved and to determine the suitability of the international transaction for the agreement. No fee is to be paid in this phase.
- **Formal submission phase:** After the pre-filing meeting, if the taxpayer is desirous of applying for an APA, an application in the prescribed format would be required to be made containing specified information. The APA filing fee is payable at this stage. In the application, the taxpayer must describe critical assumptions. Critical assumptions refer to a set of taxpayer related facts and macroeconomic criteria (such as industry, business, economic conditions, etc.), the continued existence of which are material to support the position concluded under an APA. A material change in any of the critical assumptions may result in revision of the APA or even termination in extreme circumstances.
- **Negotiation phase:** Once the application is accepted, the APA team shall hold meetings with the applicant and undertake necessary inquiries relating to the case. Post the discussion and inquiries, the APA team shall prepare a draft report which shall be provided to the Competent Authority in India (for unilateral/multilateral APA) or the Director General of Income Tax (International Tax and Transfer Pricing) (for Unilateral APA).
- **Finalisation phase:** This phase involves exchange of comments on draft APA, finalisation of the APA, and giving effect to the initial years covered under the APA term that have already elapsed.

The taxpayer will be required, as part of the APA, to prepare an annual compliance report (ACR) for each year of the APA, containing sufficient information to detail the actual result for the year and to demonstrate compliance with the terms of the APA. The ACR shall be furnished within thirty days of the due date of filing income tax

India

return for that year, or within ninety days of entering into an agreement, whichever is later.

Resources available to the tax authorities

A special transfer pricing team within the Indian tax authorities deals with transfer pricing issues. The team comprises of trained TPOs who deal with transfer pricing issues arising during an audit. Indian tax authorities are actively training their staff to increase competency in handling transfer pricing issues.

Use and availability of comparables' information

Taxpayers are required to maintain information on comparables as part of their transfer pricing documentation to demonstrate that the pricing policy complies with the arm's-length principle. Comparable information is a crucial element for defending transfer pricing in India. Indian revenue officials have indicated that, to the extent possible, Indian comparables should be used. Use of foreign comparables is generally not acceptable, unless the tested party is located overseas. In some cases, the TPOs have exercised their power to obtain private information from other taxpayers and used it against the taxpayer undergoing an audit.

The quality of comparable information available in Indian databases is reasonable. The tax authorities use a couple of electronic databases giving detailed financial and descriptive information for companies. Taxpayers also usually rely on these databases. It is also possible to obtain information about Indian public companies from the Registrar of Companies upon payment of statutory fees.

Liaison with customs authorities

The Indian Ministry of Finance had constituted a joint working group, comprising officers from Income Tax and Customs, to suggest measures for cooperation between the Income Tax and Customs departments. Based on the recommendations of the working group, the Ministry of Finance has laid down that periodic meetings should be held between Income Tax and Customs personnel to discuss joint issues requiring attention.

The Ministry of Finance also has decided that exchange of information in specific cases would be done, and for this purpose, officers from the two departments would be nominated at each of the four metros. Furthermore, officers from the two departments would make databases available to one another, relating to related parties/AEs on a need-to-know basis. The Ministry of Finance also has decided to develop and organise training programmes to train the officials of both departments to familiarise them with the treatment of transfer pricing matters in the other department.

The above action by the Ministry of Finance can be seen as the first clear statement of intent of the government of India towards addressing transfer pricing matters in a harmonious manner between the Customs and Income Tax departments (as transfer pricing officers have, in the past, expressed a view that the price accepted by other authorities is not conclusive evidence for determining the arm's-length price for transfer pricing purposes). This also suggests that going forward, Customs and Income Tax authorities could coordinate and exchange information with one another on transfer pricing matters. Such an increase in liaison between the two departments makes it imperative for companies operating in India to plan and document their transfer prices comprehensively based on valuation principles contained in Customs

as well as Income Tax laws and also deal with both authorities in a harmonious and seamless manner.

Risk transactions or industries

No transactions or industries are excluded from the possibility of a transfer pricing investigation. Software development, business process outsourcing, banking, telecommunications, pharmaceutical, FMCG and automobile (and ancillary) are some of the industries that have been subject to intense transfer pricing audits in recent times.

Outsourcing companies rendering core/high-value services to AEs need to carefully analyse and set their transfer prices. Furthermore, specific situations such as sustained losses, business strategies, business restructurings, transactions with entities in tax havens, and royalties and management charges paid should be sufficiently documented.

Thin capitalisation

The arm's-length principle applies to loans and interest charges. However, at present, there are no rules that specifically deal with thin capitalisation and no set permissible debt-to-equity ratios in the Act or the transfer pricing code. However, the Indian government has put forward a proposal for a new direct tax code that will replace the existing Income tax Act with effect from 1 April 2012². A draft of the new direct tax code has been circulated for public comment and includes thin capitalisation provisions.

The proposed regulations do not prescribe any capital gearing ratio unlike typical thin capitalisation regulations, but instead provide for recharacterisation of debt as equity and vice versa upon identification of an impermissible avoidance arrangement – in other words, where the arrangement among parties is (1) not at arm's length, (2) lacks commercial substance, or (3) adopts means that are ordinarily not adopted for bona fide purposes. The absence of a specified capital gearing ratio allows subjectivity and discretion at the hands of Revenue while it evaluates whether a given capital structure is an impermissible avoidance arrangement.

The proposed thin capitalisation provisions are now becoming an area of concern – it is therefore desirable that multinational enterprises operating in India should review their respective capital structures in light of appropriate and acceptable benchmarks.

Management services

Under India's exchange control rules, charging management service fees to Indian residents in certain situations could require regulatory approval. It may be possible to obtain regulatory approval for such a charge based on transfer pricing documentation proving its arm's-length nature. Management service fees charged to Indian taxpayers are tax-deductible if charged on an arm's-length basis. Management charges to Indian taxpayers are generally scrutinised in detail during transfer pricing audits. To mitigate the risk of disallowance, the charges should be evidenced by extensive supporting documentation proving that the services were rendered and were necessary to the business of the recipient of the services (the benefit test).

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2 Provided the implementation of the new Direct Tax Code is not deferred by the Government.

India

Where an Indian taxpayer is providing such services, the taxpayer should be compensated on an arm's-length basis.

Limitation of double taxation and competent authority proceedings

The competent authority provisions/mutual agreement procedure (MAP) is an alternate dispute resolution mechanism that companies are increasingly beginning to use, especially in cases where the tax amount in dispute is significant. MAP settlements typically have been sought on issues relating to transfer pricing, PE matters and profit attribution.

Most Indian tax treaties contain an 'associated enterprises' article, which contains relieving provisions that require one country to reduce the amount of tax charged to offset the enhanced tax liability imposed by the other country to reflect the arm's-length standard. This article refers to competent authority provisions (contained in the relevant MAP article of the treaty) for consultation between authorities of both countries to prevent double taxation on taxpayers. MAP/competent authority provisions are an integral part of India's extensive treaty network.

The MAP route can be pursued by taxpayers simultaneously with the domestic dispute resolution process. In the event the MAP route is invoked, the competent tax authorities of the countries involved negotiate until they reach an agreement on the transfer prices acceptable to both the authorities. To facilitate the MAP, the Indian government has introduced rules and also has entered into memorandum of understanding (MoU) with the competent authorities of the United Kingdom and United States. An advantage of applying for the MAP under the MoUs mentioned is that Revenue will suspend the collection of tax, where the taxpayer has an adjustment in relation to transactions with the associated enterprises. Under the MoUs, the collection of tax is deferred while the MAP is in process. However, taxpayers need to provide appropriate bank guarantees in support of the potential tax payable prior to resorting to the MAP.

The increasing use of MAPs by taxpayers in seeking effective resolution of transfer pricing disputes is an encouraging step in the Indian scenario.

OECD issues

India is not a member of the OECD. However, India has been invited to participate as an observer in the OECD's Committee on Fiscal Affairs, which contributes to setting international tax standards, particularly in areas such as tax treaties and transfer pricing. India's transfer pricing regulations broadly adopts the OECD principles. Tax offices have also indicated their intent of broadly following the OECD Guidelines during audits, to the extent the OECD Guidelines are not inconsistent with the Indian Transfer Pricing Code.

Joint investigations

There is no evidence of joint investigations having taken place in India. However, almost all Indian tax treaties contain provisions for the exchange of information and administrative assistance, under which the Indian tax authorities may exchange information with other countries for transfer pricing purposes. Furthermore, with transfer pricing awareness increasing and India signing agreements/renegeotiating

double tax avoidance agreements with various countries for exchange of information, joint investigations may be undertaken by the Indian tax authorities in the future.

Anticipated developments in law and practice

Revenue officials have indicated the possibility of introducing rules on safe harbour, cost contribution arrangements and thin capitalisation.

In the recent budget, the Government has proposed to introduce the General Anti-Avoidance Rule (GAAR) but as of now it has been deferred to April 2013. Current discussions indicate that the Government may further defer the implementation of GAAR by another three years. Under the GAAR provisions, Revenue authorities are empowered to disregard/combine/recharacterise the whole or any part of any impermissible avoidance arrangement. An arrangement may be regarded as an impermissible avoidance arrangement if the main purpose of the same or any part thereof is the availing of any tax benefit and is not at arm's length or is not for bonafide purpose or lacks commercial substance or results in the abuse of any provisions of the code.

Payment of royalty

The Government of India has permitted lump-sum fees for transfer of technology and royalty payments for use of trademarks/ brand names and technology under the automatic route without any restrictions. The objective of this change in policy is to freely promote the transfer of high-end technology into India.

This amendment in the exchange control regulations could have implications on the intercompany royalty arrangements that multinational enterprises have with their Indian affiliates. Because of exchange control limitations, multinational enterprises may have in the past restricted the royalty charge to their Indian affiliates in line with the limits prescribed under the automatic approval route. With the removal of such a restriction, multinational enterprises may consider revisiting their royalty arrangements with their Indian affiliates to align them with the arm's-length standard.

With this change in policy, a robust transfer pricing documentation for supporting the arm's-length nature of royalty payments would be of utmost importance to defend the deductibility of such payments before Revenue.

Legal cases

Since the enactment of the transfer pricing regulations took effect from 1 April 2001, Indian tax authorities have completed seven rounds of transfer pricing audits. There have been a few noteworthy judicial cases, which have established certain important transfer pricing principles, such as preference for transaction-by-transaction analysis over the aggregation of transactions approach, importance of functional similarity between tested party and comparables and disregard of comparables having controlled transactions. Also, while the common issues such as availability of contemporaneous data and use of secret comparables remain unsolved, the tax authorities have increased their focus on complex issues including intangibles, procurement models and cost allocations. Certain recently concluded eminent cases that have marked the transfer pricing landscape in India are summarised below:

India

Quark Systems Pvt. Ltd.

The taxpayer is engaged in providing customer support services to an AE. In the transfer pricing documentation, TNMM was applied as the most appropriate method for determining the ALP. During the scrutiny audit, the Revenue rejected one company selected as a comparable by the taxpayer on the grounds that the said company was in a start-up phase and had made losses for consecutive years.

Before the Appellate Tribunal, the taxpayer contested that once functional comparability is established, the comparable should not be rejected on grounds such as start-up phase, negative net worth, etc. In addition, the taxpayer argued for the rejection of one high-margin comparable company on the basis that the company had significant controlled transactions.

In its ruling, remanding the order back to Revenue, the Appellate Tribunal upheld the need for a proper functional analysis of the tested party and the comparables in determination of ALP and objected to the selection of comparables merely on the basis of business classification provided in the database. The Appellate Tribunal also highlighted the need to follow principles of substantial justice, where the taxpayer should be given an opportunity to rectify a bona fide mistake when it is based on facts on record.

The ruling emphasised that selection of comparables rests on a proper functional analysis and principle of substantial justice to be considered in applying the burden of proof. In addition, the Appellate Tribunal held that the taxpayer may reject its own comparable selected in the transfer pricing study on merits, in light of additional/substantive facts available at the time of a transfer pricing audit.

Schefenacker Motherson Limited

Schefenacker Motherson Limited (SML) is a joint venture company engaged in the manufacture of rear-view mirrors and cable assemblies for rear-view mirrors for automobile manufacturing companies. The rear-view mirrors were supplied to automobile manufacturing companies in India, and the cable assemblies were exported outside India to group entities.

SML applied the TNMM to substantiate the arm's-length pricing and used cash profit to sales as the profit level indicator (PLI) to remove the effect of differences in capacity utilisation, technology used, age of assets used in production and depreciation policies between SML and comparable companies. The TPO rejected the use of cash profit to sales as the acceptable PLI.

The Appellate Tribunal opined that the elements that constitute operating income should be decided on a case-by-case basis depending on the facts, circumstances and nature of business involved. The ruling highlights that the fundamental principle of comparability analysis is to compare like with like. For this purpose, adjustments should be made for material differences to make transactions/entities comparable to each other. Furthermore, the ruling creates a precedent in support of the use of cash profit to sales or cash profit to cost as a PLI in applying the TNMM in certain circumstances.

Skoda Auto India Private Limited

The key international transactions of the taxpayer involved the purchase of kits and payment of royalties, the pricings of which were justified using TNMM as the most

appropriate method. In addition, CUP data (in the form of transaction price between the parent company and other group companies) was used as a corroborative analysis for the transaction of purchase of kits. The TPO rejected the application of the CUP and further made an adjustment by disregarding certain comparables selected by the taxpayer. At the Appellate Tribunal level, the taxpayer argued on the following issues:

- Differences in business models of comparable companies (full-fledged manufacturers) vis-à-vis the company (operating as an assembler).
- Low-capacity utilisation of the taxpayer as it was in the start-up phase.

The Appellate Tribunal laid down that:

- wherever necessary, economic adjustments (for capacity utilisation, unusual high start-up costs) should be made
- the taxpayer cannot be expected to get detailed information, which is not available in the public domain
- in the absence of information in the public domain for making the adjustments, approximations and assumptions can be relied upon
- the benefit of the +/-5% range should be allowed to the taxpayer.

The principle of adjustment for high start-up costs enunciated in the judgment holds significant value for companies that are in their initial stage of operations. The ruling reemphasises the fact that a comparison should be made after economic adjustments whenever necessary.

Fulford (India) Limited

The taxpayer imported Active Pharmaceutical Ingredients (APIs) for secondary manufacturing of formulations. The TPO rejected the TNMM analysis undertaken by the taxpayer and considered the CUP method as the most appropriate method. The TPO compared the purchase price of APIs imported by the taxpayer from an AE with the price for which generic APIs were purchased by the taxpayer's competitors.

The taxpayer contended that the CUP method requires stringent comparability and any differences in the third party price and the international transaction price which could materially affect the price in the open market, warrant appropriate adjustment to such third party prices. In the pharmaceutical world, APIs may have similar properties but still could be different on quality, efficacy and levels of impurities present in the drug amongst other things. Therefore, the two products cannot be compared. Further, the assessee imported the APIs from the AEs and performed secondary manufacturing functions converting the APIs into formulations and marketed and sold the formulations in the Indian market, and therefore, was akin to a value added distributor. It was therefore entitled to a return for its distribution functions and secondary manufacturing functions commensurate to its level of involvement for the relevant product. The selection of the method should be based on functional analysis and the characterisation of the transactions and the entities. CUP method cannot be applied here as the application of the CUP method is blatantly absurd. By applying the CUP method and reducing the import price, the TPO was expecting the assessee to earn an operating margin of 32.09% in the manufacturing AE segment as compared to 11.37% earned in that segment. The profit earned in the AE segment was higher than the operating margin of 8.69% earned by the assessee in its non-AE segment.

India

Therefore, the assessee made several arguments rejecting CUP as the most appropriate method and distinguished the prior *Serdia Pharmaceutical* ruling on a similar issue. In the said ruling, the Appellate Tribunal had stated that the arm's-length price of generic APIs can be computed using the CUP method, as long as comparables for application of CUP are available.

However, in this ruling, the Appellate Tribunal did not make any adverse observations in relation to any of the arguments placed by the assessee. The Tribunal observed that the assessee's submission that it acted as a secondary manufacturer, which was akin to a 'value added distributor', was not made before the lower authorities. Accordingly, the Tribunal opined that in the interest of justice, they deem it proper to restore the issue to the file of the Assessing Officer for fresh adjudication.

IL Jin Electronics (I)(P) Ltd.

The taxpayer is engaged in the manufacture of printed circuit boards for one of its group companies in India. The taxpayer imported 45.51% of its raw materials from its AE in Korea, while the balance of 54.49% was procured locally. The AE in Korea purchased these raw materials from unrelated vendors and charged a mark-up for its procurement services. The taxpayer adopted the TNMM and used the operating margin results of a set of comparable companies to demonstrate the arm's-length nature of the import transaction. During the audit, the TPO rejected certain high-loss-making comparable companies identified by the taxpayer and made an upward adjustment to the taxpayer's import prices by applying a higher arm's-length operating margin to the total turnover of the taxpayer.

The taxpayer contested before the Appellate Tribunal that in arriving at the arm's-length price for the import transaction, it is important to consider the actual purchase price paid by its AE to the unrelated vendors as well as the mark-up charged by its AE for its procurement services. In addition, the taxpayer argued that working capital differences between the taxpayer and the comparable companies needs to be considered in arriving at the arm's-length operating margin under the TNMM. Finally, the main contention of the taxpayer was that because only 45.51% of the total raw materials were imported from its AE, any upward adjustment to the import price should be based only on 45.51% of the taxpayer's turnover, not the total turnover.

The Appellate Tribunal observed that an alternative methodology for TP analysis taking a foreign AE as a tested party by applying the resale price method or CPM would have been the ideal approach to determine the arm's-length price in the present case. However, in the absence of any supporting analysis/information presented in relation to the details of prices of the raw material purchased by the AEs from the third-party vendors by the taxpayer, the Appellate Tribunal held that the adoption of alternative methodology was not possible and hence, only TNMM could be used as the most appropriate method.

The Appellate Tribunal agreed with the taxpayer that transfer pricing adjustment should be made based only on 45.51% of the turnover, not the total turnover.

This ruling is important in the context of application of the TNMM, when the method has been applied on an entity-level basis where segmented financial data is not available with the taxpayer for transactions with its AEs. In such a case, any transfer pricing adjustment is to be made only on a proportionate basis and not on the basis of

the total turnover of the taxpayer. The Appellate Tribunal also commented on use of foreign AEs as the tested party to determine the arm's-length price.

Cheil Communication India Private Ltd.

The taxpayer is primarily engaged in the business of rendering advertising services to its AEs against payment of commission. The taxpayer applied the TNMM to confirm the arm's-length price of the international transactions and selected operating profit/value-added expenses as the profit level indicator (PLI). As part of its business of providing consultancy services related to advertisement, the taxpayer also facilitates placement of such advertisements in the print/electronic media. For this purpose, the taxpayer makes payment to third parties including advertisement agencies and printing presses for booking of advertising space/time slots, etc. on behalf of its customers, namely its AEs, and recovers them from its AEs.

In its audited accounts, the taxpayer recognises revenue on a net basis (i.e. it recognises the commission received as 'revenue' and treats the 'gross media spends' passed on to the customers/AEs as 'pass-through costs', thereby not including such third-party costs in its profit and loss account and operating margin computation).

The TPO held that the PLI for comparability purposes should be taken as OP/total cost where total cost includes the costs of placing advertisements on behalf of the AEs, which costs were reimbursed by the AEs to the taxpayer on an actual basis.

The Appellate Tribunal accepted that the gross media spends paid to the media agencies do not represent the taxpayer's value-added activity and accordingly, mark-up is to be applied on the cost incurred by the taxpayer in performing the agency functions and not on the gross media spends. The Appellate Tribunal endorsed the OECD's view that while applying the TNMM, the costs to be considered should be the costs incurred in relation to the value-added activity (i.e. the costs relating to the agency function in the taxpayer's case).

This is the first Appellate Tribunal ruling in India on the treatment of pass-through costs. The ruling extensively relies on the OECD guidelines and establishes the principle that in applying a cost-based remuneration model, a return or mark-up is appropriate only for the value-added activities.

Maruti Suzuki India Ltd.

The taxpayer manufactures and sells cars and trades in spares and components of vehicles. The taxpayer had entered into a license agreement with its AE for use of licensed information and a licensed trademark for the manufacture and sale of the products and parts in specified territories. The taxpayer paid composite royalties for the licensed trademark as well as for the technology license. The TPO proposed to make an adjustment by disallowing the royalty paid by the taxpayer to its AE for use of the trademark and imputing as reimbursement with mark-up on the non-routine advertising, marketing and promotion expenses incurred in promoting the AE's brand name.

The taxpayer filed a writ petition with the High Court against the proposed addition by the TPO. The High Court, while disposing of the writ petition, referred the case back to the TPO with certain observations/directions. One of these was that if there is an agreement between the AE and the taxpayer which carries an obligation on the taxpayer to use the trademark owned by the AE, such agreement should be

India

accompanied either by an appropriate payment by the AE or by a rebate provided to the taxpayer. Appropriate payment should be made on account of benefit derived by the AE in the form of marketing intangibles obtained from such mandatory use of the trademark. However, if the agreement between the AE and the taxpayer for the use of the trademark is discretionary, no payment is required to be made by the foreign entity. The High Court also directed application of the concept of 'bright line' in the context of the taxpayer. Aggrieved by the order of the High Court, the taxpayer filed a special leave petition before the Supreme Court. The Supreme Court has directed the TPO to proceed in accordance with law 'uninfluenced' by the observations/directions given by the High Court in the impugned order on merits.

This is a landmark case on the issue of marketing intangibles in the Indian transfer pricing landscape. If the licensed manufacturer contributes to creation of and also economically owns marketing intangibles arising out of advertising and marketing expenses, then it would be entitled to rewards arising out of such spend and thus not required to be compensated by the foreign licensor for any part thereof. The bright line concept is generally applied in cases of distributors and not entrepreneurial licensed manufacturers such as the taxpayer. Further, import of components from group company suppliers needs to be ideally benchmarked in the hands of the foreign suppliers as tested parties, if such components are not embedded with significant intangibles. This approach would ideally be the situation in the majority of the cases where the licensees carry out significant localisation.

Gemplus India Pvt. Ltd.

The taxpayer is a part of the Gemplus group, which is engaged in providing smart card solutions for the telecommunications industry, financial services industry and other e-businesses. The taxpayer entered into a management services agreement with its AE for receipt of services in marketing and sales support, customer service support, finance, accounting and administration support and legal support.

The TPO observed that there was no clear proof that such services had actually been rendered by the AE. There was no specific benefit derived by the Indian entity. The taxpayer had not established the necessity for availing these services from the AE and had already incurred expenses towards professional and consultancy services and employed qualified personnel in India for rendering similar services. The volume and quality of services were disproportionate to the amount paid, and the charge was based on cost apportionment amongst the group entities on a mutually agreed basis and not on the basis of actual services rendered.

The Appellate Tribunal decided the case in favour of Revenue. This ruling has laid down some critical principles applicable for service transactions, which would in fact apply to any transactions involving intra group services or intangibles. Simply put, to satisfy the arm's-length standard, a charge for intra group services or intangibles must at least meet the following conditions:

- The need for intra group services or intangibles is established.
- The intra group services or intangibles have actually been received.
- The benefit from intra group services or intangibles is commensurate with the charge.

It may be noted that in the case of Dresser Rand India Private Limited, the Tribunal held that commercial wisdom of the taxpayer cannot be questioned in deciding the

necessity for availing such services. However, a few principles that are common in both the rulings are documentary evidences to establish actual receipt of services and cost incurred must be commensurate with expected benefits.

Logix Micro Systems Ltd.

The taxpayer is a software developer. It entered into a product development services agreement and a professional service agreement with one of its AEs. During audit proceedings, the TPO upheld that all the transactions of the taxpayer with the AE were compatible with the ALP but proposed an adjustment for notional income to be earned by the taxpayer relating to large receivables outstanding with its AEs.

The Appellate Tribunal has considered the concept of charging interest only on the overflowing interest-free period and has clarified that any interest loss on non-receipt of funds on time should form the basis of computing the notional income.

It should be noted that in the explanation added to definition of International transactions by the Finance Act 2012, receivables or any debts arising in course of business are considered as international transactions.

Reliance Industries Ltd.

The taxpayer hired a vessel from its AE and paid time charter hire charges based on a per day rate (PDR). In order to establish the ALP of the transaction, the taxpayer relied on the approval received by the Director General of Shipping (DG Shipping) and contended the same as comparable uncontrolled price (CUP). Further, the taxpayer also relied on monthly charter hire rate indicated in Drewry Monthly Report by contending that the PDR paid by the taxpayer was reasonable taking into account that the vessel provided by the AE was of less capacity i.e. 2,242 cubic meters, as against the rate published in Drewry Monthly Report which was for a capacity of 3,000 cubic meters.

The TPO considered published prices in the shipping publications, the Shipping Intelligence Weekly and the Drewry Monthly Report and arrived at their arithmetic mean. Further, the TPO made a prorated adjustment for the difference in capacity and determined the ALP, without considering any technical and commercial factors.

The Appellate Tribunal held that in the absence of comparable transactions (i.e. in view of the unique vessel, with no comparable ships available), the matter should be set aside to the file of the Assessing Officer for the limited purpose of re-computing the ALP by taking the data available in the public domain in the form of publication of Shipping Intelligence Weekly and Drewry Monthly as a 'comparable price', and adjusting it for differences in weight, capital cost, risk, etc.

The ruling reiterates the important principle that in the absence of actual transaction which can be considered as CUP, the data available in the public domain can be considered as a 'comparable price' after making adjustment for the differences.

Li & Fung (Trading) Ltd.

Li & Fung (Trading) Ltd., Hong Kong (AE) entered into contracts with its global third party customers for provision of sourcing services with respect to products to be sourced by such global customers directly from third party vendors in India. For the sourcing services, the AE received a commission from these global customers at 5% of the FOB value of goods sourced. The taxpayer was engaged in providing sourcing

India

support services to its AE, and was remunerated by the AE at cost plus 5 percent mark-up for provision of these services. The TPO alleged that a cost plus form of remuneration did not take into account substantial intangible assets such as supply chain management and human capital owned by the taxpayer. Based on above, the TPO ascertained that the taxpayer ought to have earned a commission of around 5% on the free on board (FOB) value of the goods sourced from India.

The Appellate Tribunal, in principle, rejected the cost plus remuneration model in favour of a commission based remuneration model (i.e. percentage of value of goods sourced). The Tribunal held that the compensation received by the AE (i.e. 5% of the FOB value of goods sourced) should be distributed between the taxpayer and the AE in the ratio of 80:20 based on the functional profiles of the AE and the taxpayer.

This decision of the Tribunal was based on its conviction regarding the following aspects of the functional profiles of the AE and the taxpayer:

- The taxpayer had actually performed all critical functions, assumed significant risks and had also developed unique intangibles over the years.
- AE did not have either any technical expertise or manpower to carry out the sourcing activities.

GAP International Sourcing (India) Pvt. Ltd.

The taxpayer was engaged in facilitating the sourcing of apparel from India for its group companies. The primary activity of the taxpayer comprised of assistance in identification of vendors, provision of assistance to vendors in procurement of apparel, inspection and quality control and coordination with vendors to ensure delivery of goods to group companies. The necessary technical and intellectual inputs for the discharge of these services were provided by the group companies. The taxpayer adopted the TNMM to benchmark the service fee determined at full cost plus 15% from the foreign group company for its transfer pricing documentation. During the TP audits, TPO disregarded the functional profile and characterisation of the taxpayer by assuming that the functional profile of taxpayer was substantially higher than those of limited risk support service providers.

The TPO alleged that a cost plus form of remuneration did not take into account substantial intangible assets owned by the taxpayer. These intangibles were primarily construed by the TPO to be in the nature of human asset intangibles, supply chain intangibles and location savings. Based on above, the TPO ascertained that the taxpayer ought to have earned a commission of around 5% on the free on board (FOB) value of the goods procured by the group companies.

The Tribunal has stated that for determining the ALP of every international transaction, it is imperative to take the characterisation of the taxpayer and its AEs into consideration through functional analysis of international transactions. While stating this, the Tribunal has observed the following specifically for the taxpayer's case:

- No significant business risks were borne by the taxpayer.
- The taxpayer did not have capacity to assume business risks.
- No human resource intangibles were developed by the taxpayer.
- No supply chain intangibles were developed by the taxpayer.
- Location savings could not be attributed to the taxpayer.

In view of all of the above, the Tribunal held that the arm's-length cost plus mark-up for the taxpayer should be 32%, as opposed to the exorbitant numbers (830% and 660% for the two years under consideration) imputed by the TPO in a derived manner, by resorting to a commission based model of 5% on the FOB value of goods procured by the AE directly from Indian vendors.

The Appellate Tribunal has acknowledged that procurement companies may have different remuneration models based on their functional profiles (e.g. cost plus, commission or buy-sell margin), therefore it is important to ensure that the ALP is determined using the appropriate PLI and suitable benchmarking method. The ALP as determined by either the taxpayer or Revenue cannot lead to manifestly absurd or abnormal financial results, as had happened in the present case.

L'oreal India Pvt. Ltd.

The taxpayer is engaged in manufacturing and distribution of cosmetics and beauty products. In respect of the distribution segment, i.e. the international transaction of purchase of finished goods; the taxpayer had applied the RPM by benchmarking the gross margin of the taxpayer at 40.80% against that of comparables at 14.85%. The TPO rejected application of RPM by the taxpayer on the basis that the taxpayer was consistently incurring losses and the gross margins cannot be relied upon because of product differences in comparables. Accordingly, the TPO adopted Transactional Net Margin Method (TNMM).

The taxpayer contended that it was following market penetration strategy since the commencement of its distribution segment while the comparables had been present in the Indian market since long and had established themselves firmly in the Indian market.

The Appellate Tribunal observed that the taxpayer buys products from its AEs and sells to unrelated parties without any further processing and as per OECD Guidelines, in such a situation, RPM is the most appropriate method. The taxpayer had also produced certificates from its AEs that margin earned by AEs on supplies to the taxpayer was 2% to 4% or even less. The Revenue had not disputed these certificates. Therefore, the TPO's contention that the AEs have earned higher profit was not based on facts. On the other hand, profit earned by the AEs was also reasonable and hence there was no shifting of profits by the taxpayer to its AEs.

In this ruling, the impact of business strategies has been appreciated and operating losses were not attributed to non-arm's-length nature of international transactions.

39.

Indonesia

Introduction

Indonesia has adopted the arm's-length standard for transactions between related parties. As the tax system is based on self-assessment, the burden of proof lies with the taxpayer, not with the tax authorities.

Statutory rules

For income tax purposes, the legislation dealing with transfer pricing is found in Article 18 of the 1983 Income Tax Law, as revised by the 1991, 1994 and 2000 Income Tax Laws and further by Income Tax Law No. 36/2008.

Article 18 states that the tax authorities may adjust a taxpayer's taxable income for related party transactions that were not carried out on an arm's-length basis. Related parties are deemed to exist in the following circumstances:

- Where a taxpayer directly or indirectly participates in 25% or more of the capital of another taxpayer, or where a company participates in 25% or more of the capital of two taxpayers, in which case the latter two taxpayers are also considered to be related.
- Where a taxpayer directly or indirectly controls another taxpayer or where two or more taxpayers are under common control.
- Where there is a family relationship by blood or marriage.

In September 2008, Parliament passed Income Tax Law No. 36/2008, which came into effect 1 January 2009. Article 18 (3) of the Income Tax Law provides that the five arm's-length pricing methodologies from the Organisation for Economic Co-operation and Development (OECD) Guidelines should be used to set or review transfer prices.

For value-added tax (VAT), a virtually identical provision is included in Article 2 of the 1983 VAT Law, as revised by the 1991, 1994 and 2000 VAT Laws and further revised by VAT Law No. 42/2009.

Other regulations

Government Regulation No. 80/2007, which was issued 28 December 2007 and effective from 1 January 2008, explicitly states that taxpayers engaging in transactions under common control must maintain documentation which proves their adherence to the arm's-length principle.

The 2007 tax administration law states that documents requested in a tax audit must be delivered within one month of the request. This could mean that transfer pricing documentation submitted after 30 days can be ignored.

In late 2010, the Indonesian Director General of Taxation (DGT) issued several important transfer pricing regulations, laying the foundation for a new era of transfer pricing development in Indonesia. The transfer pricing regulation, PER-43/PJ/2010 (PER-43), represents the first specific transfer pricing guidance to Indonesian taxpayers since transfer pricing documentation became mandatory 1 January 2008.

PER-43 was amended by PER-32/PJ/2011 (PER-32) on 11 November 2011 which provides additional guidance on comparability analysis required in the transfer pricing documentation, preference towards internal comparables over external comparables and application of the most appropriate method as compared to the hierarchical approach in selecting transfer pricing methodology under PER-43. The regulation also mentioned that PER-32 is only applicable to transactions exceeding 10 billion Indonesian rupiah (IDR) with a single related party. Domestic related party transactions are also covered in the purview of the transfer pricing (TP) regulation if the related parties are effectively not taxed on the same basis.

The above amendment was in addition to the regulations released in 2010 on the Mutual Agreement Procedure (MAP), PER -48/PJ/2010 (PER -48), and the Advance Pricing Agreement, PER-69/PJ /2010 (PER -69).

Implementation of arm's-length principle

PER-32 indicates that the arm's-length principle should be implemented using the following steps:

- Perform a comparability analysis and identify comparables.
- Determine the most appropriate transfer pricing method.
- Apply the arm's-length principle to the tested transaction based on the result of the comparability analysis and the selected transfer pricing method.
- Document each step of the process used to determine the arm's-length price or profit.

The regulation notes that taxpayers are not required to comply with these steps for transactions with related parties who earn income, or incur expenses, of less than IDR 10 million. In practice, not many taxpayers are able to take advantage of this exemption.

Selection of transfer pricing methods

PER-32 has abandoned the hierarchy approach and adopted the most appropriate method approach, though from a practical perspective, the DGT still considers the comparable uncontrolled price (CUP) to be the most preferred method. The selection of the most appropriate method requires the following considerations:

- The strength and weakness of each transfer pricing method.
- The appropriateness of the method based on the nature of the related party transaction, determined by a functional analysis.
- Availability of valid information (on independent transactions) to apply the selected method.
- The comparability level between related party transactions with independent transactions, including whether any appropriate adjustments would need to be made to eliminate any material differences between the compared transactions or enterprises.

Indonesia

Comparability analysis

The comparability analysis outlined in PER-43 which has been amended by PER-32, is based upon the five comparability factors contained in the OECD Guidelines. These are as follows:

- Characteristics of property or services.
- Functional profile of parties involved.
- Contractual terms.
- Economic conditions.
- Business strategies.

Guidance is provided on how each of these comparability factors should be analysed. The guidance is consistent with explanations of the comparability factors in the OECD Guidelines. It is common practice for regional benchmark studies to be leveraged in Indonesian transfer pricing studies.

The Indonesian TP regulation also provides detailed guidelines on assessing the arm's-length nature of intragroup services (IGS) and intangible property (IP) transactions. Rigorous tests must be applied in a hierarchical manner to prove the arm's-length nature of IGS and IP transactions.

Burden of proof

Indonesia operates on a self-assessment system, with companies setting their own transfer prices. The burden of proof lies with the taxpayer to prove that the original price has been set at arm's length. In a tax audit context, if a taxpayer does not have documentation to support its position, there is a high risk that the Indonesian Tax Office (ITO) will make substantial adjustments, such as the denial of all deductions for management services fees or royalties paid to related parties.

Tax audit procedures

Audits are a significant feature of tax administration in Indonesia because of the self-assessment system. For the years preceding 2007, the tax office has ten years (but no later than 2013) within which to audit and issue assessments (and additional assessments if new facts, previously undisclosed, are found). For the years from 2008 onwards, the time span for the issuing of underpaid tax assessment letters has been reduced to five years.

So far, the tax authorities have not undertaken any audits specifically relating to transfer pricing. Nevertheless, tax audits conducted in relation to overall tax compliance will invariably focus on inter-company transactions, especially transactions involving non-residents. Where there appear to be price discrepancies between intragroup transactions and third-party transactions, corrections of transfer prices will be included in the audit findings.

The ITO has been strictly enforcing the 30-day rule in tax audits. In practice, if a taxpayer has not prepared transfer pricing documentation prior to receiving a request in an audit, it is likely to find it difficult to provide a satisfactory response within the 30-day timeframe.

Tax audits are conducted through desk reviews as well as visits to company premises by the tax authorities. These may involve meetings or correspondence, and settlement of

the transfer pricing audit may in many cases take place through formal negotiation and appeal at the tax court. The conduct of the taxpayer may influence the outcome.

The tax authorities also have the power to perform investigations. Investigations are generally used only where fraud or evasion is suspected. Experience has shown that the main trigger of an investigation by the tax authorities has been information obtained by them through their information network or provided to them by informants, such as disgruntled former employees.

Selection of companies for audit

Indonesia has an extensive system of tax audits. Taxpayers claiming refunds are automatically subject to tax audits. A tax return that indicates a loss generally also triggers a tax audit. In addition, the ITO has recently commenced a risk-profiling exercise designed to identify high-risk candidates for transfer pricing audits. Risk factors include losses (or poor profit performance compared to industry norms) and high volumes of related party transactions.

The provision of information and other duties of a taxpayer

The tax authorities have wide-ranging statutory powers to call for information relevant to an audit, such as accounting records, agreements, supporting documents and tax returns.

Tax objections and the appeals procedure

Tax auditors adjust related party transactions where they do not believe an arm's-length price has been used. Taxpayers have the right to object to assessments made by the tax office. The objection must be lodged in writing within three months of the issuance of the assessment and should be addressed to the DGT at the particular office from which the assessment was issued. The DGT has 12 months to issue a decision in relation to the objection.

Under the 2007 Tax Administration Law, which was effective from 1 January 2008 (and applies to tax years beginning on or after this date), taxpayers are required to pay only an amount agreed with the tax auditors during the tax audit's closing conference. If the taxpayer does not agree with any of their corrections, it need not pay anything at this point.

However, taxpayers need to take care when deciding how much to pay, because an unfavourable DGT decision on their objection results in an administrative penalty of 50% of the underpaid tax. The penalty increases to 100% if an appeal is lodged and the decision is not in the taxpayer's favour.

Taxpayers may appeal to the Tax Court against DGT decisions on their objections. To have the Tax Court hear the appeal, the taxpayer must pay 50% of the total tax assessment. There is uncertainty over the minimum amount to be paid for filing an appeal. According to the 2007 Tax Administration Law, the same rule should apply: taxpayers pay only as much as agreed in the closing conference. However, the Tax Court Law, which governs tax appeals, demands a minimum payment of 50% of the tax due. Notwithstanding the above, we note from some experiences of taxpayers, the court judges did not throw out taxpayers' cases on a technicality when the 50% minimum payments have not been satisfied.

Indonesia

Currently, the Tax Court gives taxpayers their best chance of receiving a fair hearing. If an appeal to the Tax Court is still unsuccessful, taxpayers can appeal to the Supreme Court, provided that certain criteria are met.

It is worth noting that Indonesia has a civil law system in which the courts do not operate on the basis of precedence and their decisions are not published. Furthermore, tax cases cannot be appealed beyond the Tax Court or Supreme Court or in any civil court other than the State Administrative Court. This court deals with complaints by persons adversely affected by government decisions and has rarely, if ever, been used in tax cases.

Tax penalties

Penalties of 2% per month are imposed for late payment of tax, up to a maximum of 48% of the unpaid tax. In criminal cases, fines of 200%-400% of the unpaid tax are possible, as is imprisonment.

A team within the central tax office specialises in transfer pricing issues. Generally, tax auditors who handle the day-to-day aspects of a tax audit are not transfer pricing specialists, although they usually have some training in the area. Transfer pricing related inquiries are undertaken by the relevant tax audit department, without assistance from external advisors.

Risk transactions or industries

There are no excluded transactions. For certain industries where it may be difficult to establish levels of actual profit arising in Indonesia, tax authorities have the power to impose taxes based on deemed profit. Marine or international aviation companies, oil and gas drilling companies, and foreign representative offices are included under this principle/regulation (Article 15 of the 1983 Income Tax Law, as revised by the 1994 and 2000 Income Tax Law and further by Income Tax Law No. 36/2008).

Although most of the transfer pricing issues challenged in tax audits in Indonesia have focused on cross-border transfer pricing, the law also covers transfer pricing that takes place within the country. Examples of where the tax office may use these provisions are in respect of luxury sales tax imposed on domestically produced luxury goods, transactions subject to VAT, or profit shifting to utilise losses.

Companies must disclose transactions with related companies in their annual income tax returns. The disclosures are quite detailed and include information such as whether transfer pricing documentation has been prepared.

The statement requires taxpayers to disclose the following details about their transactions with related parties:

- With whom the transaction is made and the nature of the taxpayer's relationship with the counterparty.
- The type of transaction.
- The value of the transaction.
- Which method was applied in determining the relevant transfer price (one of the five arm's-length transfer pricing methods recognised in the OECD Guidelines must be disclosed for each transaction), and the rationale for the choice of that method.

For 2009 and later tax years, taxpayers must also make detailed disclosures about whether they have prepared transfer pricing documentation, such as:

- Company profile and ownership structure.
- Types of transactions and any similar transactions with independent parties.
- Analysis of OECD comparability factors.
- Selection and application of the most appropriate transfer pricing method.

It is currently unclear whether the tax authorities will use these disclosures to select candidates for transfer pricing audits, as has been the practice in other countries where disclosures are required.

Limitation of double taxation and competent authority proceedings

The competent authority process has been increasingly used in Indonesia, because transfer pricing assessments have become more common over the last few years.

The ITO had received a number of competent authority requests arising from transfer pricing assessments raised in the previous year. Given the increase in transfer pricing audit activity and assessments raised by the ITO, it is likely that the number of competent authority cases will continue to increase in the future. An Indonesian resident taxpayer may file a MAP request with respect to transfer pricing adjustments. The request for MAP must be submitted in written form to the DGT through the head of the relevant tax office by providing the information specified in the prevailing regulation. If the request can be further processed by consultation with an authorized official in the tax treaty partner country, the DGT sends a written request for MAP to this official.

The DGT terminates the MAP process if the Indonesian resident taxpayer or the Indonesian citizen that has been a resident taxpayer in the partner country that makes the request for MAP:

- submits a cancellation of the MAP request to the DGT
- does not agree with the content of the mutual agreement draft
- does not meet all the requirements for information or documents as required by the DGT
- gives false information to the DGT.

With the issuance of Government Regulation No. 74/2011 (GR 74) taxpayers can apply for a MAP and simultaneously pursue local dispute resolution mechanism. The local dispute resolution includes applying for a tax objection, appealing to the Tax Court and requesting for a reduction or cancellation of administrative sanctions.

However, MAP application shall be discontinued if an appeal decision is declared by the Tax Court prior to the finalisation of the MAP. If one of the parties is not satisfied with the Tax Court decision, a judicial review by the Supreme Court is still allowed.

Advance pricing agreements (APAs)

As from 1 January 2001, the Indonesian Income Tax Law includes a provision that authorises the Indonesian DGT to enter into an APA, which is valid for agreed periods and is renegotiable. As is the case in many other countries, unilateral or bilateral APAs

Indonesia

can be an advantageous way of resolving transfer pricing uncertainties before they become acrimonious disputes.

On 31 December 2010, the DGT released APA regulation No.69/PJ/2010 (PER 69). The coverage period for an APA is three fiscal years from the conclusion of the agreement.

A rollback to previous years is possible, provided that the following criteria are met:

- The taxpayer's corporate income tax return for the relevant tax year has not been audited.
- The taxpayer has not filed any tax objection regarding the tax return.
- There is no indication of tax crime.

The rollback of an APA to prior years is not automatic and will be subject to negotiation between the taxpayer and the ITO.

GR-74 stipulates that any documents used during the negotiation of an APA should be returned to the taxpayer if no agreement is reached and the documents cannot be used by the Indonesian Tax Office (ITO) as the basis to conduct a tax audit or audit for preliminary evidence.

Anticipated developments in law and practice

It is anticipated that further regulations concerning MAP and APA will be issued in the near future. It is also anticipated that the tax authorities will continue to conduct extensive transfer pricing audits in the next few years.

Liaison with customs authorities

Although the income tax authorities and customs authorities both fall under the Minister of Finance (MOF), there does not appear to be a routine exchange of information between them.

Joint investigations

No information is available on the DGT's willingness to participate with tax authorities from foreign countries in joint investigations of taxpayers. However, the DGT, according to the 'Exchange of Information' article in double-taxation agreements, is not precluded from carrying out investigations.

40.

Ireland

Introduction

As part of the 2010 Finance Act, enacted in April 2010, Ireland has finally introduced broad-based transfer pricing legislation. The legislation endorses the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and adopts the arm's-length principle. The introduction of general transfer pricing legislation in Ireland was widely anticipated and brings the Irish tax regime into line with international norms in this area. The new regime applies to domestic as well as international related party arrangements and comes into effect for accounting periods commencing on or after 1 January 2011, in relation to certain arrangements entered into on or after 1 July 2010.

Prior to the publication of the new legislation, the transfer pricing provisions contained within the Irish tax legislation were previously only of limited application, and few resources were devoted to the issue by the Irish tax authorities. Despite the absence of local regulations and scrutiny prior to the 2010 Finance Act, transfer pricing was already a significant issue both for multinationals operating in Ireland and for Irish companies investing abroad because of the transfer pricing regulations in place in many overseas jurisdictions where the affiliates trading with Irish companies were located. For this reason, it is considered that the introduction of equivalent transfer pricing rules into the Irish system is not expected to result in significant changes to the underlying pricing for these transactions.

Statutory rules

Part 35A of transfer pricing legislation

Part 35A, Section 835A to Section 835H, of the 1997 Taxes Consolidation Act (Part 35A), contains Ireland's newer domestic law dealing with transfer pricing. Part 35A confers a power on the Irish tax authorities to recompute the taxable profit or loss of a taxpayer where income has been understated or expenditure has been overstated as a result of certain non-arm's-length arrangements. The adjustment will be made to the Irish taxable profits to reflect the arrangement had it been entered into by independent parties dealing at arm's length.

The new transfer pricing rules apply to arrangements entered into between associated persons (companies) on or after 1 July 2010, involving the supply or acquisition of goods, services, money or intangible assets and relating to trading activities within the charge to Irish tax at the trading rate of 12.5%. However, an exemption from the new rules is available for small- and medium-sized enterprises.

Ireland

Two unique characteristics

The new regime includes many features expected of a jurisdiction introducing transfer pricing rules for the first time, but interestingly the legislation contains the following two unique characteristics:

- The new regime is confined to related party dealings that are taxable at Ireland's corporate tax rate of 12.5% (i.e. trading transactions¹).
- A 'grandfather' clause whereby arrangements entered into between related parties prior to 1 July 2010, are excluded from the new transfer pricing rules.

Exclusion of non-trading activities

The new transfer pricing regime is confined to related party dealings that are taxable at Ireland's corporate tax rate of 12.5% (i.e. trading transactions). Activities that are deemed to be non-trading or 'passive' in nature and which are taxable at the higher rate of 25% will be excluded from the scope of the new regime.

Passive income for the purposes of the new regime may include interest, royalties, dividends and rents from property where the income arising is not derived from an active trade. In practice, each transaction must be examined in the context of the company and its business to determine if it will constitute trading or passive income.

The question of whether a trade exists will initially be decided by the taxpayer because the Irish tax system is based on the principle of self-assessment. The term 'trade' is defined in Irish tax legislation as including 'every trade, manufacture, adventure or concern in the nature of trade'. However, the legislation does not outline specific rules for distinguishing between trading and non-trading activities. Guidance as to what constitutes trading is available from case law and from a set of rules known as the 'Badges of Trade', which have been laid down by the courts in various cases over the years and which were set out in the 1954 report of the UK Royal Commission on Taxation. This report and the approach of the courts have been adopted into practice in Ireland to examine the specific facts of an individual case and look for the presence, or absence, of common features or characteristics of trade.

In addition to the available case law, it is possible for a taxpayer to make a submission to the Irish tax authorities to seek an advance ruling on whether trading activities are being carried out.

The distinction between whether a company's activities are deemed to be trading or passive in nature is therefore crucial for determining whether the related party transactions will fall within the scope of the new regime. The determination will depend on the specific facts and circumstances of each case.

Grandfather clause

The other unique characteristic in the legislation is that the transfer pricing rules will apply only to arrangements entered into on or after 1 July 2010. The term 'arrangement' is defined within the draft legislation as 'arrangements or agreements, whether or not legally enforceable or intended to be legally enforceable'. The Irish tax authorities have not yet provided any guidance on how they will interpret what a new arrangement will be.

¹ Certain 'excepted trades' are taxed at Ireland's higher corporate tax rate of 25% as are subject to Irish transfer pricing rules. Excepted trades are limited to dealings in land other than construction activities, working with certain minerals and petroleum activities, section 21A of the Taxes Consolidated Act 1997 refers.

Other key features of the new transfer pricing regime

Associated persons

Part 35A will apply only to arrangements between associated persons. Two persons party to an arrangement will be considered associated if one person participates in the management, control or capital of the other person or if a third person participates in the management, control or capital of each of the two persons party to the arrangement. A person is deemed to be participating in the management, control or capital of another person if that other person is a company and is controlled by the first person.

Nature of related party dealings

Part 35A applies only to related party arrangements involving 'the supply and acquisition of goods, services, money or intangible assets'. It is noted that all these terms are commonly used in the OECD Transfer Pricing Guidelines, with the exception of the term 'money'. The OECD guidelines instead use the terminology 'financial relations'.² The Irish tax authority has not issued any guidance on how it will interpret the term 'money'; therefore, this represents an area where further clarification from the Irish tax authorities can be expected in the future.

Effective date

Part 35A will come into effect for accounting periods commencing on or after 1 January 2011, in relation to any arrangement entered into on or after 1 July 2010. For example, a company with a 31 December year-end will be subject to the new transfer pricing rules for the year ended 31 December 2011, and any subsequent year but only in relation to arrangements entered into on or after 1 July 2010.

Understatement of Irish profits

The new regime is 'one way', facilitating an upwards adjustment to taxable profits where the profits of an Irish taxpayer are understated as a result of non-arm's-length transfer pricing practices. The regime confers a power on the Irish tax authorities to recompute the taxable profit or loss of a taxpayer where income has been understated or where expenditure has been overstated. The adjustment will be made to reflect arrangements that would be entered into by independent parties.

Exemption for small- and medium-sized enterprises

Part 35A contains an exemption from the transfer pricing rules for small and medium enterprises (SMEs). The definition of a SME is assessed at a group level and is based on the definition in the EU Commission Recommendation of 6 May 2003. In this regard, a group will be regarded as a SME if it has:

- fewer than 250 employees, and
- either a turnover of less than 50 million euro (EUR) or assets of less than EUR 43 million.

This exemption is likely to have the effect of excluding a large number of domestic Irish companies from the new transfer pricing regime.

Summary

Following is a summary of the conditions that need to be met for the Irish transfer pricing rules to apply to an arrangement:

.....
2 OECD Guidelines, Chapter I, I-3

Ireland

- The taxpayer does not qualify as a small- or medium-sized enterprise.
- The arrangement involves the supply or acquisition of goods, services, money or intangible assets.
- At the time of the supply, the supplier and the acquirer are associated.
- The profits, gains or losses arising from the relevant activities are within the charge to Irish tax under Case I or Case II of Schedule D (that is, trading transactions within the charge to tax at the 12.5% trading rate).
- The consideration payable or receivable under the arrangement is not at arm's length and results in an understatement of Irish profits.
- The terms of the arrangement were agreed on or after 1 July 2010.

Branches

Based on the definition of 'person' as defined in domestic Irish tax legislation, any arrangements entered into between a branch and its head office will not fall within the scope of the transfer pricing rules on the basis that a branch and head office cannot constitute two separate persons. However, a transaction between an Irish branch and a foreign affiliated company will fall within the scope of the rules on the basis that this will constitute a relationship between two separate persons.

Other rules and regulations

Documentation

Part 35A states that companies will need to provide documentation 'as may reasonably be required' and that documentation will need to be prepared 'on a timely basis'. The Irish tax authorities issued further guidance (Tax Briefing Issue 07 of 2010) on the documentation that is required to be prepared by taxpayers to be compliant with the transfer pricing rules.

The guidance note supports the legislative basis and indicates that a company is required to have transfer pricing documentation available for inspection if requested by the Irish tax authorities.

Reference is made to the fact that the purpose of the documentation should be to demonstrate compliance with the transfer pricing rules. The Irish tax authorities have stated that the form and manner that the documentation takes 'will be dictated by the facts and circumstances of the transactions' and recognise that the cost involved in preparing the documentation should be 'commensurate with the risk involved'. As an example, the guidance note states that the Irish tax authorities would expect complex transactions to have more detailed documentation in place in comparison with simple transactions.

Notably, the guidance note states that 'it is best practice that the documentation is prepared at the time the terms of the transaction are agreed'. Additionally, the guidance note states that 'for a company to be in a position to make a correct and complete Tax Return', appropriate transfer pricing documentation should exist at the time the tax return is filed. It is worth noting that the taxpayer can maintain documentation in a form 'of its own choosing'. Additionally, where documentation exists in another territory which supports the Irish arrangement, this will also be sufficient from an Irish transfer pricing perspective, on the basis that the documentation is in English. The Irish tax authorities have also confirmed that they will accept documentation that has been prepared in accordance with either the OECD

Transfer Pricing Guidelines or the code of conduct adopted by the EU Council under the title 'EU Transfer Pricing Documentation'.

The Irish tax authorities have set out a comprehensive list of information that must be included in the documentation that is prepared. The 'documentation must clearly identify':

- associated persons for the purposes of the legislation
- the nature and terms of transactions within the scope of the legislation
- the method or methods by which the pricing of transactions was arrived at, including any benchmarking study of comparable data and any functional analysis performed
- how that method has resulted in arm's-length pricing or where it has not, what adjustments were made and how the adjustment has been calculated
- any budgets, forecasts or other papers containing information relied on in arriving at arm's-length terms, etc., or in calculating any adjustment, and
- the terms of relevant transactions with both third parties and associates.

The Irish tax authorities have confirmed that transfer pricing documentation must be available for relevant arrangements 'that take place in accounting periods beginning on or after 1 January 2011'. The Irish tax authorities have also confirmed that documentation requirements will not apply to so-called grandfathered arrangements, the terms of which were agreed before 1 July 2010. The guidance note states that an arrangement will qualify for this 'transitional treatment' if:

- the terms of the pre-1 July 2010, agreement clearly envisage the transaction, and
- the application of these terms delivers the price of the transaction.

Other regulations

Prior to the introduction of the new transfer pricing regime, domestic transfer pricing provisions in Irish tax legislation, with one exception, were specific to particular types of transactions or to particular categories of taxpayer. A brief summary of these limited provisions is set out as follows.

Section 1036

One other general transfer pricing provision is contained in Section 1036, Taxes Consolidation Act 1997. This section applies where, for example, an Irish company carries on business with an overseas affiliate and, through the control exercised over the Irish company, the Irish company produces either no profits or less than the ordinary profits that might be expected to arise. In these circumstances, the overseas affiliate will be chargeable for Irish income tax in the name of the Irish company as if it were an agent of the Irish company.

Although a broad-based section, Section 1036 is not supported by any guidance from the Irish tax authorities on the application of the legislation, and definitions are not provided for key terms such as 'close connection and substantial control' included in the section. Further, the section focuses on whether the profits realised by an Irish company are commensurate with the ordinary profits expected, rather than whether the prices for the international related party transactions entered into by the Irish company are at arm's length.

Owing to these uncertainties, it is not believed that this section is applied in practice.

Ireland

Companies engaged in businesses qualifying for incentive tax rates

Among the more limited transfer pricing provisions which had been enacted were those applying to Irish companies qualifying for Ireland's incentive tax rate of 10%. The 10% incentive tax rate dates to the early 1980s and was known as 'manufacturing relief'. The relief is due to expire on 31 December 2010, and the introduction of a specific transfer pricing regime in Ireland has been timed to coincide with the expiration of manufacturing relief.

VAT and transfer pricing

On 2 April 2007, the Irish government enacted anti-avoidance legislation in relation to transactions between connected persons. This legislation gives the Irish tax authorities the power to impute an open-market value to the amount on which VAT is chargeable on a supply of goods or services. The legislation is a transposition of Article 80 of EU Council Directive No. 2006/112/EC, an EC directive that member states were not necessarily obliged to enact locally.

Other domestic transfer pricing provisions

Other anti-avoidance provisions have been enacted for:

- the transfer of land between connected persons
- the charge to capital gains tax on the sale of assets to connected persons
- the transfer of trading stock to a connected person at the time a trade is discontinued, and
- the exemption from tax in Irish tax legislation for income arising from certain qualifying patents.

In the last point, the provisions apply where the payer and beneficial recipient are connected, stating that the exemption will apply only to as much of the payment as would have been made by an independent person acting at arm's length.

Legal cases

Although Ireland's new transfer pricing legislation is effective only for accounting periods commencing on or after 1 January 2011, the decision of the Irish High Court in the case of *Belville Holdings Limited v Cronin* in 1985 suggests that the Irish courts have been willing in the past to impose arm's-length pricing in transactions between related parties.

The transaction considered in this case was the provision of management and other head-office services by Belville Holdings Limited, an Irish company, to its Irish resident subsidiary companies. As well as holding shares in subsidiaries, Belville Holdings Limited carried on a trade of managing its subsidiaries and providing finance to them. For all periods up to the year ended 30 October 1978, the total expenses incurred by Belville Holdings Limited were apportioned among the subsidiaries and recharged to them. This company policy changed with effect from the period commencing 1 November 1978, whereby only the operating expenses directly incurred for the benefit of the subsidiaries were recharged; other expenses not specifically allowable to the subsidiaries were borne by Belville Holdings Limited. This had the effect of trading losses being incurred by Belville Holdings Limited following the change of policy.

The case focused on two accounting periods, the period ended 30 June 1979, and the year ended 30 June 1980, in which Belville Holdings Limited and all but two

of its subsidiaries realised trading losses. Belville Holdings Limited did not receive management fees from its subsidiaries in these periods. However, the two profitable subsidiaries paid over their entire profits in each period to Belville Holdings Limited as dividends. Under tax legislation in force at the time, Belville Holdings Limited, by virtue of the trading loss it incurred in each period, claimed a repayment of the tax credits attaching to the dividends received from its two subsidiaries.

The Inspector of Taxes rejected the repayment claim of Belville Holdings Limited. The Irish tax authorities took the view that the losses of Belville Holdings Limited were not genuine trading losses, on the basis that Belville Holdings Limited had arranged its policy for recharging its management expenses to facilitate the claim for repayment of the tax credits. This position was upheld in the Appeal Court, which relied on the UK case of *Petrotim Securities Limited v Ayres* (1963) in stating that notional management fees equivalent to the market value of the services provided by Belville Holdings Limited should be included as assessable income of Belville Holdings Limited.

On appeal by Belville Holdings Limited to the High Court, the judge upheld the position of the Appeal Commissioners that notional management fees should be included in the tax computation of Belville Holdings Limited. However, the High Court also found that there was no evidence to uphold the Appeal Commissioner's arbitrary estimation of the market value of the services provided, which was set at 10% of the income of each of the two subsidiaries. For this reason, the High Court upheld the appeal of Belville Holdings Limited, but crucially did not refer the matter back to the Appeal Commissioners to reconsider a more appropriate valuation of the notional management fees.

The issue later arose as to whether the High Court division in Belville Holdings Limited had definitively found in favour of the taxpayer or whether the High Court intended to refer the matter back to the Appeal Commissioners. A Supreme Court hearing found that the High Court decision could be interpreted only as being in favour of Belville Holdings Limited.

In conclusion, although the Irish courts never ruled on an appropriate market value for the notional management fees, the case of *Belville Holdings Limited v Cronin* indicates that the Irish courts may support the Irish tax authorities in applying arm's-length pricing for transactions between connected persons. No other such cases have come before the Irish courts since 1985, and it is doubtful whether the Belville Holdings case could be solely relied upon in consideration of transactions between an Irish company and an international related party prior to the effective date of the new transfer pricing rules.

Burden of proof

Under Ireland's self-assessment system, the burden of proof in the event of an audit by the Irish tax authorities will fall on the taxpayer.

Tax audit procedures

Selection of companies for audit

Legislation permits the Irish tax authorities to carry out an inspection of tax returns filed under self-assessment. The purpose of such an inspection is to satisfy the Irish tax authorities that a return is complete and accurate.

Ireland

The Irish tax authorities are not obliged to disclose why they have picked a particular company or tax return for inspection. However, the selection of a return for inspection does not mean that the Irish tax authorities have evidence that tax has been underpaid. In many cases, the return is selected for audit for straightforward reasons, such as the level of turnover or profits generated by the company or the industry sector in which the company operates.

In the past, it would have been unusual for the Irish tax authorities to audit an Irish taxpayer for the sole reason of reviewing the arm's-length nature of its international related party dealings. Rather, transfer pricing issues have been considered as part of a general corporation tax audit. However, with the introduction of Part 35A, it can be expected that the Irish tax authorities will begin to enforce the new rules with specific transfer pricing audits for larger multinational groups.

The first opportunity that the Irish tax authorities will have to audit any related party arrangements and apply the new transfer pricing rules will come in 2012, when companies file their corporate tax returns for their 2011 financial year.

The annual corporation tax return form does not require an Irish company to disclose details to the Irish tax authorities on the type and value of the international related party dealings entered into by the taxpayer.

The provision of information and the duty of the taxpayer to cooperate

Auditors of the Irish tax authorities are fully entitled to inspect any original record of transactions conducted in the period under audit which is relevant to the company's tax position, or any document that links an original record to the company's finalised financial statements. Recent legislation has significantly widened auditors' inspection powers. An auditor is now entitled to inspect any document that relates to the company's business, not just records the company is obliged to maintain for tax purposes.

Part 35A states that only authorised officers, designated in writing by the Irish tax authorities, may make enquiries in relation to transfer pricing. The Irish tax authorities have yet to clarify who will be an authorised officer, but it is expected to be inspectors within the Large Cases Division of the Irish tax authorities.

The audit procedure

The Irish tax authorities will conduct a tax audit under the terms of the Charter of Taxpayers' Rights. Under the charter, the Irish tax authorities are obliged to approach the audit on the assumption that the company is fully tax compliant and its returns are correct. Prior to commencing the audit, the auditor can be expected to have carried out a detailed review of the company's tax files under all tax heads. The auditor will also have conducted a review of any information contained within the Irish tax authorities regarding the company's industry sector.

Also relevant to the audit procedure in Ireland is the Irish tax authorities' Code of Practice for Tax Audits, which sets out the procedures to be followed by the Irish tax authorities in their conduct of an audit and in reaching a settlement with the taxpayer. In notifying the company of their intention to undertake an audit of the company's tax affairs, the Irish tax authorities give the company until a specified date to decide whether it needs additional time to prepare a written disclosure of any

negligent underpayments of tax. In the context of an audit by the Irish tax authorities, a disclosure states the amounts of any tax liabilities previously undisclosed for the taxheads or periods within the scope of the audit enquiry, together with the company's calculation of the associated interest and penalties arising from the undisclosed liabilities. The disclosure must be accompanied by payment of the total liability arising in respect of tax, interest and penalties. (*Details on the calculation of interest and penalties are set out under Additional tax and penalties section*).

Audits generally commence with an opening meeting between the company and the official(s) of the Irish tax authorities carrying out the audit. In the situation where the taxpayer decides to make a written or verbal disclosure in relation to the returns under review, this will be presented to the auditor at the opening meeting. The auditor may ask for more information concerning the disclosure.

The initial audit work is likely to be devoted to checking the accuracy of any disclosure made by the taxpayer following notification of the tax audit. The auditor will then commence the inspection of the books and records supporting the tax return being audited.

We expect the Irish tax authorities will adopt the same approach for dealing with transfer pricing audits.

Revised assessments and the appeals procedure

Following an audit, the Irish tax authorities may make an assessment where they are dissatisfied with a return or returns made by the company. Generally, a time limit of four years applies to the making of assessments where a full return has been made.

Where a taxpayer is dissatisfied with an assessment raised by the Irish tax authorities, the taxpayer has the right to appeal against the assessment. This appeal must be in writing and be made within 30 days of the issue of the assessment. The appeal can be resolved by an agreement reached with the Irish tax authorities or by means of a hearing in front of the Appeal Commissioners.

Depending on the decision of the Appeal Commissioners, the taxpayer may have further avenues to appeal for a re-hearing to the Circuit Court, or to the High Court or Supreme Court on a point of law.

Additional tax and penalties

Part 35A does not contain any specific penalty provisions with respect to a transfer pricing adjustment. In the absence of specific penalty provisions being included, the Irish tax authorities have indicated that the general corporate tax penalty provisions and the Code of Practice will apply to assessments raised due to transfer pricing adjustments under the new transfer pricing rules. The Finance (No.2) Act 2008 formally introduced Ireland's tax geared penalty system with the new penalty regime applying to cases of tax default occurring on or after 24 December 2008.

Under the general corporate tax penalty provisions, interest arises on underpaid tax at a daily rate of 0.0273%, which is 9.96% per annum.

Also in their Code of Practice, the Irish tax authorities have set out a 'penalty' grid, which shows the penalties charged for each of three categories of default on the part

Ireland

of the taxpayer. The least serious category of default is 'careless behaviour without significant consequences' (with a 20% penalty), and the most serious is 'deliberate behaviour' (with a 100% penalty). The grid also shows that the penalty level can be reduced where the taxpayer cooperates during the audit with the Irish tax authorities. (Essentially this means that the taxpayer complies with all reasonable requests made by the Irish tax authorities for records and assistance.) The grid is reproduced here:

No Qualifying Disclosure	Category of Default	No Co-operation	Co-operation only
All defaults where there is no qualifying disclosure	Careless behaviour without significant consequences	20%	15%
	Careless behaviour with significant consequences	40%	30%
	Deliberate behaviour	100%	75%

An additional penalty grid is provided which shows how the level of penalty can be reduced based on the level of disclosure made by the taxpayer and whether or not another disclosure was made within the previous 5 years. The two types of disclosure are:

- a prompted qualifying disclosure; where the disclosure is made as a consequence of a notification letter received from the Irish tax authorities that the taxpayer has been selected for audit, or
- an unprompted qualifying disclosure; where no notification of audit is received from the Irish tax authorities.

The additional grid is reproduced here:

Penalty Table 1	Category of Default	Qualifying disclosure on or after 24/12/2008	
All defaults where there is a qualifying disclosures in this category.		Prompted qualifying disclosure and co-operation	Unprompted qualifying disclosure and co-operation
All qualifying disclosures in this category	Careless behaviour without significant consequences	10%	3%
First qualifying disclosure in these categories	Careless behaviour with significant consequences	20%	5%
	Deliberate behaviour	50%	10%
Second qualifying disclosure in these categories	Careless behaviour with significant consequences	30%	20%
	Deliberate behaviour	75%	55%
Third or subsequent qualifying disclosure in these categories	Careless behaviour with significant consequences	40%	40%
	Deliberate behaviour	100%	100%

It remains to be seen how the Irish tax authorities will apply the Code of Practice to transfer pricing cases. The authorities have clarified in Tax Briefing Issue 07 of 2010 that ‘the quality of the supporting documentation will be a key factor in determining whether the adjustment should be regarded as correcting an innocent error or as being a technical adjustment’.

Resources available to the tax authorities

The Irish tax authorities do not have a dedicated transfer pricing unit. When transfer pricing issues have arisen, resources have been drawn from international tax specialists or the Large Cases Division of the Irish tax authorities. Going forward, only authorised officers designated in writing by the Irish tax authorities may make enquiries in relation to transfer pricing. The Irish tax authorities have yet to clarify who will be authorised officers, but they are expected to be inspectors within the Large Cases Division of the Irish tax authorities.

Use and availability of comparable information

Should an Irish company not have internal comparable data to support the arm’s-length nature of its international related party transactions, it may be able to obtain data on the gross and net margins of comparable companies operating in Ireland by acquiring the annual returns of relevant companies from the Companies Registration Office.

All companies registered in Ireland are obliged to file an annual return with the Companies Registration Office, unless an exemption from filing applies. Depending on the size of the company, financial statements may be required to be filed with the annual return.

Risk transactions and industries

There are not considered to be particular related party transactions or industry sectors that could be regarded as facing a higher-than-normal risk of a transfer pricing enquiry from the Irish tax authorities.

To some extent, Irish taxpayers could be considered (indirectly) to be at a higher risk of a transfer pricing review should overseas tax authorities, which have developed extensive transfer pricing regulations, focus their attention on transactions or industries that include overseas affiliates of an Irish taxpayer.

Limitation of double taxation and competent authority proceedings

Irish companies normally contemplate competent authority proceedings in respect of transfer pricing adjustments imposed by overseas tax authorities on international related parties that trade with the Irish companies, rather than transfer pricing adjustments imposed by the Irish tax authorities.

Currently all of Ireland’s tax treaties contain a mutual agreement procedure. The Irish tax authorities are willing to support requests for competent authority relief on application by Irish taxpayers, subject to the facts and circumstances of the cases coming within the provisions of the relevant double tax treaty.

Ireland

It should also be noted that as a member of the European Union, Ireland is bound by the Code of Conduct to eliminate double taxation in the area of transfer pricing, approved by the EU Council of Finance and Economic Ministers on 7 December 2004. The Code of Conduct aims to ensure more effective and uniform application by EU member states of the 1990 Arbitration Convention (90/436/EEC), which was designed to deal with double taxation issues faced by taxpayers arising from transfer pricing adjustments.

Advance pricing agreements (APA)

Ireland does not have a formal APA procedure for Irish companies to agree prices with the Irish tax authorities for international related party transactions. However, the Irish tax authorities have been willing to negotiate and conclude bilateral advance pricing agreements with treaty partners, and they are generally willing to consider entering such negotiations once a case has been successfully accepted into the APA programme of the other jurisdiction. It remains to be seen whether Ireland will formalise its APA procedures in light of the recent introduction of the new transfer pricing rules.

It should also be noted that the Irish tax authorities have, upon request, provided inward investors with advance rulings on key tax issues relevant to the decision to establish operations in Ireland. Until recently, these advance rulings were generally provided on a company's qualification for Ireland's manufacturing relief. Of late, the key tax issue upon which taxpayers are requesting advance rulings from the Irish tax authorities is whether income from a particular activity would be regarded as trading income (taxed at 12.5%) or passive income (taxed at 25%).

In May 2003, the Irish tax authorities released a document titled *Guidance on opinions on classification of activities as trading*. This document was prepared in response to the growing number of advance opinions being requested of the Irish tax authorities on the appropriate classification of particular activities for taxation purposes. While its main purpose is to clarify the procedure for requesting an advance opinion, the document from the Irish tax authorities also provides significant practical guidance on the tax authorities' attitude about what constitutes a trading activity.

The practical guidance is found in a number of examples set out in the document. These examples are used by the Irish tax authorities to illustrate their thinking on three key issues discussed in the document:

- The notion that trading presupposes activity.
- The distinction between trading and investment.
- The importance of the role of the applicant company in a group structure.

It should be noted that the Irish tax authorities have chosen not to set threshold criteria (such as number of employees, value of tangible fixed assets, etc.) which, once met or exceeded, would automatically deem an activity to be considered a trade.

Liaison with customs authorities

It is understood that there is no liaison between the income tax authorities and the customs authorities, even though they are both under the same Board of Management and are controlled by the Minister for Finance.

Nevertheless, there is a significant overlap between the methods applied by the Customs Service to value a transaction between related parties and the methods contained in the OECD Guidelines to assess compliance with the arm's-length principle. Companies also must take care to ensure that any transfer pricing policies implemented are also appropriate from a customs perspective and vice versa.

OECD issues

Ireland is a member of the OECD, and the Irish tax authorities have publicly recognised that the OECD Guidelines are the internationally accepted standard for the allocation of profits among entities of a multinational. The new transfer pricing rules endorse the OECD Guidelines, and Part 35A should be construed in a manner that best ensures consistency with the OECD Guidelines.

Joint investigations

Under the terms of Ireland's tax treaties and the EU Mutual Assistance Directive, the Irish tax authorities can and do exchange information with treaty partners and fellow EU member states. Generally, Ireland's tax treaties also allow for communication between Ireland and the treaty partners for the purposes of implementing the provisions of the double tax treaty.

Thin capitalisation

There are no specific thin capitalisation rules in Ireland, but some provisions in the Irish tax legislation can deny a full deduction for interest payments in certain circumstances.

Interest payments to overseas affiliates may, depending on the location of the recipients, be reclassified as distributions in certain situations, and therefore would not be tax-deductible.

Other provisions apply to deny an interest deduction in circumstances where borrowings from a related party are used to acquire share capital from (or lend to) a company which immediately before the loan was connected with the borrower.

The reader is urged to consult with an Irish tax adviser concerning the application of the deemed distribution and restriction on deductibility of interest rules.

Management services

The new transfer pricing rules will apply to the provision of management services where those services represent an arrangement for the purposes of Part 35A as described previously. Where an Irish company is paying for management services, the general rules on deductible expenses will apply. Generally this means that a payment will be deductible for tax purposes where a company receives a benefit from the management services provided, once the payment is connected with the company's trade and was at an arm's-length price.

When a company is providing services, it should be remunerated for those services on an arm's-length basis and be seen to be generating income from the services provided to ensure a tax deduction is obtained for the costs it incurs in providing the services. This would usually be achieved by adding a profit element or mark-up to the cost of providing the services.

41.

Israel

Introduction

On 24 July 2002, the Israeli Parliament completed comprehensive tax reform legislation, which came into effect 1 January 2003. The reform includes transfer pricing provisions which require all cross-border inter-company transactions to be carried out at arm's-length terms. The enacted Sections 85A, 243 and 244(A) incorporate the arm's-length principle, which applies to any international transaction in which there is a special relationship between the parties of the transaction, and a price was settled for property, a right, a service or credit. Sections 85A, 243 and 244(A) came into effect upon issuance of final transfer pricing regulations by the Israeli Parliament on 29 November 2006.

Statutory rules

Overview

The Israeli transfer pricing regulations (the 'Israeli TP rules') promulgated under Sections 85A, 243 and 244(A) of the Israeli Tax Ordinance (ITO) generally follow the Organisation for Economic Co-operation and Development (OECD) Guidelines as well as Section 482 of the US Internal Revenue Code. The Israeli TP rules require that all cross-border transactions carried out between related parties be consistent with the arm's-length principle and are expected to be taxed accordingly. Upon approval by the tax-assessing officer granted to a taxpayer, certain one-time transactions may be excluded from the scope of the regulations.

According to Section 85A of the ITO, the Israeli TP rules apply substantially to all types of cross-border transactions in which a special relationship exists between the parties to the transaction. Special relationship includes the association between an individual and his/her relative, the control of one party to the transaction over the other or the control of one individual over the other parties to the transaction, whether directly or indirectly, singly or jointly with other individuals. These transactions, including various types of services (such as research and development, manufacturing, marketing, sales and distribution), the use or transfer of tangible and intangible goods and financing transactions, are required to be carried out according to the arm's-length principle. The Israeli TP rules also address topics such as determining market terms, reporting research of market terms and transitional provision.

Application of the arm's-length principle under the Israeli TP rules

Application of the arm's-length principle is generally based on a comparison of the conditions in a cross-border controlled transaction with the conditions surrounding similar transactions entered between independent companies (comparable companies). To determine if a cross-border controlled transaction has been carried out in accordance with the arm's-length principle, the following steps need to be taken:

- Identify the cross-border controlled transactions within the group.
- Identify the tested party for each respective transaction.
- Perform a functional analysis with special emphasis on comparability factors such as business activity, the characteristic of property or service, the contractual conditions of the cross-border transaction and the economic circumstances in which the taxpayer operates.
- Select the appropriate transfer pricing method(s).
- Select the comparable companies and establish an arm's-length range determined by the comparable companies.
- Examine whether the tested party's results fall within the arm's-length range.

Transfer pricing methods

In general, the Israeli TP rules specify the following transfer pricing methods which would need to be applied in hierarchical order as further described below:

- Comparable uncontrolled price (CUP) method – A method that compares the prices for property or services transferred or provided in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction under comparable circumstances.
- If the CUP method cannot be applied, then one of the following methods, which is most appropriate according to the specific circumstances, should be applied:
 - Profitability Method – a method that compares the profitability that a taxpayer realises from a controlled transaction to profit margins in comparable uncontrolled transactions.
 - Cost Plus (CP) method – a method that compares mark up on direct costs.
 - Resale Price method (RPM) – a method that compares the gross profit margins.
 - If the CP or RPM cannot be applied, then the Comparable Profit method (CPM) should be applied. The CPM compares profitability according to profit level indicators (PLIs), which are most appropriate according to the specific circumstances, as determined in the Israeli TP Rules.
 - Profit split method (PSM) – A method that compares the controlled transaction with an uncontrolled transaction according to the division of profits or losses between related parties, that reflects the contribution of each party to the transaction, including the exposure to risks and rights to the assets relating to the transaction.
- Other methods – In cases where none of the above-mentioned methods can be used to derive the most reliable measure of an arm's-length result, the taxpayer may apply any other method as the most appropriate method under the specific circumstances.

The arm's-length range

A cross-border controlled transaction is considered to be arm's length if, following the comparison to similar transactions, the result obtained does not deviate from the results of either the full range of values derived from comparable uncontrolled transactions when the CUP method is applied (under the assumption that no comparability adjustments were performed) or the interquartile range (the values found between the 25th and 75th percentiles in the range of values) when applying other methods. Under a transfer pricing audit, if the results of the cross-border controlled transaction fall outside the relevant range (either the full range or the interquartile range, depending on the method used), the transfer price will be set at the median of the comparable results.

Israel

Transitional provision

The Israeli TP rules shall apply to international transactions carried out on and after the day of their publication. However, a transfer pricing study carried out before these regulations were published and that within two years of their publication, shall be deemed a transfer pricing study carried out according to these regulations if it was carried out according to the accepted guidelines published by the OECD or by its member states.

Advanced pricing agreements (APA)

A taxpayer that is a party to a cross-border controlled transaction may request an APA from the Israeli tax authorities for a particular transaction or for a series of transactions that have been set at arm's-length levels. The request for such an agreement should include supporting documentation with respect to the transaction, including documents that demonstrate how the transfer price was established, inter-company agreements, and opinions or any other supporting documentation that supports the arm's-length compensation that has been established for the specific transaction.

The tax-assessing officer will inform the taxpayer of his decision within 120 days (this period can be extended to 180 days). If the tax-assessing officer does not respond during this period, the transfer price will be deemed to have been set at arm's-length levels.

Currently, the Israeli tax authorities issue only unilateral APAs. At the conclusion of the APA procedure there is a binding agreement between the taxpayer and the Israeli tax authorities.

Timing of Transfer Pricing Documentation

Under the Israeli TP rules there is no stated requirement as to documentation needing to be contemporaneous with the company's tax filings. However, a taxpayer engaged in a cross-border controlled transaction is required to include in its annual tax return a special form describing the transaction and its nature, including references to its price and other relevant terms and conditions (see further discussion below). In addition, the tax assessing officer may issue the taxpayer a formal letter of request, requiring the taxpayer to submit, within 60 days, all relevant documentation and other information related to the intercompany transaction.

Reporting procedures

The Israeli TP rules require all taxpayers engaging in cross-border controlled transactions to include in their annual tax return the 'Declaration of International Transactions' form (#1385). The form must be filled out for each and every cross-border transaction between related parties and attached to the annual income tax return. This form applies as from the 2007 tax year and has been updated during 2010. The transfer pricing form contains the following details:

- Transaction number – a separate form must be filled out for each and every cross-border transaction with each related party.
- Transaction Description – the field of activity must be specified, such as: manufacturing, marketing, sales, distribution, research and development, consulting and provision of services. Furthermore, in cases of buying and selling of goods or provision/receipt of services, the type of asset or service must be specified.

- Details of the related party involved in the transaction – The name of the related party involved in the transaction must be specified in addition to the related party's registration number abroad, as documented in its incorporation documents.
- The total price of the transaction – The selected transfer pricing method must be specified in addition to the total consideration regarding the intercompany transaction between the related parties.

The taxpayer is required to attach to the annual tax return the signed transfer pricing form, stating that *'I hereby declare that the transaction with foreign related parties is in accordance with the arm's-length principle, as defined in Sections 85A of the Israeli Tax Ordinance and the relating regulations'* (free translation from Hebrew).

In addition, the taxpayer should submit supporting documentation such as contracts; any disclosure made regarding the controlled transactions to any foreign tax authority, including any request for an advanced pricing agreement; and any differences between the prices reported to the foreign tax authority and the prices reported in the Israeli tax returns. Furthermore, the taxpayer is required to disclose all transfer pricing studies conducted or an assessment prepared for purposes of filing to the Israeli or other foreign tax jurisdictions, as well as any opinion from an accountant or lawyer, if such were given.

Burden of proof

According to the Israeli TP rules, the initial burden of proof lies with the taxpayer. The taxpayer is required to submit the appropriate documentation and relevant information of the inter-company transactions to the tax-assessing officer within 60 days of the latter's request. Once the taxpayer has presented all relevant information as required, the burden of proof shifts to the assessing officer.

Penalty regime

No specific transfer pricing penalties exist under the Israeli TP rules. However, general penal and monetary sanctions set in Israeli tax legislation may apply.

42.

Italy

Introduction

Transfer pricing has gained increasing attention in recent years in Italy. Until 2010 this was due to an ongoing relocation of manufacturing out of Italy to territories with low production costs, developed infrastructure, tax incentives and a skilled labour force as a long-term strategic response to the increasingly challenging business environment. In addition, highly centralised business model structures resulting from supply chain restructuring became more common within multinational enterprises with a concentration of high-value intangibles and entrepreneurial functions and risks in tax-advantaged jurisdictions.

In 2010, Italy introduced penalty protection documentation rules together with early recognition of the 2010 OECD Guidelines. Now Italy also requires reporting of the totals of inter-company transactions in the annual tax return. These latter developments have significantly enhanced the profile of transfer pricing in Italy with a much broader level of awareness and general interest. From the perspective of the Italian tax authorities transfer pricing has also become one of their key audit and tax adjustment areas in the past year.

Statutory rules

Statutory rules on transfer pricing are set out in Article 9 and Article 110 of the Italian Income Tax Code.

Article 110, paragraph 7, states that components of the income statement of an enterprise derived from operations with non-resident corporations that directly or indirectly control the enterprise, are controlled by the enterprise or are controlled by the same corporation that itself controls the enterprise should be valued on the basis of the normal value of the goods transferred, services rendered and services and goods received, if an increase in taxable income would arise thereby. Possible reductions in taxable income as a result of the normal value rule are allowed only on the basis of mutual agreement procedures or the European Union (EU) Arbitration Convention.

Article 9, paragraph 3, states that ‘normal value’ means the average price or consideration paid for goods and services of the same or similar type, carried on at market conditions and at the same level of business, at the time and place in which the goods were purchased or the services were performed. For the determination of the normal value, reference should be made to the extent possible to the price list of the provider of goods or services. In the absence of the provider’s price list, reference should be made to the price lists issued by the Chamber of Commerce and to professional tariffs, taking into account usual discounts.

Other regulations

The translation of the above statutory rules into operating guidelines was effected through the Ministry of Finance instructions in Circular Letter No. 32/9/2267, dated 22 September 1980. The Circular Letter provides principles and methods to be used in determining normal value. As it is based on the 1979 OECD Transfer Pricing Report, and the transfer pricing documentation provisions introduced by Law Decree 78 of 31 May 2010 make clear reference to the 2010 Organisation for Economic Co-operation and Development (OECD) Guidelines, its current status is now unclear. Tax auditors have used the Circular Letter for many years and may continue to do so, although this is discouraged by the International Office of the Italian Tax Authority. In some cases, local practice in the field continues to vary from the most up-to-date OECD position.

Transfer pricing documentation provisions have been included in Law Decree 78 of 31 May 2010, which was converted into law on 30 July 2010. The law provides a penalty protection regime for companies which comply with the documentation requirements, including the detailed format as set out in a Regulation dated 29 September 2010 and who notify possession of documentation when they file their tax returns. The provision of compliant documentation relieves taxpayers from the normal regime of tax geared penalties on adjustments insofar as the adjustment relates to a transfer pricing matter.

Legal cases

In recent years, there have been a number of court decisions relating to transfer pricing. The most important cases are summarised below; they provide general principles on various points (i.e. concept of free competition, arm's-length definition, burden of proof, and necessary documentation for deducting inter-company service charges). Decisions from the Supreme Court represent the final judgment in an Italian tax case. Provincial and regional tax court decisions represent first and second instances.

Judgment No. 13233 of the Supreme Court, fiscal division (October 2001)

Judgment No. 13233 deals with the concept of 'free competition'.

The Italian company subject to assessment (ITCO) purchased goods from its foreign parent. The Italian tax authorities (ITA) adjusted the purchase price on the grounds it was not at arm's length. ITCO appealed to the court and claimed that transfer pricing provisions were not applicable in its case due to the absence of free competition in this sector in Italy; only one other Italian company produced the same product, and this was under licence from its foreign parent. The court determined that in order to speak of 'free competition', it is enough that a similar product is sold in Italy without any legal restriction on pricing. There is no need to have 'ideal' free competition. For this reason, the court rejected the appeal.

Judgment No. 130 of the Tax Court of Tuscany (January 2002)

Judgment No. 130 concerns the definition of 'arm's-length value'.

The tax court stated that normal value can be determined by reference to average data from the sector in particular, data provided by the trade association to which the Italian resident company belongs, or data confirmed by financial statements from Italian companies in the same sector.

Italy

Judgment No. 253 of the Tax Court of Ravenna (November 2002)

Judgment No. 253 concerns a non-interest-bearing loan made to a controlled non-resident company.

ITCO granted a non-interest-bearing loan to a controlled company resident in Luxembourg. The ITA assessed interest income at the 'normal value' based on the Italian Bankers Association (ABI) prime rate. ITCO was not able to justify the reasons for having granted a significant non-interest-bearing loan to its foreign affiliate when ITCO bore interest costs on its own external debt. The tax court recognised that the inter-company loan should have generated interest receivable for the Italian company as argued by ITA.

Judgment No. 1070 of the Tax Court of Vicenza (February 2003)

Judgment No. 1070 concerns inter-company sales made without mark-up.

The ITCO sold raw materials to a German related company at a price equal to purchase price without any mark up. Based on data in the company's financial statements, ITA derived an average mark-up on costs realised by ITCO in its other operations (38%) and applied this mark-up to the sale of raw materials.

The tax court determined that the assessment should be cancelled for the following reasons:

- The operation under review was of negligible value compared with the volume of purchases and sales made by ITCO as a whole.
- The operation was not comparable with the company's usual inter-company transactions (ITCO's business activity consisted of sales of finished products).
- The operation was undertaken for the purpose of allowing the German company to produce a particular product for sale to an important Italian client. The aim was a significant increase of ITCO's overall business.

Judgment No. 13398 of the Supreme Court, fiscal division (September 2003)

Judgment No. 13398 concerns the burden of proof.

ITCO (in a tax loss position) applied to sales made to its French parent company a 6% rebate once a certain sales threshold was reached. The ITA considered the rebate had not been justified by reference to costs and risks borne by the French company and consequently determined an adjustment on ITCO, arguing that the company should have demonstrated that the rebate was justified by reference to distribution costs and risks borne by the parent company and consequent savings for ITCO. A matching of savings and rebates was considered necessary to show that the prices applied were in line with those applied to the third parties.

The court decided that in the absence of the required benefits demonstration, the ITA adjustment was correct.

Judgment No. 158 of the Tax Court of Milan (June 2005)

Judgment No. 158 concerns the documentation necessary to support the deductibility of inter-company services charges.

The ITCO received charges from its foreign parent company under a multilateral service agreement. These charges were considered non-deductible by the ITA due to alleged lack of documentation.

The Milan Tax Court decided in favour of ITCO, judging that it had presented sufficient documentation to show the certainty of the costs sustained and that the costs were related to ITCO's business, including:

- Written agreement describing the services provided.
- Comfort letter issued by a major audit firm attesting that the cost allocation had been correctly performed and that the attribution of costs to the various group entities had been made on the basis of the benefits they received.
- Invoices containing a detailed description of the services performed.
- Demonstration that the costs borne, with reference to the services received, were correctly recorded in the accounting records and included in the financial statements of the Italian company.
- Documentation describing, for each type of service, the nature of the activity performed and the advantage received by the Italian company.

Judgment No. 22023 of the Supreme Court, fiscal division (October 2006)

Judgment No. 22023 sets out the important principle that the inappropriateness of a company's transfer pricing must be proved by the ITA, which bears the burden of proof that the company does not comply with the arm's-length principle.

The ITCO, which purchased cars from foreign related companies, bore repair and maintenance costs on new cars, without adequate remuneration. The ITA argued that this caused a reduction in the Italian tax base and an increase of profit for related companies resident in low-tax jurisdictions but did not provide any real evidence of this.

The court decided in favour of ITCO because the ITA did not demonstrate that the group's transfer pricing was unfair. The court referred to the OECD Guidelines, which expressly state that if the local jurisdiction provides that the tax authorities should set out the reasons for any adjustment, the taxpayer is not obliged to prove the correctness of its transfer prices unless the tax authorities have first demonstrated (at least *prima facie*) that the arm's-length principle has not been observed.

Judgment No. 52 of the Tax Court of Pisa (February 2007)

Judgment No. 52 concerns the applicability of the CUP methodology.

The ITA issued a notice of assessment on the ITCO, a company operating in the garden pumps market, to cover revenue resulting from the sale of products to a French related party at a price lower than normal value. The ITA compared the sale prices applied to third parties with those applied to the French related company, observed that the inter-company prices were lower by about 10%, and assessed the difference.

However, the court agreed with the arguments of the taxpayer, which demonstrated that the transactions taken by the ITA were not comparable as regards to the stage of commercialisation, the volumes involved, and the number of shipments. These differences would have been sufficient to justify a 10% difference in the sale price. The court stated that the ITA should at least have carried out an analysis of the tax rates in force in the two countries and of the comparable transactions.

Italy

Judgment No. 9497 of the Supreme Court, fiscal division (April 2008)

Judgment No. 9497 concerns the power of the ITA to verify the appropriateness of compensation agreed between Italian resident companies.

ITCO had an existing contract with its directly controlled Italian refinery for the receipt of certain refinery oil services. The refinery compensation was guaranteed to cover all the plant's fixed costs and variable costs and provide a fair profit margin.

Both the ITA and the provincial tax court disallowed the profit margin paid by ITCO to the refinery. However, the regional tax court decided that the service received by ITCO was definitely related to its own operations, and any requirements in transfer pricing and anti-avoidance provisions that would allow the ITA to disregard the agreement between the parties were not met.

The Supreme Court revoked this judgment, determining that the ITA may verify the amount of costs and profit in financial statements or tax returns and make relative adjustments where there are no accounting irregularities or errors in legal documents. The ITA may deny deductibility, in whole or in part, where a cost is considered to be without foundation or is disproportionate. Therefore, the ITA is not bound to the values or the compensation arrived at in company decisions or contracts.

Judgment No. 20 of the Regional Tax Court of Bologna (April 2008)

Judgment No. 20 concerns the deductibility of management costs derived from a written contract between the parties prior to the cost recharge and the use of a percentage of turnover mechanism.

ITCO was charged certain management costs by its parent based on a lump sum linked to estimated turnover. The ITA disallowed the deductibility of these costs as there had been no analysis of their nature and, therefore, it might be assumed some were not relevant to ITCO's business.

ITCO argued that although it was part of a group, it was not wholly controlled, as there was a 35% minority interest. The services were agreed and performed on the basis of a written agreement signed before the fiscal year in question. The contract stated remuneration for these services (equal to 2.86% of turnover), which should be considered arm's length.

The regional tax court agreed with the taxpayer arguments taking into account the fact that the ITA's case was based on mere assumption. The ITA did not prove the absence of services or that the services had no bearing on ITCO's business.

Judgment No. 87 of the Regional Tax Court of Milan (March 2009)

Judgment No. 87 concerns the application of the arm's-length principle to inter-company sales in a multinational group.

The ITA issued a notice of assessment on ITCO (a contract manufacturer) for fiscal year 2003, on the basis that ITCO had sold finished goods to a Swiss related company at a price lower than the arm's-length price in order to transfer income to Switzerland. The ITA's challenge was based on the fact that the Swiss company sold the same products to an Italian reseller in the group at a higher price.

The ITCO claimed the higher price charged by the Swiss company to the Italian reseller was justified for the following reasons:

- The Swiss company owned the trademarks and patents; performed research and development; and bore the foreign exchange, credit, and inventory risks.
- ITCO performed manufacturing for the Swiss company and did not bear any inventory risk as a contract manufacturer.
- The Italian reseller performed finishing activities based on local market preferences and managed the sales network.

The court cancelled the assessment, as it did not consider the ITA had discharged the burden of proof to show the prices to be non-arm's length. Moreover, the court considered that the sales prices from ITCO to the Swiss company were in line with those applied by the Swiss company.

Judgment No. 5926 of Supreme Court, fiscal division (March 2009)

Judgment No. 5926 concerns the deductibility of inter-company costs charged by a non-resident entity to its permanent establishment in Italy.

The case dealt with the determination of certain overhead costs (administrative expenses, flight operations, and maintenance of the fleet) related to the international airline business and paid by a company resident outside Italy also for its permanent establishment in Italy.

The ITA issued a notice of assessment on ITCO for 1998, disallowing costs that it considered undocumented. The provincial tax court confirmed the ITA's position. ITCO appealed to the Supreme Court, claiming that it was not possible to make a detailed individual analysis of costs as they were incurred by the overseas company and charged pro rata to the branches based on the latter's sales. The financial statements and the auditor's report were appropriate to support the non-resident company costs charged to Italy, unless the tax office could show error committed by the auditor.

The Supreme Court agreed with the taxpayer and confirmed that the auditor's report on the financial statements was sufficient to support the costs registered in the annual financial statements.

Judgment No. 396 of the Provincial Tax Court of Milan (January 2010)

Judgment No. 396 concerns the transfer of functions and risks from an Italian company to another firm of the group for registration tax purposes.

The case dealt with the conversion of an Italian entity operating as a fully fledged manufacturer into a toll manufacturer with the relocation of certain functions and risks to a Swiss related company. The ITA argued that this operation represented a transfer of a going concern, subject to registration tax.

The ITA issued a notice of assessment, which was challenged by ITCO. The Provincial Tax Court of Milan determined that the mere transfer of risks and functions does not represent a business transfer and therefore no registration tax was due.

Judgment No. 7343 of the Supreme Court, fiscal division (March 2011)

Judgment No. 7343 concerns the application of rebates on inter-company sales.

The case regards the application of discounts granted by ITCO on sales to inter-company entities. The ITA made a transfer pricing adjustment disallowing the discounts on the grounds that no discount was granted on sales to third parties. ITCO argued that the transactions were not comparable since the goods sold to related

Italy

parties were at a different stage in the production/distribution chain. The Supreme Court confirmed the ITA view rejecting ITCO's arguments as to lack of comparability.

Judgment No. 134 of the Provincial Tax Court of Reggio Emilia (March 2011)

Judgment No. 134 concerns the possibility that the taxpayer is exempted from the burden of proof.

The court stated that the burden of proof in transfer pricing cases is on the ITA, which has to demonstrate that the inter-company transactions, as implemented by ITCO, were not at arm's length. The ITA has to determine the 'normal value' of the transaction and demonstrate that a tax advantage was achieved by ITCO (i.e. taxation in the counterparty's country was lower than in Italy).

Judgment No. 580 of the Tax Court of Lazio (September 2011)

Judgment No. 580 concerns the application of a different transfer pricing method by the ITA compared to the method selected by ITCO for its inter-company transactions.

The taxpayer calculated its inter-company prices based on the return on capital employed (ROCE). ITA argued that the ROCE was not the appropriate ratio and made a transfer pricing adjustment based on what is described as TNMM but without further reference to the ratio.

The Tax Court of Lazio rejected ITA's challenge based on the following reasons: ITA should have demonstrated both the lack of economic reasons underlying the ROCE and that ITCO was pursuing a tax avoidance strategy. The Court stated that since ITA did not provide the above evidences and ROCE is an indicator provided by OECD, the application of an alternative method compared to the one chosen by the taxpayer was not legitimate. The Tax Court also commented on the benchmark analysis performed by ITA recognising the lack of comparability of some comparables found by the Office.

Judgment No. 129/19/2011 of the Tax Court of Lombardia (October 2011)

Judgment No. 129 concerns the burden of proof in relation to transfer pricing disputes.

This case concern the prices applied by an Italian manufacturer to the Group Swiss Principal. In particular ITA compared these prices with the prices at which the principal sold the same goods to an Italian related distributor. This approach resulted in an adjustment since the prices between the principal and the distributor were higher than those applied by the manufacturer to the principal. The Tax Court rejected ITA's adjustment for the following reasons: the prices between the principal and the distributor, as inter-company prices, do not represent a market comparable; the company demonstrated the business reasons of the principal structure; ITA did not challenge any violation of tax law in Switzerland or Italy; the fact that both the manufacturer and the distributor are resident in Italy and their premises are close to each other is not relevant since the whole business model underlying the transactions needs to be considered.

Judgment No. 80/27/12 of the Tax Court of Lombardia (June 2012)

Judgment No. 80 concerns the deductibility of inter-company services charged.

The case relates to a challenge by the ITA to the deduction of costs charged by its French parent to ITCO for administrative, legal, accounting and fiscal services and

the costs related to the implementation and maintenance of operating software. In particular ITA challenged that these costs were not deductible because the taxpayer did not demonstrate that these were relevant to its business activity (art. 109, par. 5 Italian Tax Code).

ITCO, in order to prove the deductibility of the costs, produced: the inter-company contract signed before the services were provided, describing the nature of services provided; the monthly reports summarising the activities performed by the service provider; spreadsheet showing the costs incurred by the service provider and the allocation of these costs to the Group recipients.

The Regional Tax Court stated that the evaluation of the deductibility of service costs should be made applying the transfer pricing principles stated by the OECD, particularly regarding the analysis of the benefit provided to the recipient. According to the Tax Court, the existence of the above mentioned documentation and, in particular, the consistency between the contractual provision and the services actually supplied, was sufficient to demonstrate the actual provision of the services and the benefit for the recipient. Therefore the Tax Court acknowledged the deductibility of the service costs.

Judgment No. 11949 of the Supreme Court, fiscal division (July 2012)

Judgment No. 11949 concerns the burden of proof in case of adjustment of costs. ITCO was an Italian distributor of software purchased from a UK related party. Close to the year-end ITCO received a transfer pricing adjustment from the UK entity increasing the transfer prices of the goods supplied during the year. ITA challenged the deduction of this year-end adjustment. It is worth mentioning that the Regional Tax Court denied the ITA challenge. The Supreme Court acknowledged that the arm's-length principle (Art. 110, paragraph 7 of the Italian Income tax code) is an anti-avoidance provision and, accordingly, the burden of the proof of the taxpayer's avoidance aims lies with the tax authorities. However since the challenge considered here related to inter-company costs incurred by the Italian taxpayer, the latter has to demonstrate that the costs are necessary for its business activity and resulted in a benefit for the Italian taxpayer. The Supreme Court stated that the ITCO did not provide evidence of the benefit deriving from the costs challenged particularly regarding the year-end adjustment; the transfer pricing study prepared by the company to support its transfer pricing was not considered sufficient.

Burden of proof

The general principle is that the burden of proof lies with the ITA; however, the taxpayer is expected to demonstrate the fairness of its inter-company transactions in the event of an assessment by the tax authorities. This general principle also has been confirmed by the above Supreme Court's decision dated October 2006; by Judgment No. 52 of Tax Court of Pisa, dated February 2007; by Judgment No. 134, dated 21 March 2011, of the Provincial Tax Court of Reggio Emilia; by Judgment No. 11949, dated 13 July 2012, of the Supreme Court .

Particular rules apply to cross-border transactions involving counterparties (including third parties) resident in tax havens. The Italian taxpayer, in order to deduct the relevant costs, must provide evidence:

- that the foreign party is a genuine commercial undertaking, and

Italy

- that the transactions were effected in connection with a real economic interest and that the relevant transactions actually took place.

The costs must be disclosed in the company's tax return; otherwise, penalties will apply. The rules relating to such costs ('Black List' transactions) are independent of Italian transfer pricing rules.

Tax audit procedures

Selection of companies for audit

The ITA focuses its attention on major taxpayers and hence on multinationals. From 2002, taxpayers with turnover above approximately 26 million euro (EUR) are expected to be systematically audited at least once every two years. Also from 2002, taxpayers with turnover exceeding EUR 5.2 million will be systematically audited at least once every four years. These audits may be complete and extensive or focus just on specific items such as transfer pricing. Even if these parameters, introduced by Article 42 of Law 388/2000, are not consistently met, they are considered as a general guideline for tax audits, as stated by Revenue Office Circular (hereinafter Circular) 6/E, dated 25 January 2008.

Provisions concerning 'large taxpayers' were introduced by Law Decree n. 185/2008 (the so-called anti-crisis decree), converted into Law n. 2, dated 28 January 2009. The decree provides that companies with turnover exceeding EUR 100 million will be audited by dedicated tax offices, so-called 'Large Taxpayer Offices'. As also confirmed by Circular Letter 21/E of 18 May 2011, ITA should focus attention on large taxpayers.

Law Decree n. 185/2008 also provided that companies with revenue exceeding a certain threshold will be subject to substantial checks on their income tax and VAT returns in each fiscal year following that in which the filing has been made (so-called 'tutoraggio fiscale'). The threshold was originally fixed at EUR 300 million but has been reduced to EUR 150 million from 2011. It should be further reduced to EUR 100 million by the end of 2011.

With limited exceptions, corporations that usually are repeatedly in tax loss position should be subject to specific controls.

The ITA is also increasing the level of exchange of information with foreign tax authorities.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Transfer pricing documentation provisions were included in Law Decree 78 of 31 May 2010, converted into law on 30 July 2010, with effect from 2010. Detailed specification about the form and content of this documentation are contained in the Regulation of 29 September 2010.

The Regulation is based on the EU Code of Conduct for Transfer Pricing Documentation and uses the concept of master file and country file. Italian-based groups which include non-Italian subsidiaries must produce both a master file and a country file; Italian subsidiaries/branches need produce only a country file. An Italian sub-holding company with at least one non-Italian subsidiary must produce a sub-holding master file as well as a country file, although it can choose to produce

the group master file if compliant as to form and content. This requirement of a sub group master file also applies to an Italian branch of a company that has non Italian subsidiaries regardless of whether the investments are held by the Italian branch.

Both documents must be prepared in Italian, but an Italian sub-holding company can produce a master file in English provided the file is for the entire EU-based group. Annexes can be in English.

While documentation is not mandatory, the regulation indicates that whether or not a company has communicated the existence of such documentation will influence the tax authorities in their risk assessment and as an indication of taxpayer transparency and willingness to cooperate. Documentation which is considered to meet the requirements of the regulation will protect taxpayers from tax-g geared penalties on any transfer pricing adjustments. The format is prescribed in detail and is mandatory. Although a number of interpretative points still remain unclear, further guidance was provided on tax authority expectations in Circular Letter 58 issued on 15 December 2010.

The penalty protection is also applicable to past open years if the taxpayer has notified possession of such documentation by 28 December 2010 or at any point thereafter until a tax authority audit or visit takes place. However, once an audit has begun, the opportunity has passed.

On tax auditor request, the documentation must be produced within 10 days. Taxpayers have a further seven days to produce additional supplementary information if requested. If the taxpayer is unable to meet these deadlines, penalty protection is lost.

Transfer pricing documentation must be produced annually and on a company-by-company basis, although large companies may produce divisional files. Small and medium companies (defined as those with a turnover of less than EUR 50 million) need to perform the method selection and economic analysis part of the documentation only every three years, provided there has been no significant change in the business and that the economic analysis is based on publicly available databases.

Documentation must be submitted electronically, and it needs to be signed on each page by the company's legal representative.

The regulation does not impose specific methodologies but refers in general to the 2010 OECD Guidelines and emphasizes the preference for traditional transaction-based methods. Transaction profit-based methods are acceptable provided there is sufficient justification, in the presence of potential traditional transaction-based methods, of the reasons why the latter are not used.

General rules on tax documentation also continue to apply to inter-company transactions. Accordingly, the company should be able to adequately substantiate all income and expense items.

The ITA may require taxpayers to produce documents or other information (also in the form of answers to questionnaires) during an audit. In this case, taxpayers are obliged to comply with the requests. If a taxpayer fails to submit documentation within the time frame provided in the tax authorities' request, an assessment may be made based on the tax authority's assumptions.

Italy

The audit procedure

Tax audits in Italy are normally carried out on the taxpayer's premises. The audit visit may be preceded by a formal request for information by the tax authorities, but normally tax audits are not announced in advance.

Apart from exceptional cases, the duration of an on-site tax audit may not exceed 60 days of presence at the taxpayer premises. At the end of the audit, the authorities release a report with findings and proposed adjustments.

The company may file a defence brief or rebuttal against the tax audit report with the relevant tax office within 60 days. Until the 60 days have elapsed, the tax office may not issue a tax assessment. The tax authorities will not necessarily issue an assessment immediately after the 60 days expire, and the formal assessment may not appear for some time.

Tax issues, including transfer pricing, may be settled with the tax authorities without litigation. The relevant procedure was introduced by Decree 218/1997 and is termed *accertamento con adesione*. If an agreement is reached, an official report is drawn up showing the amount of taxes, interest and penalties due. In the event a settlement is reached, penalties are reduced to 33% of the total amount due.

Once litigation commences, the company and the tax authorities may still settle the dispute out of court. Indeed, they are required to consider this option if they have not already done so. The procedure, introduced by Article 48 of the Decree 546/1992, is called the judicial settlement procedure. In the event a settlement is reached during the judicial settlement procedure, penalties are reduced to 40% of the total amount due.

If the dispute is decided in court against the taxpayer, penalties are applied in full. There are three stages before a final judgment is reached with no further prospect of appeal: First Instance (provincial), Second Instance (regional) and Supreme Court, or *Corte di Cassazione*. Unless a suspension is obtained while the dispute is pending, the tax authorities are allowed to collect 50% (reduced to 33% by Law Decree 70/2011) of the tax assessed before the first instance decision is given; two-thirds of the tax (and penalties) due following the first-degree judgment; and the total taxes (and penalties) due following the second-degree judgment.

Additional tax and penalties

Italian tax law requires taxpayers to file tax returns, maintain tax books and records, withhold tax at source, etc. If the taxpayer does not fulfil these obligations, then administrative – or in certain cases, criminal penalties – may be imposed. The general penalty regime applies to transfer pricing.

Administrative penalties range from 100% to 240% of the amount of tax unpaid. Special rules apply where similar violations are repeated over various fiscal years. Administrative penalties arise because of an adjustment. There is no need for the tax authorities to adduce negative taxpayer behaviour for penalties to arise.

Penalties may be reduced as follows:

- To one-eighth of the minimum (i.e. 12.5% of tax on adjustment) for spontaneous disclosure (without any tax audit in place).

- To one-third of the minimum (i.e. 33%) if the taxpayer agrees to pay the taxes assessed within 60 days from issuance of the official notice of assessment. The penalty is reduced even further to one-sixth but only if the taxpayer agrees to all adjustments proposed at the end of the audit within 60 days and before the issue of a formal assessment.
- To one-third of the minimum (i.e. 33% of tax agreed) for a negotiated settlement following the issue of a tax assessment (*Accertamento con Adesione*).
- To 40% of tax agreed in the event of the judicial settlement procedure as described above.

The tax office has four years from the end of the year in which the tax return was filed to issue assessments for additional tax. This period is increased to five years if no return was filed (Art. 43 DPR 600/1973) and to eight years if a criminal report is issued.

Based on Legislative Decree n. 74 dated 10 March 2000, transfer pricing adjustments may also trigger criminal penalties in addition to the administrative sanctions outlined above as related to issues of 'valuation.' Although it is arguable that the concept of valuation in the legislative decree should not cover transfer pricing, the Italian tax authorities do tend to notify the outcome of a transfer pricing assessment to the local public prosecutor when the adjustment amount exceeds the relatively low threshold for notification (approx EUR 2 million).

In cases of a transfer pricing adjustment, no administrative penalty should apply if the taxpayer has prepared documentation to support its inter-company transactions drawn up in accordance with the 29 September 2010 Regulation and had notified possession on its tax return. If during a tax audit a taxpayer is not able to deliver documentation for which a formal notification had been made, the tax authorities may take account of such behaviour in the event of a transfer pricing adjustment to determine the suitable level of penalties applicable. The implication is that the level of penalty would be set higher in the range (100% to 200% with reductions for early settlement) than would otherwise apply.

Resources available to the tax authorities

There are units dedicated to transfer pricing, and the number of audits has increased in recent years. There are more qualified personnel performing audits, and staff members in local offices also have received transfer pricing training. There is an improved level of preparation and appreciation of resources that can be used in conducting transfer pricing audits.

The Italian administrations have created specific task forces to monitor larger companies on all their tax issues, with particular emphasis on transfer pricing and permanent establishments where appropriate.

Use and availability of comparable information

Use

To support their transfer pricing policy, a taxpayer's documentation is expected where appropriate to include a benchmark analysis showing that the results earned by the company fall within the arm's-length range of results realised by comparable companies. Under the penalty protection rules the Italian tax authorities have indicated that, except for small and medium sized enterprises (turnover less than

Italy

EURO 50 million), they expect to see a new benchmark (including new company selection) each year.

Availability

Italian companies are required by law to file their financial statements with the local Chamber of Commerce. In this respect, it is possible to obtain detailed data on the results of other companies, including extensive notes in many cases. These can be accessed online both by taxpayers and the tax authorities. There are databases allowing research of comparable companies at the European and Italian levels. The Italian tax authorities have access to these.

Risk transactions or industries

In 2008, the Italian tax authorities (*Agenzia delle Entrate*) issued Circular Letter n. 6/E, dated 25 January 2008. The circular highlights for consideration international transfer pricing as well as inter-company transactions between resident Italian companies when an internal transfer pricing issue could occur because of the presence of a favourable tax regime. The focus on transfer pricing was confirmed by Circular Letter n. 13/E of 9 April 2009 and Circular Letter n. 20/E of 16 April 2010.

The Italian Tax Police (*Guardia di Finanza*) issued Circular Letter n.1/2008 containing guidelines to be followed by its officers when performing tax audits. Chapter 6, titled 'International Tax and Tax Audits Methodologies', provides specific operative guidelines for tax officers when they assess companies on transfer pricing and permanent establishment issues.

The circular provides specific criteria for officers to identify Italian companies whose inter-company transactions warrant particular attention. The following are specifically mentioned and are typical of the type of transaction where emphasis is placed in practice:

- Transactions with foreign-related companies in jurisdictions where they benefit from favourable tax regimes.
- Transactions concerning intangible assets (such as royalties) and services (management fees).
- Transactions where the Italian company acts as a mere intermediary (commissionaire, agent) and receives a commission-based remuneration.
- The sale of high-value intangible properties by the Italian company to foreign entities.

Limitation of double taxation and competent authority proceedings

Italy has begun to use the EU Arbitration Convention and has given an impetus to mutual agreement procedures for intra-EU issues. Based on our experience, use of the competent authority process to obtain correlative adjustments has not been common in Italy in other circumstances to date. Some aspects of the mutual agreement procedure have been clarified by the Italian Tax Authority in Circular No. 21/E of 5 June 2012.

Some key points of the Circular are:

- It is not possible for an agreement under MAP or the Arbitration Convention to override an Italian court judgement or any negotiated settlement between

the Italian tax authorities and an Italian taxpayer. Hence a court judgment or an out of court settlement will preclude any alternative outcome in Italy at competent authority.

- An Italian taxpayer must appeal the tax assessment in order to apply for MAP under a bilateral tax treaty. For an Arbitration Convention procedure to go ahead, however, the taxpayer must be prepared to withdraw from the tax appeals procedure.
- It is possible to continue with appeals on other matters not covered by MAP or the Arbitration Convention at the same time as embarking on the mutual agreement procedure for transfer pricing issues.
- The process for requesting that the collection of tax assessed in Italy be suspended varies between MAP and the Arbitration Convention. However the implication is that suspension should be granted in both cases.
- Concerns that the automatic referral in Italy of a tax adjustment above a certain (low) threshold for consideration in the criminal courts constitutes a 'serious penalty' and hence prevents access to the Arbitration Convention are confirmed to be groundless. This should be evaluated on a case by case basis.
- If an agreement under MAP is successfully concluded and the circumstances have not changed, the Circular recognises the possibility of also applying the terms for the years immediately subsequent to those of the MAP.

Advance pricing agreements (APAs)

On 23 July 2004, an official procedure was published for a so-called 'International Ruling', which had been introduced by Article 8 of Law Decree No. 269 of 30 September 2003. This advance ruling is unilateral, although it is possible to achieve a bilateral effect by using two unilateral agreements. From the latter part of 2010, particularly the ITA has increased the number of instances where a bilateral process with other countries is followed.

The procedure involves companies engaged in 'international activity' and may cover transfer pricing, dividends, royalties and interests. The following may apply:

- Italian resident enterprises that have transactions that fall under the Italian transfer pricing rules and/or entities that are owned by non-resident shareholders or themselves own non-resident entities and/or enterprises that receive or pay dividends interest or royalties to or from non-Italian persons.
- Any non-resident company carrying on activity in Italy through a permanent establishment.

The application for a ruling must be submitted to one of the competent offices (i.e. Milan or Rome office, on the basis of company or permanent establishment tax residence, although any application interested in invoking a bilateral approach needs to be made to Rome). The information to be included in the ruling application, under penalty of non acceptance, is as follows:

- General information concerning the company, such as the name, its registered office, its tax and VAT identification number, and so on.
- Documentation that proves the eligibility requirements.
- Scope of the application and the purpose of the ruling request.
- The signatures of the legal representatives.

Italy

Within 30 days from receipt of the application or from the completion of any inquiry activity, the relevant rulings office may notify the taxpayer to appear to verify the accuracy of the information provided and to define terms and conditions for the subsequent negotiations. The full procedure should be completed within 180 days from the filing of the request, but the parties may agree to extend the deadline. In practice, the APA negotiation procedure is fairly lengthy.

Once an agreement has been reached, it remains in force for three years (the year in which the agreement is signed and the two following years). There is no formal rollback provision either for years before the application was made or for years subsequent to the application but before the agreement was signed.

Within 90 days before the expiry of an existing APA agreement, the taxpayer may ask for a renewal. The Revenue Office must approve or decline a renewal at least 15 days before the agreement expires.

In 2010, the ITA issued a report of the number of APAs achieved and in process as at 31 December 2009, with some analysis of time taken, methods used, etc. The number of applications has increased significantly since that date.

Anticipated developments in law and practice

The ITA has indicated on more than one occasion that it hopes to establish a framework for bilateral APAs under the relevant tax treaties. As indicated above, it appears that the ITA is now doing this on a wider basis even though there has been no formal announcement of change.

Liaison with customs authorities

Administrative rules enable the exchange of information between direct tax and customs authorities, and recent experience suggests that such exchanges do occur (in particular as regards importation of goods from tax haven jurisdictions).

OECD issues

Italy is a member of the OECD and uses the OECD Guidelines in bilateral dealings with other tax authorities. In the absence of detailed and up-to-date local regulations, reference has been often made to the 1995 OECD Guidelines by taxpayers, but the 1980 Ministerial Circular still tends to be a tax auditor's first point of reference until the law changes.

The Italian courts have recognised the 1995 Guidelines as persuasive. It is also important to note that in relation to other OECD material (e.g. the OECD Model Treaty Commentary) in three identical decisions relating to a permanent establishment case, all in 2006, the Supreme Court limited the role of the OECD Commentary. This was held not to have legislative value but to represent, at the most, a recommendation that may not override local law.

The 29 September 2010 regulation on transfer pricing documentation explicitly refers to the 2010 OECD Guidelines and to the EU Code of Conduct as the basis underlying Italian documentation and to the transfer pricing methodologies of the OECD Guidelines.

Joint investigations

On 1 May 2006, Italy became the 12th party to the joint OECD Council of Europe/OECD Convention on Mutual Assistance in Tax Matters. As a party to the convention, Italy enhances its ability to combat tax evasion and avoidance through exchange of information on a wide range of taxes.

The other parties to the convention are Azerbaijan, Belgium, Denmark, Finland, France, Iceland, the Netherlands, Norway, Poland, Sweden and the United States. A key feature of the convention is the ability to take part in simultaneous multilateral examinations. Some joint investigations have been carried out.

Deductibility of interest payable

The 2008 Finance Act (24 December 2007 Law no. 244) replaced the previous limitations on interest deduction (i.e. thin capitalisation and pro rata rules).

The new rule states that interest payable and similar charges are wholly deductible, in each fiscal year, to the extent of interest receivable and similar income. In addition, any excess of interest payable over interest receivable is deductible up to 30% of EBITDA. The non-deductible amount may be carried forward without any time limit.

The new interest deduction limitation does not apply to certain taxpayers, including individual entrepreneurs, partnerships, banks, financial entities and insurance companies, and their holdings. It does apply, however, to holdings of industrial and commercial groups. The rule applies to interest due both to related parties and to third parties.

43.

Japan

Introduction

Japan has had transfer pricing legislation in force since 1986, and it was one of the first countries to undertake advance pricing agreements (APAs) specifically to cover transfer pricing. Japan remains progressive and energetic in its approach to developing transfer pricing practice. The Japanese tax authorities have a tremendous amount of experience, and are committing more and more resources to the policing of the transfer pricing regime. To date, many significant tax assessments based on transfer pricing adjustments have received publicity. As a result, taxpayers should pay careful attention to Japan's transfer pricing environment.

Statutory rules and other regulations

Japan enacted formal transfer pricing legislation in April 1986 with the Act on Special Measures Concerning Taxation (ASMT) Article 66-4, and since 2005, Article 68-88 for consolidated companies (collectively, Articles 66-4 and 68-88 of the ASMT). In support of Articles 66-4 and 68-88 of the ASMT, related cabinet orders and ministerial ordinances were issued through the Order for Enforcement of the Act on Special Measures Concerning Taxation Article 39-12 (since 2005, Article 39-112 for consolidated companies; collectively Articles 39-12 and 39-112 of the Cabinet Order of the ASMT) and the Ordinance for Enforcement of the Act on Special Measures Concerning Taxation Article 22-10 (since 2005, Article 22-74 for consolidated companies; collectively Articles 22-10 and 22-74 of the Ministerial Ordinance of the ASMT). The National Tax Agency's (NTA) interpretation and guidance for the application of the transfer pricing rules are set out in the related Commissioner's Directives, i.e. Commissioner's Directive on Interpretation of the Act on Special Measures Concerning Taxation (the ASMT Directive) and Commissioner's Directive on the Operation of Transfer Pricing (the TP Directive).

Japan is a member of the Organisation for Economic Co-operation and Development (OECD) and actively participated in drafting the 1995 OECD Guidelines for multinational enterprises (MNEs), including the 2010 revisions. As such, the NTA generally supports the theory and practices set out in the OECD Guidelines, as confirmed by the TP Directive and in amendments to the transfer pricing legislation under the 2011 Tax Reform. In practice, however, the OECD Guidelines are interpreted and implemented within the framework of Japan's own transfer pricing legislation, as well as Japan's unique political and economic context. This localisation of OECD principles has historically created some differences in the implementation of the OECD Guidelines in Japan compared with other jurisdictions, although such differences have lessened over time as a result of Japan's extensive competent authority experiences with other OECD jurisdictions.

Nevertheless, Japan's transfer pricing legislation, consistent with the OECD Guidelines, is based on the arm's-length principle. Put briefly, Articles 66-4 and 68-88 of the ASMT provide that a corporation (or other juridical person) that has conducted the sale or purchase of inventory, rendered services, or engaged in other transactions with a foreign related party, must do so at an arm's-length price. In transactions where the Japanese tax authorities determine that arm's-length principles have not been adhered to for the purposes of corporation tax, the price can be adjusted to approximate a third-party transaction. In this situation, under the legislation, the Japanese tax authorities have broad powers to recalculate the transfer price.

Framework of the transfer pricing legislation

In general terms, the legislation applies to international transactions between a 'juridical person' and an affiliated 'foreign juridical person'. As discussed in more detail later, two juridical persons are affiliated when a juridical person is engaged in a transaction with a foreign juridical person with which it has a special relationship.

Applicability

Foreign transactions

In general, the Japanese authorities do not believe that there is a threat of lost tax revenues in domestic transactions because any shifted income is ultimately taxed in Japan. Consequently, Japan's legislation applies only to foreign affiliated transactions. The rules apply between related corporations, regardless of whether the non-Japanese company is the parent or the subsidiary. However, the rules do not apply to Japan-sourced income of a non-Japanese affiliate, where that income is taxable in Japan due to such affiliate having a permanent establishment in Japan.

Juridical persons

The legislation applies to cross-border transactions between a juridical person and a foreign juridical person. Juridical persons include corporations, corporations in the public interest such as incorporated associations or foundations, and cooperative associations such as agricultural cooperative associations or small-enterprise cooperative associations. The legislation therefore does not apply to partnerships, unincorporated joint ventures, unincorporated associations or individuals. A foreign juridical person is a juridical entity that is established under the laws of a foreign country and does not have its main office in Japan.

The legislation does not specifically refer to partnership transactions. While it is thought that the legislation does not treat corporate partners as related by reason of their partnership interests, it is believed that certain partnership transactions may be covered if the relationship test is met and the transaction is between Japanese and foreign taxpayers.

Definition of affiliated

Juridical persons are deemed to be affiliated when a juridical person is engaged in a transaction with a foreign juridical person with which it has a special relationship. A special relationship is said to exist:

- if they have a 50% or greater common ownership (*see 50% test section*), and
- if another 'special relationship' exists (*see Other special relationship section*).

Japan

The 50% test

The 50% test will be met if the taxpayer, who is a juridical person, directly or indirectly owns 50% or more of:

- the total number of issued shares (voting and non-voting) in the other juridical person, and
- the total amount invested in the other juridical person.

Thus, the test will be satisfied in the typical case of a Japanese subsidiary of a foreign parent as well as in the case of a foreign subsidiary of a Japanese parent. Two corporations are deemed to be affiliated in instances where, in a brother-sister group, 50% or more of the issued shares (voting and non-voting) in each of the two corporations are owned by the same party. Under the indirect ownership rules, a corporation is deemed to own the stock held by another corporation if the first corporation owns 50% or more of the issued shares of the second corporation. This ownership can be through one corporation or through several corporations. There are no provisions in the Japanese tax law with respect to partnerships. Each partner, however, is generally deemed to personally hold the assets of the partnership. Accordingly, in the case of stock in a corporation, the number of shares deemed held by each partner is proportionate to the partner's ownership in the partnership. Family attribution rules would also apply in determining whether ownership would meet the 50% test. Thus, in the case of a spouse, any holdings of the spouse are included and, in certain cases, holdings of the spouse's family.

Other special relationship

A special relationship will also exist in situations where the 50% stock ownership test is not met. A special relationship includes situations where:

- 50% or more of the officers of the company are or were employees or officers of the other company (to date no time limit has been specified)
- the representative director of the company is or was an employee or officer of the other company
- a considerable proportion of a company's operating transactions are with the second company (operating transactions are those transactions that are generally related to the corporation's main source of revenue), and
- a considerable proportion of a company's outstanding loans, which are necessary to the company's operations, have been borrowed from or guaranteed by the second company.

Transactions through unaffiliated parties

The Japanese legislation will also apply to transactions entered into with unaffiliated persons in cases where the transactions with the foreign affiliates are conducted through an unaffiliated person (presumably acting as a conduit). This rule is designed to address transactions that take place with an unrelated trading company. Trading companies in Japan play a vital role in facilitating the import and export of goods. They act as an intermediary between the seller and the purchaser of the goods in question. Some commentators believe this provision was necessary because in Japan a substantial portion of the import/export business is conducted through trading companies.

Types of transactions covered

The legislation covers transactions involving the sale or purchase of tangible personal property and other transactions. The legislation was deliberately left quite broad to give the NTA a greater degree of flexibility. The types of transactions falling within the other transactions category include:

- Rents from tangible assets.
- Royalties for the use of and consideration for the sale or purchase of intangible assets.
- Interest on loans or advances.
- Fees for intercompany services.

The legislation sets out detailed rules for transactions involving tangible personal property, and requires the use of equivalent methods for other transactions. It should be noted that the Japanese reporting form (Schedule 17(4) for taxpayers with fiscal years ending on or after 1 April 2009, formerly Schedule 17(3)), which is part of a corporation's annual tax return, includes requests for information regarding these other transactions (*see Tax audit procedure section*).

Methods of arm's-length price determination

The legislation provides that the affiliated juridical persons must conduct their transactions at an arm's-length price. While the legislation does not specifically recognise either a range of arm's-length prices or net profitability as a standard for establishing specific arm's-length prices, the range concept is incorporated in the ASMT Directive and TP Directive. The ASMT Directive provides that no transfer pricing assessment shall be issued if the taxpayer's price or profitability falls within the range earned by several comparable transactions with a high level of comparability. In addition, the TP Directive provides that in determining the arm's-length price for the purpose of issuing an assessment, the average of those transactions may be used if the price/profitability of the tested transaction falls outside the range.

The sale or purchase of inventory

The legislation provides specific methods for determining an appropriate arm's-length price. It provides that the arm's-length price should be determined, in the case of the sale or purchase of inventory, under:

- The comparable uncontrolled price (CUP) method.
- The resale price method.
- The cost plus method.
- The method similar to the above methods.
- The other methods.

Until the 2011 tax reform, only if the CUP, resale price or cost plus methods. could not be used, a method similar to one of them, or other methods prescribed by Articles 39-12 and 39-112 of the Cabinet Order of the ASMT, could be applied. However, under the 2011 tax reform this priority rule was abolished and instead the so-called best method rule was introduced for business years beginning on and after 1 October 2011.

The other methods

Articles 39-12 and 39-112 of the Cabinet Order of the ASMT in effect introduce the profit split method and the transactional net margin method (TNMM) as other methods.

Japan

Three types of profit split method are allowed (paragraph 8(i)), i.e. the comparable profit split method, the contribution profit split method and the residual profit split method.

- The comparable profit split method distributes the profit to the parties by reference to the profit split ratio of a comparable transaction between unrelated parties where such information is available.
- The contribution profit split method requires profits to be allocated between enterprises based on factors illustrating the degree to which each party contributed to the realisation of income, such as the amount of expenses incurred or the values of fixed assets used.
- The residual profit split method may be applied when either party to the controlled transaction owns significant intangible assets. In this method, routine profits are first distributed to the respective parties by reference to the information of the uncontrolled transaction without having significant intangible assets. The residual profit is then distributed to the respective parties in proportion to the value, or the costs incurred for the development, of the significant intangible assets that they own.

The TNMM as described in the Articles 39-12 and 39-112 of the Cabinet Order of the ASMT provides three ways by which arm's-length pricing may be determined:

- TNMM by return on sale (paragraph 8(ii)) computes the transfer price in a controlled transaction as the tested party's resale price minus the sum of:
 - the tested party's resale price multiplied by the operating margin of the comparable transaction, and
 - the tested party's selling, general and administrative expenses.
- TNMM by full cost mark-up (paragraph 8(iii)) computes the transfer price in a controlled transaction as the sum of:
 - the tested party's total costs, being the sum of costs of goods sold and selling, general and administrative expenses, and
 - the tested party's total costs multiplied by the full cost mark-up of the comparable transaction, i.e. the ratio of operating profit to total costs of the comparable transaction.

Under paragraph 8(iv), the transfer price in a controlled transaction may also be computed by reference to a method similar to those described under paragraphs 8(i) or 8(iii).

Other transactions

For transactions other than the sale or purchase of inventory (such as rent for the use of tangible property, royalties for the use of or consideration for the sale or purchase of intangible property, services rendered, and interest on loans or advances) the legislation provides that methods equivalent to the CUP, resale price, cost plus method, profit split method and TNMM can be used.

Moreover, for intercompany services, the TP Directive includes specific reference to the treatment of intragroup services, largely as a reiteration of the OECD commentary on intragroup services (Chapter VII, OECD Guidelines). Payment for such services is deductible by the recipient company if the recipient would need to acquire the services from an unrelated party, or perform them itself, if they were not provided by the related party. However, services provided by a parent company in its capacity

as shareholder are not treated as services performed for consideration and are not deductible. This treatment applies equally to both Japanese parent and foreign parent multinational companies. In addition, the TP Directive contains a provision enabling the tax examiners to treat payments for intercompany services that cannot be supported by the Japanese payer as non-deductible donation expenses under the domestic tax legislation, rather than as a matter of transfer pricing under Articles 66-4 and 68-88 of the ASMT. (It is the NTA's position that taxpayers subject to an adjustment to taxable income under the domestic tax legislation are not entitled to relief through mutual agreement procedures even if double taxation occurs as a result.)

The TP Directive also prescribes guidance on the appropriate treatment of Cost Contribution Arrangements (CCAs) and transactions involving intangible property.

Legal cases

Court cases

On 30 October 2008, the first court case on the application of Articles 66-4 and 68-88 of the ASMT was won by the taxpayer on appeal to the Tokyo High Court (the decision at first instance was issued by the Tokyo District Court on 7 December 2007). The basis for the High Court's decision related primarily to the selection of transfer pricing methodology and the issue of comparability. The NTA's use of secret comparables, which was upheld by the Tokyo District Court, was not addressed by the Tokyo High Court (*see Use and availability of comparable information section*). The NTA abandoned its right to appeal the decision of the Tokyo High Court.

Tribunal cases

On 2 February 2010, TDK announced that the National Tax Tribunal had reduced a determination made by the Tokyo Regional Tax Bureau (RTB) against the company in 2006 arising from electronic parts transactions with foreign affiliates in Hong Kong and the Philippines. As it is extremely rare for a taxpayer to succeed in an appeal to the National Tax Tribunal on purely transfer pricing grounds, this result was interesting in itself. In addition, the size of the reduction made by the National Tax Tribunal in favour of TDK was also significant. In fact, it is understood that the National Tax Tribunal reduced the originally assessed amount of 21.3 billion Japanese yen (JPY) by about JPY 14.1 billion.

Burden of proof

The Japanese legal system places the burden of proof in all taxation matters with the government. Transfer pricing examiners consider that this requires them to obtain detailed information regarding comparable transactions, although they also believe that generally such information cannot be disclosed to a taxpayer, as this is prohibited by taxpayer confidentiality requirements. This situation gives rise to the issue of so-called secret comparables (*see Use and availability of comparable information section*). In practice, in any audit, the taxpayer has a clear burden under the legislation to provide information and, in any case, as a matter of examination management strategy, it could be potentially disadvantageous to withhold information.

Tax audit procedures

Companies are required to complete and return an annual corporation tax return. As part of that return, Schedule 17(4) must be completed; this gives details of the taxpayer's foreign affiliated parties and any transactions with those parties, including disclosure of the transfer pricing methodology adopted for each transaction. A review

Japan

of this form, in conjunction with the company's financial statements and a review of the company's results, may lead the tax authorities to select a company for audit.

Within the context of this review, the NTA is likely to be alerted to the possibility of transfer pricing issues in cases where:

- the volume of transactions with affiliated foreign companies is notably large
- intercompany prices, commission paid, and royalty rates charged are set but later changed so that related foreign parties receive advantages or benefits
- a company's profit does not increase in proportion to expansion in the market for its principal product or is not in proportion to the taxable income of comparable companies
- losses are made on the sale of products purchased from affiliated foreign companies
- affiliated foreign companies are making profits that do not reflect the functions they perform
- the functions performed by affiliated foreign companies are not clearly identified
- the basis on which royalty rates have been calculated is not identified, and
- the basis on which income is allocated between the company and affiliated foreign parties appears to be unreasonable.

The likelihood of a transfer pricing audit is the same for domestic or for foreign-owned companies.

The audit procedure

Once a transfer pricing issue has been identified, specialist examiners from the appropriate RTB or tax office visit the taxpayer's premises to conduct an investigation.

The tax authorities are entitled to request any information they consider necessary to determine the appropriate transfer price.

A list of documents that may be requested to be presented or submitted during a transfer pricing audit was incorporated into the Japanese transfer pricing legislation as part of the 31 March 2010 legislative revisions (under the 2010 Tax Reform). Two categories of documents are now required to be presented or submitted during a transfer pricing audit. These are:

- Documents providing details of the taxpayer's foreign affiliated transactions.
- Documents used by the taxpayer for the calculation of arm's-length prices.

Prior to this amendment, there was no explanation of what documents were required to be presented or submitted during an audit under the Japanese legislation (although a similar list of documentation was contained in the TP Directive). Now, a more detailed list of the documents contained in each category is formally provided in Articles 22-10 and 22-74 of the Ministerial Ordinance of the ASMT. Among others, these include the books of account, records and other documents, not only of the taxpayer but also of the foreign affiliate. As to requests for overseas information, the taxpayer is required to endeavour to meet such requests.

In an audit, if a taxpayer fails to present or submit the documents requested (including overseas information that is recognised to be necessary to determine an arm's-length price) within a reasonable period of time, the tax examiners may exercise their power

to use secret comparables (*see Use and availability of comparable information section*) or to conduct taxation by estimation. Taxation by estimation allows the tax examiners to estimate transfer prices without reference to the taxpayer's own transfer pricing method (including based on transactions between affiliated parties, so in theory not at arm's length). In addition, the authorities may estimate taxable income to the Japanese company on its cross-border transaction with a foreign affiliate by applying one of certain prescribed methods. The prescribed methods include either the resale price method, the cost plus method, or a profit split method using a high-level global profit split (i.e. based on an allocation of the total consolidated operating margin of the entire group to which the taxpayer belongs, as disclosed in the group's annual report, assuming that a segmented consolidated operating margin including the transactions under audit is not provided in the annual report). However, taxation by estimation is a last resort for the tax authorities, and to date there has reportedly been only one case where it has been applied.

In addition, in order to provide clarification of the factors that should be taken into account when examiners are investigating the negotiation of transfer prices between affiliated parties, TP Directive also highlights the facts that:

- taxpayers may in fact use arm's-length principles to determine their transfer prices, in order to properly assess both their own financial performance for the business relating to the intercompany transactions, and that of their affiliated party, and
- in some cases, such as joint ventures, third parties (i.e. shareholders of a joint venture) may be involved in the negotiation of transfer prices between two affiliated parties, taking into account arm's-length principles.

The 22 June 2010 amendment goes on to specify that the tax authorities should consider not only the profitability of the two affiliated parties engaged in any intercompany transaction, but also the above-noted negotiation procedures conducted in deriving the transfer price for that intercompany transaction. That is, where a transaction is conducted between a taxpayer and a joint venture owned equally by that taxpayer and a third party, the transaction is subject to the Japanese transfer pricing legislation; however, if the transfer price for that transaction is determined by negotiation with the third-party investor taking into account arm's-length principles, the transfer price may well be accepted as being at arm's length.

Recourse options

There are three domestic methods and one bilateral method of recourse for tax relief available to taxpayers upon receiving a notice of assessment:

- Domestic recourse:
 - Request for reinvestigation to the applicable RTB.
 - Request for reconsideration to the National Tax Tribunal.
 - Litigation.
- Bilateral recourse under the Japan/Treaty Partner Nation Tax Convention (competent authority negotiations or arbitration).

Additional tax and penalties

Interest is charged on unpaid tax at the lower of 7.3% per annum or the sum of the basic discount rate and basic loan rate (previously known as the official discount rate) as of 30 November of the previous year (0.30% as of 30 November 2011), plus 4% (i.e.

Japan

total of 4.30% for interest accruing in 2012) for one year after the due date for filing, and for the period from the issuance of the notice of assessment until the date on which the additional tax is actually paid. The interest rate increases to 14.6% if unpaid tax is not subsequently paid within three months of the date that a notice of assessment is issued. This is statutory interest and is not deductible for corporation tax purposes.

There is an automatic penalty of 10% of additionally assessed taxes, plus 5% of additionally assessed taxes exceeding the amount higher of taxes originally reported or JPY 500,000. However, a 35% penalty is imposed on understatements where deliberate tax evasion is judged to have taken place. These penalties are not deductible for corporation tax purposes.

Effective 1 April 2007, in the event that a taxpayer files a request for mutual agreement procedures following a transfer pricing assessment, payment of national tax and penalties pertaining to the assessment can be deferred until the completion of mutual agreement procedures (one month after the day following the date of reassessment based on mutual agreement, or should agreement not be reached, one month from the day following the notification of this fact to the taxpayer), if requested by the taxpayer. In addition, the taxpayer is exempted from delinquent tax for the deferral period. The taxpayer, however, needs to provide collateral for the amount of taxes to be deferred. (The same deferral system for local taxes was introduced in 2008.)

Resources available to the tax authorities

Tokyo, Osaka, and several other RTBs each have a team of specialist transfer pricing examiners who conduct investigations. Over the past several years, the NTA has increased its transfer pricing enforcement by monitoring and expanding the scope of its examinations. The NTA has been increasing the number of examiner positions and the number of offices to be used to investigate transfer pricing strategies in order to handle the increase in the number of transfer pricing cases and APA (*see Advance pricing agreements section*) requests. Additionally, the NTA is educating its staff to identify red-flag issues to consider when auditing corporations that are operating in Japan. As the NTA has become tougher, more experienced and sophisticated in transfer pricing, it has made some very large assessments against a number of companies in various industries, including the pharmaceutical and medical equipment industries.

Use and availability of comparable information

The Japanese tax authorities' very strict compliance with the legislation leads the auditors to review transfer pricing on an individual transaction basis (or product line basis or business segment basis), with a strong focus on the profitability of both affiliates involved in a transaction. While the TP Directive issued by the NTA refers to the operating profit margin in the context of an irregularity check, the NTA's and RTB's historical preference for profit split analyses remains unchanged where such is used either as a transfer pricing methodology itself or as a reasonableness check of the method used by the taxpayer, depending on the situation. However, when it is not possible to conduct a profit split analysis because of a lack of financial data about the foreign affiliate, the examiners generally revert to gross or operating profit margins to establish arm's-length prices.

Given the tax authorities' practice of reviewing transfer prices on an individual transaction basis, they place heavy reliance on comparable transactions. In the past, these were external uncontrolled comparable transactions obtained by reverse audit

of the taxpayer's competitors (i.e. secret comparables). However, the use of secret comparables is very restricted these days. The TP Directive requires examiners to provide the taxpayer with an explanation of conditions of selection of the secret comparables, the content of the comparable transactions, and the method of adjustment for any differences between those transactions and the taxpayer. However, the scope of such explanation is restricted by a confidentiality requirement placed on examiners, and thus the identity of the secret comparables remains undisclosed and can create major difficulties at audit.

Limitation of double taxation and competent authority negotiations/arbitration

All tax treaties concluded by Japan contain a provision for competent authority negotiations. The Deputy Commissioner (International Affairs) of the NTA, who head the NTA's Office of International Operations and Office of Mutual Agreement Procedures, are in charge of competent authority negotiations. Since mid-2010, tax treaties concluded by Japan have also contained provisions for arbitration, where competent authority negotiations are not concluded within a two-year period.

If competent authority negotiations or arbitration result in the Japanese authorities having to cancel a portion of a proposed transfer pricing adjustment, the RTB will reduce the amount of tax due accordingly (i.e. the taxpayer does not need to file for a reassessment of tax). Such reductions will have a corresponding effect on the amount of local taxes due, since municipal and prefectural taxes are based on the amount of corporation tax paid.

As of 30 June 2011, there were 357 ongoing cases under competent authority negotiation (for both transfer pricing assessment and APA cases) and it is anticipated that the number of cases will continue to increase. One of the major reasons for difficulties in competent authority negotiations is the difference in tax policies relating to the methodology that should be used in determining an appropriate arm's-length price. For example, as was evident in the bilateral US-Japan APA reportedly obtained by Komatsu, Ltd., it is understood the US IRS preferred to use the comparable profits method (CPM) while the NTA preferred to use a profit split method, especially given a Japanese multinational was involved.

No cases have been taken to arbitration in Japan as yet.

Advance pricing agreements (APAs)

The original Japanese APA system was called the pre-confirmation system (PCS) and was instituted in April 1987, immediately following the introduction of transfer pricing legislation. Japan was one of the first countries to introduce such a system solely for transfer pricing purposes.

A significant body of APA experience has developed since then, and in October 1999, the NTA issued a formal directive on APA procedures, which in large measure brought existing practice onto a more formal basis. That directive has since been integrated into the TP Directive.

Under the TP Directive, there is a strong expectation that an APA will be bilateral. Under an APA, a taxpayer submits its transfer pricing methodology to be used to determine the arm's-length price and its specific content (together, the TPM) to the

Japan

relevant RTB. The RTB will evaluate the TPM and, if appropriate, confirm it or suggest changes. As part of this process, if the APA is bilateral, coordination through the NTA's Office of Mutual Agreement Procedures will arrive at competent authority agreement. Once a TPM is agreed upon (as long as tax returns comply with the agreed TPM), pricing is regarded by the RTB as arm's length. In principle, the period to be covered by an APA is three to five years.

The TP Directive recognises pre-filing conferences as an important part of the APA process. In addition, the formal filing requires a body of detailed supporting documentation, including a functional analysis, details of the transfer pricing methodology applied for, standalone financial statements of the taxpayer as well as its foreign affiliate that is party to the transaction subject to the APA application, and an explanation of the material business and economic conditions assumed. An amendment (effective 25 June 2007) to the TP Directive also strengthened the wording of the application requirements. As a result, the inclusion of the standalone financial statement of the foreign affiliate into the APA application is a strict requirement to be adhered by the taxpayer, and non-submission may result in the RTB's refusal to process the APA application. Moreover, the same amendment also provides that an APA application may not be processed if it results in profit in Japan being reduced without reasonable economic grounds.

An APA application will not stop an ongoing transfer pricing audit; although there is specific clarification that roll-back – the use of an agreed TPM for periods prior to an APA being in force – may be acceptable for bilateral or multilateral APAs. There is also guidance relating to post year-end adjustments to conform to a TPM.

Between 1987 and 1992, few PCS cases were filed and only a handful of these were approved. Since 1992, however, transfer pricing legislation around the world (particularly in the United States) has developed considerably. In response to this, the NTA has taken an even more proactive attitude towards the bilateral APA procedures. Between 30 June 1999 and 30 June 2011, some 1,054 bilateral APA applications had been filed, with more than 784 APAs completed during the same period. In addition, the number of APA examiners at the Tokyo RTB has continued to increase, from 27 in 2007 to 58 in 2011. Examples of reported APAs include:

- Apple Computer Japan, Inc. was the first foreign parent company to obtain a bilateral APA with the NTA and IRS. It was reported that the profit ratios from domestic sales of Apple's personal computers were to be based on ratios that were mutually agreed to by the NTA and the IRS.
- Matsushita Electric Industrial Co. became the first Japanese-parent taxpayer to obtain an APA that was mutually agreed by the NTA and IRS.

OECD issues

Japan is a member of the OECD.

44.

Kazakhstan

Introduction

Kazakhstan, unlike other central Asian countries and Russia, adopted a separate law concerning transfer pricing, which included the arm's-length concept and took effect from 1 January 2009. Currently, Kazakhstan's transfer pricing legislation is regarded as the most detailed within the Commonwealth of Independent States.

This law has become the subject of much attention from both local and foreign companies operating in Kazakhstan. This attention stems mainly from the fact that the transfer pricing law, in certain aspects, significantly departs from the key principles outlined in the Organisation for Economic Co-operation and Development (OECD) Guidelines. Thus, the transfer pricing law and corresponding rules contain a number of unusual concepts, some of which have the effect of widening the scope of the application of transfer pricing by the auditing authorities.

However, the transfer pricing law and the rules contain a number of ambiguous provisions, which in turn impact the practice of how the authorities apply the law.

Statutory rules

Scope

While the transfer pricing law focuses on cross-border transactions, it remains extremely broad in scope primarily because transfer pricing control extends to certain transactions involving unrelated parties. Thus, the relevant state authorities (i.e. tax and customs) are empowered to control transfer prices applied for the following types of international business transactions:

- Between related parties.
- Barter transactions.
- Involving counter-claims and reducing claims.
- With parties registered in tax havens.
- With legal entities that have taxation privileges.
- With legal entities that have reported losses in their tax returns for the two tax years preceding the transaction.

The control also may be carried out in respect of domestic intercompany transactions within the territory of the Republic of Kazakhstan in case they are directly related with international business transactions:

- When minerals are sold by a subsoil user.
- If one of the parties has tax exemptions.
- If one of the parties has losses for the two most recent tax periods, preceding the year of the intercompany transaction.

Kazakhstan

The law is accompanied by six decrees with additional information on:

- List of goods and services subject to special transfer pricing monitoring.
- List of pre-approved official sources of comparable pricing information.
- Procedure for conclusion of APAs.
- List of goods from which prices could be identified through official sources of information.
- Rules on pricing of natural uranium concentrate.
- Rules on pricing of titanium and magnesium products.

Related parties

The transfer pricing law generally defines related parties as individuals or legal entities whose special mutual relations may allow the economic results of the transactions to be influenced. The transfer pricing law further sets out a comprehensive, non-exhaustive list of 15 scenarios that would result in parties being deemed as interrelated for the purpose of the transfer pricing law. Included in the list of scenarios is a somewhat unusual rule that determines interrelationship between transaction parties in the following situations:

‘When parties to a transaction apply a price that deviates from market price, as determined based on a range of prices according to the data of one of the authorised bodies’, such transactions could be treated as those performed between related parties.

Therefore, this provision allows the Kazakh authorities to treat any transaction as a related-party transaction based on their set of market prices.

Pricing methods

For determining market prices, one of the five methods (comparable uncontrolled price method [CUP], cost plus method, resale price method, profit split method, and net [comparable] profit method) must be applied. Formally, only in cases where it is impossible to apply the CUP method, one of the other four alternative methods should be used. Thus, Kazakh legislation attaches a clear priority on the use of the CUP method.

As mentioned, the transfer pricing rules comprise a list of official sources of information on market prices, and taxpayers whose transaction prices conform to prices from the official sources appear to be safeguarded from transfer pricing adjustments in practice.

However, these information sources mostly quote commodity prices. With respect to other goods and services (including intangibles), the availability of comparable information is limited or of a low quality.

Detailed instruction on the usage of the approved transfer pricing methods is currently pending approval by the relevant authorities.

Documentation requirements

The Kazakhstan transfer pricing law sets out formal transfer pricing documentation requirements for transactions eligible for the authorities’ control (i.e. international business transactions and domestic transactions related thereto).

Taxpayers in such transactions must keep and maintain documentation substantiating the applied transfer prices. Upon request from the tax authorities, taxpayers must submit the documentation within 90 days. The law stipulates a comprehensive list of information that must be included in transfer pricing documentation. This list can roughly be summarised as follows:

- Industry analysis.
- Interrelations overview.
- Functions and risks analysis.
- Information of the intercompany transactions.
- Description of applied pricing methods.
- Financial analysis.
- Comparability analysis, including specification on the official sources of information used.
- Other relevant information for substantiating the arm's-length nature of the prices applied.

Other regulations

In February 2009, Kazakhstan introduced the Rules for Performance of Monitoring of Transactions. According to these rules, certain taxpayers involved in intercompany transactions shall submit a special transfer pricing monitoring declaration by 15 April following the financial year when the controlled transactions took place. There are two conditions for this requirement:

- A taxpayer should be included in the list of the 300 largest taxpayers.
- Item of the transactions are included in the monitoring list (e.g. oil and gas products, marketing services).

The list of the 300 largest taxpayers is updated by the Ministry of Finance on a biannual basis.

Legal cases

The most significant legal cases on transfer pricing matters involved appeals of subsurface users working in Kazakhstan on the tax authorities' transfer pricing adjustments in relation to the export of oil and other commodities.

Burden of proof

Generally, the transaction price is deemed to be the market price unless proved otherwise by the tax authorities. However, in practice, it is often the case that the burden of proof is shifted to the taxpayer to demonstrate that the applied price was at market level.

Tax audit procedures

The tax and customs authorities are responsible for controlling, monitoring, and evaluating cross-border transactions for transfer pricing purposes.

The tax authorities are generally responsible for monitoring transactions on certain exported goods and services, maintaining an information database on market prices for goods (works and services), conducting tax audits, and assessing and collecting taxes and penalties resulting from price adjustments.

Kazakhstan

The customs authorities are generally responsible for monitoring transactions on certain imported goods, maintaining an information database on customs declarations, providing information to the tax authorities on the monitored goods, participating with the tax authorities in tax audits, and assessing and collecting customs payments and penalties resulting from price adjustments.

Transfer pricing audits are normally carried out within the scope of regular tax audits, while thematic audits aimed at transfer pricing issues can be carried out in some cases. In practice, transfer pricing audits may last from 30 working days to as long as one year.

Revised assessments and the appeals procedure

Taxpayers have the right to appeal the transfer pricing adjustments at the higher level tax authority, up to the Tax Committee of the Kazakhstan Ministry of Finance. Should the outcome of the appeal with the tax authorities be unsatisfactory, taxpayers may further appeal the assessments in Kazakhstan courts (taxpayers have the right to appeal directly to courts as well). Certain foreign subsurface users operating in Kazakhstan have the right to appeal through international arbitration (e.g. UNCITRAL).

About 34% of cases are vindicated in courts by the taxpayers.

Additional tax and penalties

As a result of the application of the transfer pricing law, the tax authorities may adjust prices leading to the additional assessment of taxes, including corporate income tax, value-added tax, excise, and excess profits tax for subsurface users, and customs payments.

The Kazakhstan Code of Administrative Violations does not provide for specific fines for the violation of transfer pricing legislation. Generally, as a result of transfer pricing adjustments, the taxpayers are penalised based on the provision for underreporting taxes in tax returns, which is calculated at 50% of the additionally assessed tax.

Interest penalties also apply at the annual rate of 19% (currently) applied on a daily basis for each day of delay of the tax payment.

Control approach of the tax authorities

The tax and customs authorities carry out the transfer pricing control using the following means:

- Monitoring of certain transactions (i.e. gathering detailed information on the sale/purchase of certain goods and services).
- Carrying out transfer pricing audits.
- Enquiries to the parties of the transaction, any third parties directly or indirectly involved in the transaction as well as the competent authorities of the other jurisdictions involved.

The tax and customs authorities also maintain databases on export/import prices of goods and services. However, these are not available for public use.

Risk transactions or industries

Based on practical experience, the most risk-intense types of transactions from a transfer pricing perspective involve subsurface-use operations (i.e. export of oil and other commodities) and financial services.

In practice, management services are subject to scrutiny by the tax authorities. However, we have not seen large transfer pricing adjustments with respect of management services. This is likely because the Kazakhstan tax authorities have limited experience in evaluating the pricing of services and intangibles.

Limitation of double taxation and competent authority proceedings

Although the majority of double tax treaties concluded by Kazakhstan contain provisions on competent authority proceedings, the Kazakhstan tax authorities have not applied them regularly in practice. In part, this is because Kazakhstan transfer pricing legislation on several points is non-compliant with the OECD Guidelines, thus making the competent authority proceedings difficult to achieve with the majority of Kazakhstan trading countries.

Advance pricing agreement (APA)

In February 2009, Kazakhstan introduced the Rules for Concluding of Agreements on Application of Transfer Pricing (APA). These rules determine the procedures and documents required for application to the Kazakh tax authorities for APAs.

The tax authorities have the right to review the taxpayer's documents for up to 60 business days within the APA approval process. An APA could be concluded for the terms up to three years.

The APA rules do not specify whether the procedures are applicable to both unilateral and multilateral APAs, hence formally, the Kazakhstan rules allow also for the conclusion of bilateral and multilateral agreements.

In practice, despite a number of applications from taxpayers, there have been no APAs successfully concluded as of April 2011.

Anticipated developments in law and practice

The government appears willing to further develop transfer pricing legislation. As a result, the deputies of the Kazakhstan Parliament are currently considering abolishing excessive rights of the Kazakh tax authorities in determining 'related parties' and 'market prices'. There are also initiatives to provide much detailed and clearer mechanism for pricing analysis and documentation.

Although the outcome is unclear, there appears to be growing acceptance among certain deputies that the existing transfer pricing legislation requires a substantive revision in accordance with the OECD principles rather than the cosmetic changes contained in the current transfer pricing law.

Notable changes suggested in an industry-initiated draft law developed with the assistance of PwC include:

Kazakhstan

- Limitation of the transfer pricing control by the authorities to transactions between related parties and transactions with companies registered in jurisdictions with privileged taxation.
- Reference to the OECD Guidelines on transfer pricing where the law is silent or unclear.

In addition, it is anticipated that the APA regime will eventually result in successful conclusion of unilateral pricing agreements in the near future.

Liaison with customs authorities

Although both tax and customs authorities are assigned as competent authorities under the transfer pricing law, they do not appear to be effectively coordinated with each other on transfer pricing matters in practice. This often results in assessments of a different taxable base for customs and tax purposes (i.e. higher taxable base for purposes of calculating customs payments and lower base for purposes of corporate income tax deductibility).

Effective from 1 July 2010, Kazakhstan is a member of the customs union formed between Kazakhstan, Russia, and Belorussia. There are no special transfer pricing rules established for transactions within the customs union, while general transfer pricing rules apply.

OECD issues

Kazakhstan is not a member of the OECD, and Kazakhstan tax and customs authorities are not bound by OECD Guidelines on transfer pricing. However, due to the limited transfer pricing provisions in the domestic legislation, the tax authorities might unofficially refer to the OECD Guidelines for direction or alternative solutions.

Joint investigations

The Kazakhstan tax authorities may conduct joint investigations on transfer pricing matters within the Eurasian Economic Community (EEC) along with Russia, Kyrgyzstan, Tajikistan, and Belarus.

The Kazakhstan tax authorities may also request information on transfer pricing from the competent authorities of other states with which Kazakhstan has signed double tax treaties (currently 38 states).

Otherwise, the information on joint investigations is limited and not publicly available.

Thin capitalisation

Kazakhstan tax authorities pay attention to the interest rate levels deducted for Kazakhstan corporate income tax purposes. Transfer pricing control is used in addition to the debt-to-equity ratio limitations established in the Kazakhstan tax legislation.

In practice, the tax authorities were able to successfully challenge the interest rate levels deducted by one of Kazakhstan's largest banks in a well publicised transfer pricing court case.

45.

Korea, Republic of

Introduction

Since the introduction of the Korean transfer pricing regulations, transfer pricing has become one of the most important international tax issues concerning taxpayers engaged in cross-border inter-company transactions. The Korean transfer pricing regulations are based on the arm's-length standard and are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines. The Korean transfer pricing regulations prescribe transfer pricing methods, impose transfer pricing documentation requirements, and contain provisions for advance pricing agreements (APAs) and mutual agreement procedures (MAPs).

Numerous amendments have been made to the transfer pricing regulations over the years. Recent significant revisions, effective 1 January 2011, have included the codification of the most reasonable transfer pricing method, corresponding downward adjustments if transfer prices exceed arm's length, the use of multiple year data, the increase in penalty for failure to submit transfer pricing documentation, and detailed guidance on the preparation of transfer pricing documentation. These amendments provide taxpayers with increased flexibility in applying transfer pricing methods but at the same time reflect continued efforts by the National Tax Services (NTS) to enforce transfer pricing compliance.

Statutory rules

The Korean transfer pricing regulations are contained in the Law for the Coordination of International Tax Affairs (LCITA), which was enacted on 1 January 1996. The LCITA stipulates that transfer prices should be consistent with the arm's-length standard.

The transfer pricing methods specified in the LCITA and accompanying Presidential Enforcement Decree are listed below:

- Comparable uncontrolled price method, resale price method or cost plus method.
- Profit split method and transactional net margin method.
- Other unspecified methods.

Prior to 1 January 2011, the LCITA stipulated that the selection of the appropriate transfer pricing method should be based on the above hierarchy. As a result of recent amendments to the LCITA, however, transfer prices should now be supported by the most reasonable transfer pricing method without consideration to the order of method priority.

The regulations also contain primary and secondary transfer pricing documentation requirements. Primary documentation requirements refer to transfer pricing

Korea, Republic of

documentation that taxpayers are required to submit each year as part of their corporate income tax return. Primary documentation forms include:

- Declaration of Transfer Pricing Method.
- Summary of International Transactions.
- Summary of Income Statements of Overseas Affiliates.

The Declaration of Transfer Pricing Method form requires a taxpayer to report the transfer pricing method or methods used to establish or determine their transfer prices. In addition, a taxpayer is required to provide an explanation for the particular method adopted. The transfer pricing method should be the most reliable method among those available and should justify the arm's-length nature of the taxpayer's transfer prices. Separate declaration forms are required for transactions involving transfers of intangible property, services and cost-sharing arrangements.

The Summary of International Transactions form provides the NTS with a summary of the taxpayer's inter-company transactions, according to transaction counterparty and type of transaction. Taxpayers are required to report the following: (i) the name of each overseas related party with whom the taxpayer engages in transactions; (ii) the relationship between the taxpayer and the overseas related party; (iii) the nature of the transaction (e.g. tangible goods, service, financing, and investment); and (iv) the amount of the transaction.

The Summary of Income Statements of Overseas Affiliates requires a taxpayer to submit the income statement of each overseas affiliate with whom it engages in transactions. The overseas affiliate income statements should be submitted for the most recent tax year and should be prepared to the profit-before-tax level. In addition, the taxpayer should indicate the primary business activities of the overseas related parties and the taxpayer.

Although there is no concept of immateriality (or a *de minimis* transaction) in the Korean regulations, a taxpayer is not required to submit the Declaration of Transfer Pricing Method form at the time of filing the corporate income tax return if the taxpayer is engaged in cross-border inter-company goods (or service) transactions that accumulatively amount to below Korean won (KRW) 5 billion (KRW 500 million for service transactions) or amount to below KRW 1 billion (KRW 100 million for service transactions) per transaction party.

Likewise, the taxpayer is not required to submit a Summary of Income Statements of Overseas Affiliates if it is engaged in cross-border inter-company goods (or service) transactions that amount to below KRW 1 billion (KRW 100 million for service transactions) per transaction party or if the taxpayer has submitted a list of overseas affiliates and their summarised financial statements in accordance with the Corporate Income Tax Law (CITL).

Taxpayers are also required to provide the NTS, upon request, with other documentation that supports the arm's-length nature of their transfer prices. Secondary documentation includes inter-company agreements; corporate transfer pricing policies; organisational charts; financial statements segmented by business, product line or function; business descriptions; the selection and application of the transfer pricing method; and any other documents that may be useful to evaluate the arm's-length nature of a taxpayer's transfer prices.

Requests for transfer pricing documentation are made during tax audits and formal requests for transfer pricing documentation from the NTS. Taxpayers are required to submit transfer pricing documentation to the NTS within 60 days of the request; however, a one-time 60-day extension may be allowed upon application. During a tax audit, however, secondary documentation as well as other supporting documentation must be provided promptly, because the duration of tax audits are often very short and the auditors want to resolve all issues within the short timeframe.

In addition to transfer pricing, the LCITA also covers:

- interest paid to a controlling overseas shareholder
- corporate income retained in tax havens
- offshore gifts, and
- international cooperation among tax administrations.

On 26 December 2008, Korea introduced provisions to provide penalty relief to taxpayers maintaining contemporaneous documentation. The penalty waiver provision stipulates that the underreporting penalty (i.e. 10% of the additional corporate income tax) may be waived in the event of a transfer pricing adjustment if a taxpayer has maintained contemporaneous transfer pricing documentation (i.e. at the time of filing of the corporate income tax return) and the transfer pricing method has been reasonably selected and applied.

A taxpayer who wishes to obtain penalty relief should maintain the following documentation and submit the documentation within 30 days when requested by the NTS:

- General descriptions of the business (including analysis of the factors that may affect the prices of assets and services).
- Information that may affect transfer prices, including information on foreign related parties and their relationships with the taxpayer (group organisation structure).
- The following documentation which supports the selection of the transfer pricing method stated on the taxpayer's corporate income tax return:
 - Economic analysis and forecast data supporting the selection of the most reasonable transfer pricing method stated at the time of filing the corporate income tax return.
 - Profitability of the selected comparable companies and the descriptions of adjustments applied during the analysis of the arm's-length price.
 - Descriptions of other potentially applicable transfer pricing methods and the reasons why these transfer pricing methods could not be selected.
 - Additional data prepared to determine arm's-length prices after the end of the tax year and within the filing period of the corporate income tax return.

In addition, the assessment of whether a taxpayer has reasonably determined the arm's-length price is determined by considering the following factors:

- Data on profitability of comparable companies obtained at the end of the tax year should be representative and not wilfully exclude the profitability of a certain comparable company to derive an arm's-length price favourable to the taxpayer.
- Collected data should be systemically analysed to select and apply the transfer pricing method.

Korea, Republic of

- If the taxpayer has selected and applied a transfer pricing method different from the one applied in an APA concluded during the previous tax year or a transfer pricing method selected by the tax authorities during a previous tax audit, there should be a valid reason as to why the different transfer pricing method was applied.

Other regulations

The LCITA supersedes all previous domestic corporate tax laws and transfer pricing guidelines published by the NTS.

On 15 June 2004, the NTS issued basic tax rulings under the LCITA which are intended to provide guidelines for interpretation of the LCITA in accordance with internationally accepted rules and standards for taxation. These basic tax rulings consist of 29 sections and are the first rulings applicable under the LCITA since its enactment. The highlights of the basic tax rulings include sections on the deductibility of management service fees, factors when selecting comparable transactions, application of the comparable uncontrolled price method or the resale price method, circumstances for applying the berry ratio, and the use of the interquartile range. These basic tax rulings became effective from 15 June 2004.

In addition, the NTS issues official rulings upon request by taxpayers. Although these rulings are interpretations of the law for specific cases and are not legally binding, they are usually applied to similar cases. The rulings provide practical guidelines and are very influential.

Legal cases

A handful of legal cases involving transfer pricing have been filed, but very little information on these cases is publicly available. Some cases have been settled out of court, some cases are currently pending in domestic appeals, and other cases have been elevated to mutual agreement procedures.

Burden of proof

Korean tax laws do not clearly specify where the burden of proof lies with regard to supporting or challenging transfer prices. However, a taxpayer is required to report and justify the transfer pricing method(s) used to establish or evaluate its transfer prices each year, at the time of filing its corporate income tax return. If the taxpayer has submitted proper documentation, the NTS must demonstrate why the taxpayer's transfer prices are not at arm's length and propose a transfer pricing adjustment to challenge the taxpayer's transfer prices. Once the NTS has proposed an alternative transfer pricing method and adjustment, the taxpayer must defend the arm's-length nature of its transfer prices.

In the event that a taxpayer does not provide the NTS with proper transfer pricing documentation at the time of filing its corporate income tax return, the burden of proof falls on the taxpayer to corroborate the arm's-length nature of its transfer prices.

Tax audit procedures

Selection of companies for audit

In general, the NTS reviews corporate income tax returns, including transfer-pricing-related documentation, to identify taxpayers who display signs of noncompliance

with transfer pricing regulations. The NTS then requests additional information from suspected taxpayers for review. Taxpayers who fail to submit transfer-pricing related data required by the LCITA are more likely to be selected for an audit. Taxpayers are also generally subject to periodic audits every four to five years based on the statute of limitations for taxes.

The provision of information and the taxpayer's obligation to cooperate with the tax authorities

The NTS can request any relevant information that it deems necessary for an audit (e.g. contracts, price lists, cost data of manufactured goods, accounting principles used, organisation charts, and mutual investment agreements).

Since it is likely that the attitude of the taxpayer will affect both the outcome of the audit and/or the size of any adjustment, it is imperative that the taxpayer be cooperative during the negotiation process. Therefore, taxpayers are obliged to provide the requested information to avoid adverse consequences.

Secondary adjustments

A unique and problematic aspect of the Korean transfer pricing regulations is the view on secondary adjustments. Secondary adjustments are additional tax assessments that are performed if a transfer pricing adjustment is not repatriated back to Korea. Most secondary adjustments are treated as deemed dividends subject to withholding taxes at the rate specified in the corporate tax law or applicable treaty.

Transfer pricing review committee

On 30 June 2005, the NTS announced the establishment of a Transfer Pricing Review Committee (TPRC) to review proposed transfer pricing adjustments prior to the finalisation of a tax audit. Under the auspices of the Assistant Commissioner for International Taxation, the TPRC is designed to ensure that taxpayers are treated fairly and consistently with respect to transfer pricing assessments. The TPRC is responsible for reviewing proposed adjustments that are in excess of KRW5 billion or that are disputed by a taxpayer. The TPRC may also review proposed transfer pricing adjustments stemming from other issues on a case-by-case basis.

Domestic tax appeals procedure and mutual agreement procedures

A variety of domestic appeal options are available to taxpayers, including the following:

- Pre-Assessment Protest (filed at the district, regional or head tax office of the NTS).
- Request for Investigation by the NTS.
- Request for Adjudication by the Tax Tribunal (TT).
- Appeal to the Board of Audit and Inspection (BOAI).

Most domestic tax appeals are filed with the TT. Moreover, taxpayers may only pursue court litigation after appealing to the NTS, TT or BOAI. For several reasons, most transfer pricing disputes move to MAPs. First, taxpayers who initiate MAPs may apply for a suspension for the payment of a tax assessment. This option is not available to taxpayers pursuing domestic tax appeals, except in very limited circumstances. Second, pursuing MAPs increases the likelihood of obtaining relief from double taxation and a

Korea, Republic of

waiver for underreporting penalties. Finally, MAPs encourage tax authorities to rely on generally accepted transfer pricing rules and standards during negotiations.

Additional tax and penalties

The tax law imposes penalties on taxpayers who underreport their tax base or underpay corporate taxes. These rules also apply to transfer prices. However, the LCITA stipulates that the penalty for understatement does not apply in situations where a taxpayer has performed due care that has been verified during MAPs.

The following penalties may be imposed, depending on the type of taxpayers' obligations under related tax laws that the taxpayer failed to fulfil.

Failure to file corporate income tax returns or to keep books of accounts

If the taxpayer does not file corporate income tax returns within the time limit prescribed by the CITL, or the obligation to maintain or keep books of account has not been performed, the taxpayer is subject to the following penalties:

- In cases of intentional failure to file corporate income tax returns, the penalty is the larger of:
 - 40% of the computed corporate income tax amount determined by the NTS, or
 - 0.14% of the revenue.
- In cases other than the above, the penalty is the larger of:
 - 20% of the computed corporate income tax amount determined by the NTS, or
 - 0.07% of the revenue.

Underreporting of the tax base

Penalties for underreporting taxable income are imposed based on the difference between the correct taxable income amount, which should have been reported under the CITL, and the taxable income actually reported at the time of filing the corporate income tax return. The penalty is calculated as follows:

- In cases where the total reported tax base has been intentionally reduced, the penalty is the larger of:
 - 40% of the corporate income tax corresponding to the total underreported tax base, or
 - 0.14% of the total underreported tax base.
- In cases other than the above, the penalty imposed is 10% of the taxes on the underreported tax base. If there is no tax calculated, however, no penalties are imposed.

Penalty for non-payment or insufficient payment

If a taxpayer fails to pay or underpays owed taxes, it is subject to a penalty determined by the interest rate prescribed within the CITL, which is based on the default interest rate for financial institutions and the number of days that the taxes have not been paid. The current applicable interest rate is 10.95% per annum.

Penalty on noncompliance with the request for the submission of information

The LCITA imposes penalties for failing to comply with information requests.

If a taxpayer fails to submit requested transfer-pricing information, the NTS may refuse to accept such information if it is submitted at a later time (e.g. when filing a tax appeal or in the course of MAPs).

In addition, if a taxpayer is requested to submit transfer-pricing information but fails to do so within the due date without a justifiable reason or submits false information, the taxpayer may be fined up to KRW 100 million for negligence.

Penalties in practice

Under the CITL, the government automatically imposes penalties when taxpayers fail to meet specific obligations. In general, no exceptions are made and there are few opportunities to negotiate penalties. Under the LCITA, however, it is more likely that the NTS will take a taxpayer's circumstances into account when imposing penalties, if the taxpayer demonstrates a good-faith effort to comply with requests.

Resources available to the tax authorities

The Division of International Taxation is an office of the NTS which provides support to the regional tax offices on transfer pricing matters. Investigations are conducted with the assistance of the relevant departmental experts.

Use and availability of comparable information

Taxpayers may use various forms of comparable information to support their transfer pricing policies, including internal and third party data. Several company directories and electronic databases are available in Korea that contains detailed information and data on Korean companies.

Risk prone transactions or industries

The LCITA states that any transaction with overseas affiliates may be subject to transfer pricing adjustments. Recently, the NTS has aggressively challenged royalty payments and management service fees. The NTS also scrutinises transactions with affiliates located in countries that are considered tax havens and conducts industry-wide tax audits in industries where transfer pricing abuse may be prevalent (e.g. pharmaceutical, tobacco, newspaper, and private equity industries). Other peculiar situations may also draw the NTS's attention, such as when a distributor incurs operating losses or when a company adopts different transfer pricing policies that reduce the amount of taxes paid.

Limitation of double taxation and MAPs

The LCITA contains detailed information about MAPs, which taxpayers may use to seek relief from double taxation.

Advance pricing agreements (APAs)

The Korean APA programme was launched on 1 January 1997. Taxpayers may apply for unilateral or bilateral APAs. An APA can cover any number of years, but most applications are for a five-year period. For taxpayers seeking a bilateral APA, it may also be possible to roll back the results of the APA to open tax years.

A taxpayer must apply for an APA by the end of the first taxable year for which the APA is being sought.

Korea, Republic of

To apply for an APA, a taxpayer must complete and submit a formal application that describes the transactions for which the APA is being requested, the overseas affiliates involved, the transfer pricing method to be applied, and the period requested to be subject to the APA. In addition, the taxpayer must provide a description of its business activities and organisation structure as well as the financial statements and tax returns for the transacting parties for the most recent three years. The taxpayer may avoid having to submit some information if it can clearly demonstrate that the information is irrelevant.

After the terms of the APA have been finalised, the results are legally binding on the NTS but not the taxpayer. In other words, if the taxpayer's transfer prices are determined to be within the range previously agreed to with the NTS, the NTS cannot make an adjustment. The taxpayer, however, is not required or bound to meet the conditions of the APA.

The taxpayer has the right to withdraw or modify the request for an APA at any time prior to obtaining the NTS' final approval. In the event that a taxpayer decides to withdraw the application for an APA, all submitted data is returned to the taxpayer without further consequence.

APA requests are completely confidential and the data submitted to the NTS may only be used for reviewing APA requests and follow-up purposes.

As in other countries, APAs allow Korean taxpayers to obtain certainty on the acceptability of transfer prices, eliminating the risk of penalties and double taxation. Additional benefits of applying for APAs include the possibility of obtaining the assistance of foreign tax authorities to help persuade the NTS of the reasonableness of the request and the opportunity to negotiate with high-level NTS staff rather than regional tax office personnel (as in the case of audits). In addition, the NTS is much more willing to negotiate during APA requests than during tax audits or MAPs. The number of APA requests is anticipated to increase significantly over the next several years as they are actively promoted by the NTS.

Recent developments in law and practice

Each year, the NTS releases revisions or updates to the LCITA based on feedback it receives from taxpayers and tax agencies.

Liaison with customs authorities

Effective 1 July 2012, the NTS and the Korea Customs Service (KCS) introduced dual and symmetrical provisions to the LCITA and Korean customs law to provide correlative adjustments on transfer pricing adjustments and/or customs duties assessments. The new mechanism provides taxpayers with an opportunity to request correlative adjustments in the two following scenarios:

- If a taxpayer receives a transfer pricing income adjustment on import transactions, the taxpayer may request a refund of overpaid customs duties based on the adjusted price.
- If a taxpayer receives an imposition of customs duties in relation to import price, the taxpayer may request a refund of corporate income tax based on the adjusted import price, and the taxpayer may request a refund of corporate income tax based on the adjusted import price.

The correlative relief mechanism is only available in limited situations. It may not apply to voluntary adjustments to transfer prices or import prices or for taxpayers with APAs or advance customs valuation arrangements.

The correlative adjustment procedures have led to the establishment of a Pricing Review Committee, which is responsible for reviewing situations where the NTS and/or the KCS denies a taxpayer's request for correlative adjustments. The Pricing Review Committee is only empowered to make recommendations as a mediator: the NTS, KCS, and the taxpayer are not obligated to follow the Committee's recommendations. Additional provisions were also introduced regarding the exchange of information between the NTS and the KCS to help facilitate fairness and transparency.

Currently, there is uncertainty in how the process will be executed in practice. It is also important to note that the mechanism for requesting correlative adjustments represents a way of achieving 'virtual' rather than 'actual' transfer pricing and customs harmonization. Namely, there have been no fundamental changes to the LCITA or customs law with respect to the convergence in standards for measuring transfer pricing and customs compliance. Therefore, the pre-existing regulatory framework for transfer prices and customs will continue to apply, creating a challenging environment for demonstrating eligibility for correlative adjustments.

OECD issues

Korea is the 29th member of the OECD. The Korean transfer pricing regulations are largely based on the OECD Guidelines.

Joint investigations

It does not appear that the NTS has cooperated with other tax authorities for the joint investigation of transfer prices.

Thin capitalisation

The LCITA covers interest payments remitted to controlling overseas shareholders.

46.

Latvia

Introduction

The adoption of the Latvian Corporate Income Tax (CIT) Act in 1995 established a requirement that transactions with related parties comply with the arm's-length principle. Since then, the development of transfer pricing law has been relatively slow. However, recently the Latvian State Revenue Service (SRS) has started to tackle the transfer pricing issue actively and a set of supporting regulations has been developed.

Statutory rules

The transfer pricing area in Latvia is governed by the following legislation:

- The Taxes and Duties Act (Section 23 and amendments of Section 152, which will become effective as of 1 January 2013).
- The CIT Act (Section 12).
- The Commercial Code (Section 182).
- The Cabinet of Ministers' 4 July 2006 Rule 556, Application of the CIT Act (CIT rule).

Transactions

Latvian law requires that foreign-related party transactions meet the arm's-length standard. Furthermore, the CIT Act requires transfer pricing adjustments for a noncompliant transaction between two Latvian companies that belong to the same group (i.e. direct or indirect ownership of at least 90% is required). In addition, any transaction with a company located in a low-tax jurisdiction is regarded as a related party transaction and has to meet the arm's-length requirement.

Taxable income specifically for CIT purposes must be adjusted if the price applied to any of the following related party transactions differs from its arm's-length value:

- Fixed assets, goods or services sold at below-market prices.
- Fixed assets, goods or services bought at above-market prices.

The Taxes and Duties Act states in determining the market price or value of a transaction that any discounts and mark-ups applied to transactions between unrelated parties should be taken into account, as well as any pricing changes driven by the following factors:

- Demand fluctuations due to seasonality or other factors.
- Differences in the quality or characteristics of goods or services.
- Expiry of the sell-by date.
- Marketing policy on placing new products in the market or placing products in a new market.

- Sales of samples and demo versions to attract customers.

The Taxes and Duties Act provides for a wider application of the arm's-length principle than only between related parties. A tax audit may examine and adjust the price of the following transactions:

- Transactions between related parties.
- Barter and set-offs.
- Price deviations exceeding 20% of prices that a taxpayer had applied to similar goods or services over a short period.
- Exports and imports.

Other regulations

Calculating an arm's-length price

The CIT rule prescribes five transfer pricing calculation methods that are consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines:

- Traditional transaction-based transfer pricing methods:
 - The comparable uncontrolled price method.
 - The resale price method.
 - The cost-plus method.
- Transactional net profit methods:
 - The transactional net margin method.
 - The profit split method.

The CIT rule gives a preference to the three traditional transaction-based methods, whereas the transactional profit methods are to be used only when all of the traditional transaction-based methods are inadequate or inapplicable.

Transfer pricing documentation requirements

Latvian law currently does not require Latvian companies to have appropriate transfer pricing documentation, in place that provides a reasonable calculation of prices applied to related party transactions. On a tax audit, however, the SRS may demand transfer pricing documentation or other documents showing that the company's transfer prices are arm's length. In that case, the taxpayer is expected to provide appropriate transfer pricing documentation within 10-30 days after receiving a request from the SRS.

However, transfer pricing documentation rules are adopted and will be effective as of 1 January 2013. These rules set the requirements for the taxpayers and transactions who are obliged to have transfer pricing documentation and to information which should be comprised by full transfer pricing documentation.

According to pending requirements, full transfer pricing documentation will be mandatory for companies with a turnover in excess of 1 million lat (LVL) having related party transactions amounting to LVL 10 000 or more. The draft amendments state that within one month after receiving a request from the SRS a company must submit full transfer pricing documentation in Latvian containing certain information on the industry the taxpayer operates in; the overview on its operations, group and related-party transactions; functional analysis and description of what transfer pricing

Latvia

methods are applied and what comparable data is used for substantiating that transfer prices are arm's length.

Reporting related party transactions

Latvian taxpayers are required to report transactions with related parties on a special form as an attachment to their annual CIT return. The addendum gives the identification or details of the related company, describes the nature of the transaction, states the amount of business conducted and specifies the method applied for the particular transaction.

Legal cases

Until recently Latvia had no established transfer pricing practice as the Latvian tax authorities are still experiencing a learning curve in this field. In the last few years there have been some court cases dealing with disputes between taxpayers and the SRS relating to transfer pricing issues. Due to the increasing number of transfer pricing investigations over past year, the number of cases brought before the court is expected to increase.

Burden of proof

The Tax and Duties Act places the burden of proof in tax matters, including transfer pricing, firmly on the taxpayer. A tax decision issued by the SRS has to state only the basis for adjusting tax payment and calculating penalties. The taxpayer then has to provide proof to challenge the decision.

Tax audit procedures

In Latvia, transfer pricing is audited as part of a regular tax audit, which generally may cover up to three previous tax years. Under the pending amendments in statutory requirements transfer pricing audits will cover up to five years.

The SRS must give a taxpayer at least ten days' written notice of a decision to conduct a tax audit. The notice must state the commencement date and duration of a tax audit, as well as taxes and duties and tax periods subject to the tax audit.

a tax audit may not take longer than 90 days, unless the SRS director general sanctions an extension. The duration of a tax audit may be extended by 30 days if additional information is required and by 60 days if such additional information has to be requested from foreign tax authorities or foreign companies. Any period between the date an information request is made and the date it is received will be excluded from the extension.

These temporal limitations do not apply to simultaneous tax audits in which the SRS liaises with the tax authorities of a foreign country in which the related party of a Latvian entity is registered as a taxpayer. Although simultaneous cross-border tax audits are not regular, the SRS during tax audits does use its right under effective double tax treaties to request information from corresponding countries' tax authorities.

Upon completion of a tax audit, the SRS must provide the taxpayer with an audit report that sets out the results of the audit. If any tax offence is identified, the SRS will prepare a decision about increasing the tax liability to include additional taxes and penalties.

Revised assessments and the appeals procedure

If a tax audit has resulted in an additional liability, the taxpayer must pay it, together with any penalty, within 30 days of receiving a tax decision, or the taxpayer may challenge the decision by appealing to a) the Transaction Evaluation Commission within 10 days after receipt of tax decision or b) the superior official (i.e. the SRS director general) within 30 days after receipt of tax decision. If the taxpayer does not agree with a decision of the Transaction Evaluation Commission or the SRS director general, the decision may be taken to court.

Additional tax and penalties

Current tax penalties prescribe the following penalty levels:

- If the tax charge for the period under review has been understated by one of the following:
 - Up to 15% of the tax charge, there is a possible penalty of 20% of the total tax liability that should have been reported.
 - More than 15% of the tax charge, there is a possible penalty of 30% of the total tax liability that should have been reported.
- If the taxpayer admits the understatement of tax, is willing to collaborate with tax authorities and to pay the understated amount, the imposed penalty will be reduced by 50%.
- If a taxpayer who has already committed a repeat offence commits one or more similar offences within three years, there is a penalty of 100% of the tax that should have been reported for each of these subsequent offences.

To make taxpayers less willing to undertake last-minute corrections to their tax returns right before a tax audit, the law imposes a penalty of 5% of any understated tax liability on a taxpayer that submits an adjustment and pays the outstanding tax and interest only after receiving a notice of the start of a tax audit. The penalty must be paid to the tax authorities before the date the tax audit starts.

The SRS director general may decide to reduce the penalty if the taxpayer admits an offence and pays the unreported tax and penalty of 50% of the total tax liability that should have been reported within 30 days of receiving the SRS decision on the tax audit results.

Resources available to the tax authorities

The SRS has established a separate central team specialising in transfer pricing issues. If regional tax auditors face a difficult transfer pricing issue or if their decision is appealed, then they may seek assistance from the central transfer pricing team.

Use and availability of comparable information

The SRS has acquired the Van Dijk Bureau database Analyse Major Databases from European Sources (AMADEUS) to be able to perform independent benchmarking.

The Taxes and Duties Act also provides that if the price of a transaction is not at arm's length, then the tax authorities may determine during a tax audit the market price of the transaction, relying on the following methods and information sources:

- Internal comparables of the taxpayer.
- Prices and values that independent companies have applied in similar transactions.

Latvia

- Calculating the costs of the transaction and adding a mark-up calculated in line with the industry average financial results derived from either the Latvian Central Statistical Office database or the tax authorities' own databases, but if such information is not available, the relevant average profitability indicators from the information base established by the SRS.
- Using the average price of similar goods as provided by the Central Statistical Office.
- Engaging an independent valuation expert.

Risk transactions or industries

In the absence of developed transfer pricing auditing practices, there is no particular industry or transaction having any larger transfer pricing risk than others, qualifying for exemption, or governed by stricter rules than others.

However, transactions involving a related provider of services, especially management services, or intellectual property are more likely to be scrutinised. These transactions typically are challenged on the grounds that the underlying contracts or other supporting documents are inadequately formalised or the tax auditors require proof of services being received and of benefit to the taxpayer.

It is frequently forgotten that in transactions with any entity located in a low-tax jurisdiction, transfer pricing rules should be applied.

Recent cases show that tax authorities tend to challenge the transfer pricing adjustments of taxpayers even if the transfer pricing documentation is in place.

Limitation of double taxation and competent authority proceedings

Almost all double tax agreements contain a clause relating to competent authority proceedings, (i.e. mutual agreement procedures). However, there is no information about the SRS involvement with competent authority proceedings because no such information is published.

As of 1 January 2011, Section 12 of the CIT Act explicitly allows the transfer pricing corresponding adjustment. If the person or company related to the Latvian company has made a transfer pricing adjustment, the Latvian company may reduce its taxable income by the same amount. However, the corresponding adjustment is restricted to transactions with a company resident in Latvia, another EU member country or an EEA country that has an effective double tax agreement with Latvia.

Advance pricing agreements (APAs)

There are no provisions enabling taxpayers to enter into APAs with the SRS. However, the tax law amendments were adopted and provisions on APAs will be effective as of 1 January 2013.

The Administrative Proceedings Act entitles a person to seek an advance ruling regarding the exercise of his rights in specific legal circumstances, including the application of transfer pricing law.

in practice, however, this procedure is more likely to be used to substantiate the application of a particular transfer pricing method or provision of law rather than to negotiate advance approval for a specific transfer pricing situation.

An advance ruling is not binding on the requesting party, but it is binding on the issuing government agency, which may not change its position to one that is less favourable for a taxpayer, even if the legal opinion contained in the ruling is subsequently shown to have been incorrect.

Anticipated developments in law and practice

The amendments in the Taxes and Duties Act introduce APA and govern transfer pricing documentation requirements. Both developments are adopted and will become effective in 2013.

Liaison with customs authorities

The State Revenue Service is the main body for tax administration and customs authority. Thus, there are no obstacles to cooperation and information exchange between tax authorities and customs authorities.

OECD issues

Latvia is not yet an OECD member but has committed to join the OECD in the foreseeable future.

Given that the arm's-length principle and Latvian transfer pricing rules are borrowed from the OECD Guidelines, the SRS has expressed its willingness to adopt the principles set out in the guidelines. As a result, the CIT rule that came into force on 1 July 2006 contains a paragraph stating that the OECD Guidelines may be used in selecting and applying methods for determining the arm's-length price or value.

Joint investigations

The SRS practices information exchange with foreign tax authorities in line with Latvia's double tax agreements. However, there is no publicly available information about the results of joint investigations that took place as a result of information exchange.

Thin capitalisation

Latvian thin capitalisation rules are contained in the CIT Act to prevent companies from being highly leveraged and distributing profits through interest payments to shareholders and third parties. A taxpayer must comply with the following restrictions on interest deductions:

- Taxable income should be adjusted for interest payments exceeding the amount of interest calculated by applying to the interest bearing liability 1.2 times the average short-term interest rate of credit institutions as determined by the Central Statistical Office for the last month of the tax year.
- Taxable income should be adjusted for the amount of interest in proportion to the excess of the average interest bearing liability over an amount equal to four times shareholders' equity at the beginning of the tax year, less any revaluation reserve. If the shareholder's equity is negative, for calculation purposes it is assumed to be zero.

Latvia

If taxable income must be adjusted under both criteria, the larger of the two adjusted amounts would apply.

These rules are neither applied to credit institutions and insurance companies, nor to payments of interest on loans acquired from EEA credit institutions, the State Treasury, the World Bank group, the Nordic Investment Bank, the European Reconstruction and Development Bank, the European Investment Bank, the Council of Europe Development Bank, and residents of countries with which Latvia has double tax agreements.

The second restriction is also not applied to interest paid to a financial institution provided that it is a resident of EEA or of a country with which Latvia has a double tax agreement and provides crediting or finance lease services that are supervised by the respective states' credit and financial institutions' controlling body.

Management services

When auditing intragroup services, tax auditors will analyse two key questions, namely (1) whether an intragroup service has in fact been provided and, if so, (2) what charge for that service is consistent with the arm's-length principle.

To prove the existence of a management services transaction, a contract and/or an invoice might be insufficient. The taxpayer also should prepare a memorandum of delivery and acceptance explaining the nature and amount of service and confirming that the services have been acquired and approved by both parties. Also, it is useful to retain other documents, such as meeting notes or reports prepared during or as a result of consultation.

47.

Lebanon

Introduction

The introduction of the Tax Procedure Law No.44 in Lebanon (effective 1 January 2009) brought certain provisions regarding the treatment of related party transactions from a Lebanese perspective. As part of this introduction to the treatment of related party transactions, form and substance are acknowledged as well as certain fair market value concepts for evaluating such related party transactions. Lebanon does not currently have specific transfer pricing guidelines, although it does prescribe to use of the arm's-length principle. Like many Middle Eastern countries, Lebanon has a relatively low corporate tax rate at 15%.

Statutory rules

Transfer pricing legislation

On 11 November 2008, the Lebanese Parliament enacted the Tax Procedure Law No.44 (TPL), which became effective 1 January 2009. The implementing regulations related to the TPL provide further guidance on the scope and condition of its application.

The general objective of the TPL is to improve the tax administration's work and to maintain (or establish) taxpayers' rights. Despite its purely administrative nature, as part of its income tax law, the TPL specifies an anti-avoidance rule that stipulates that when profits have been shifted abroad by deviating from 'normal' prices and conditions, such prices will be adjusted and added back to the taxpayer's taxable profit in Lebanon.

Moreover, the tax administration has the right to modify the value and conditions of transactions between related parties based on the arm's-length principle. The tax administration has the right to reclassify the transaction in either of the two following cases:

- A fictitious transaction, defined as a transaction where the value of a transaction differs by 20% (less or more) from the fair market value.
- A transaction that is legal in its form but lacks the necessary economic substance.

Associated persons

According to Article 10 of the TPL, parties are considered related if one party has control and supervision over the other – that is, one party has managing authority over the other party which gives the former party financial and economic influence over the latter party from a regulatory perspective. Article 4 of Decision 453/1 further specifies that parties are considered related if they demonstrate:

- supervision and orientation powers
- a subordination relationship

Lebanon

- a tutorship relationship, or
- are jointly liable partners.

Moreover, Article 4 of Decision 453/1 provides concrete examples, when supervision and orientation powers are deemed to exist, including:

- In case a physical or moral person possesses the majority of the capital leading to a majority of the voting rights or leading to the ability to nominate more than half of the company's board of directors.
- In case a physical or moral person is entitled by the company's board of directors to take decisions concerning the financial, economic and organisational (administrative) management of the company, even if not possessing more than 50% of its capital.
- Possession by a person of more than 50% of the company's parts.
- Person holding the right to obtain more than 50% of the partnership's profits.
- One person owning many enterprises.
- Many related persons owning more than one enterprise.
- The husband, wife, brothers, sisters, adult and minor descendents are considered as one person concerning the determination of the 'related persons' status for tax purposes.

Transfer pricing methods

The Lebanese regulations do not contain any reference to specific transfer pricing methods, but do prescribe to the arm's-length principle.

Other regulations

Every person, establishment or company that satisfies either of the following terms, even if not resident in Lebanon, is considered to be resident in Lebanon for tax purposes (i.e. having a permanent establishment in Lebanon):

- Have an office or fixed place of business in its name in Lebanon, even if it is not undertaking its business activity in a normal and repetitive manner.
- Are practicing a profession or business activity in a normal or repetitive manner, even if it is not a known registered place of business in Lebanon.

Burden of proof

The burden of proof lies first with the taxable person concerning its tax declaration. If the tax administration aims at additional assessments, the burden of proof shifts to the tax administration.

Tax audit procedures

The taxable person has to be notified within 15 days before the start of the audit. The notification of the assessment includes the identification of the records and accounting documents to be audited. The audit should cover only those periods specified in the 'order to audit' unless the unit head decides otherwise (in specific circumstances). Books and records should be audited on-site, and the tax authorities may produce copies.

Previously audited tax periods cannot be audited again unless new information affecting the tax amount has been obtained. The audit period limit (at the taxpayer's premises) is three months, with a possible extension of an additional three months.

The tax administration notifies the taxable person on the audit results and allows the taxable person 30 days to provide a response. Within one month of receiving the remarks, the tax administration issues its final assessment. The taxable person is entitled to challenge the assessment according to the objections and appeals procedure stipulated in the TPL.

Penalties

Every corporation has to submit its tax return by 31 May following the year of assessment. The Lebanese tax system is based on self-assessment. The tax authorities have the right to audit the tax return and may raise additional assessments and may apply penalties (e.g. the penalty for the incorrect tax declaration which, according to Article 110 of the TPL, is 20% of the additional tax due). The incorrect declaration also leads to interest payments, because the additional tax should have been paid earlier (i.e. at the original filing date). According to Article 55 of the TPL, 1% on the additional tax (plus penalties) per month must be paid.

Tax treaty network

Until 1995, the only existing double tax treaty (DTT) was with France. As of December 2010, Lebanon had entered into DTTs with 28 countries and is currently in negotiation with 20 additional countries. Detailed guidance is available for the application of the DTT with France (ratified on 23 August 1963). The guidance describes practical experiences as well where this guidance has been applied to other DTTs by the Ministry of Finance.

Advance pricing agreements

Although the TPL does not acknowledge the use of advance pricing agreements, the TPL has introduced the possibility of receiving advance rulings for transactions or operations based on the following cumulative conditions:

- The activity has not been completed yet.
- It is a concrete activity.
- Details of the activity should be advised.
- Clarifications are required.
- The tax administration may ask for additional information.
- The tax administration should answer in writing within two months.
- The ruling is binding to both parties if complied with.
- A fixed fee will be applied.

Anticipated developments

For the time being, no detailed transfer pricing regulations have been developed in Lebanon, but detailed transfer pricing guidelines are expected to be issued in the near future. The increased use of transfer pricing methodologies within the region (by tax administrations and taxpayers) has had an impact on the tax base in Lebanon, and the Lebanese tax authority is working on its transfer pricing regime in response to this trend.

48.

Lithuania

Introduction

The arm's-length principle was introduced in Lithuania by the Corporate Tax Act of 20 December 2001. Little attention was paid to transfer pricing before this time. The detailed transfer pricing requirements (methods, documentation, etc.) are stipulated by Order No 1K-123 of the Minister of Finance of the Republic of Lithuania, dated 9 April 2004. The Organisation for Economic Co-operation and Development (OECD) Guidelines have been carried over into Lithuania's domestic transfer pricing legislation, although in a more condensed form and with a somewhat clearer stance on a number of questions.

The supplemented Lithuanian transfer pricing rules, i.e. the Order 1K-123, should be issued in the near future.

Statutory rules

The definition of related parties includes, *inter alia*, a) members of a group consisting of a parent and one or more of its 25% or greater subsidiaries, b) two entities if one of them directly or indirectly controls more than 25% of the shares in the other entity, or has the right to more than 25% of voting rights of the other entity, or has an obligation to coordinate its business decisions with that entity, or is under an obligation to third parties for the obligations of the entity, and c) two entities where one has the right to make decisions that bind the other. The term 'associated parties', to which transfer pricing rules also apply, covers all entities which may influence each other in such a way that arm's-length pricing may not be achieved.

Documentation is required of a taxpayer if its turnover is greater than 10 million Lithuanian litas (LTL) (approximately 2.9 million euros [EUR]) per year. However, there is no such exemption for financial services and insurance companies. In addition, the taxpayer has to prepare transfer pricing documentation for all transactions with the associated parties, regardless of their materiality.

Other regulations

Further guidance and interpretations of the Lithuanian transfer pricing legal acts are provided in the transfer pricing recommendations for the taxpayers issued by the State Tax Inspectorate on 24 September 2007. These recommendations are based on the OECD Guidelines.

Legal cases

There are no prior court cases relating to transfer pricing.

Burden of proof

By law, the tax authority needs to make a case for an adjustment. In practice, however, it is often the case that a comparatively simple opening argument results in the taxpayer having to make substantial effort to build a defensive case.

Tax audit procedures

Tax audits are more likely following a refund claim, a tip-off or liquidation. The tax authorities primarily choose to audit the transfer pricing of companies that have incurred taxable losses for a few years and have substantial volume in international transactions. There are two types of procedures: limited and full. Either procedure can cover either a specific tax or the whole range of taxes. There is a standard 90-day time limit on the duration of any investigation, although this may be extended. There is a five-year statute of limitations.

Revised assessments and the appeals procedure

The appeals process is firstly to the officer conducting the investigation, then to a more senior person at the tax office, followed by the commission for tax disputes and finally the courts. In practice, however, most disputes over reasonably grounded differences in interpretation are settled in compromise without litigation.

Additional tax and penalties

There is a penalty of between 10% and 50% of the unpaid tax for incorrect declaration, the exact amount being discretionary. A penalty may be limited if there is no overall loss to the state budget, for example through a corresponding adjustment. In addition, there would be penalty interest calculated as 0.03% of the unpaid tax per day (valid from 1 October 2012).

Resources available to the tax authorities

There are only a few persons specialising solely in transfer pricing within the tax authorities. This indicates that the authorities are not as experienced as many other European Union tax authorities. There have been comparatively few public statements or high-profile investigations to date. However, since 2008 they have started requesting companies to submit the transfer pricing documentations for review within a 30-day (statutory) period.

The authorities have direct access to the Amadeus database. They focus on adjustments to internal comparable uncontrolled prices, including analysis of margins and mark-ups on transactions between the taxpayer and unrelated parties. However, they are already reviewing benchmarking studies as well. Lithuania is not an OECD member, and local rules allow the use of secret comparables in certain cases.

Use and availability of comparable information

Under the Lithuanian transfer pricing legislation the Lithuanian tax authorities accept all methods outlined in the OECD Guidelines, with a preference for the application of traditional methods. The tax authorities would look to apply the comparable uncontrolled price method to establish a market price for transactions.

The transactional net margin method, or TNMM, is accepted; when applied, local comparable companies are preferred. However, practically, regional comparable companies are accepted if the number of local comparable companies is insufficient.

Lithuania

Lithuanian regulations neither specify the use of the full nor interquartile range when calculating an arm's-length range. In addition, they do not state how often comparable company sets should be updated.

Risk transactions or industries

At present the most notable risk transactions are those involving various types of services, management fees or financial instruments. The local tax authorities usually challenge interest-free or low-interest loan transactions. There are a number of benefit tests, and emphasis is placed on demonstrating the actual performance of a service.

Limitation of double taxation and competent authority proceedings

Competent authority proceedings have not yet been frequently requested by taxpayers.

Advance pricing agreements (APAs)

As of 1 January 2012 taxpayers in Lithuania have a possibility to apply for an APA from the tax authorities in respect of the future transactions. There are no fees applicable for the application. The tax authorities have 60 days for the examination of the application, additional 30 days are devoted for applications received by 1 July 2013 and other additional 60 days are devoted if the application requires additional examination. The decision made is valid for the current and following five financial years from the date it was taken by the tax authority, which must comply with the decision, while for the taxpayer it is not obligatory. To date, there were no APAs issued.

Anticipated developments in law and practice

At present, there are no penalties for failure to comply with documentation rules, but this may change.

Liaison with customs authorities

There is minimal interaction between inspectors responsible for direct tax and their colleagues in customs.

OECD issues

Lithuania is not an OECD member but follows the organisation's guidelines closely with respect to interpretation of double tax treaties. However, for transfer pricing, local rules take precedent in the event of conflict with the OECD Guidelines. One example is the use of secret comparables, which is permitted by local legislation in certain cases.

Joint investigations

At present, there is no indication that Lithuanian tax authorities are involved in projects in which specific transfer pricing information is exchanged with foreign tax authorities. However, there is exchange of information with foreign tax authorities in projects related to other tax issues.

Thin capitalisation

Very broadly, interest on debt exceeding a 4:1 debt-equity ratio is disallowed (unless it can be proved that an unrelated party would have lent at higher gearing). Debt from persons who on their own or together with related parties own directly or indirectly 50% of the payer is considered. For the purposes of the calculation, year-end balances

are used (unless the tax authorities deem these unrepresentative), and the definition of equity is the balance on the last day of the tax period, excluding the financial result of the period and certain revaluation reserves. Interest from unrelated banks is not subject to thin capitalisation restrictions, unless an associated enterprise guarantees the debt.

Management services

Management services fall under particular scrutiny as historically, over the past 15 years, they have been seen by investors as simply a repatriation tool that does not require the legal procedures of a dividend and also offers a tax deduction. Tax authorities lacked the resources and commitment to challenge this practice effectively. For this reason, shared service centres and headquarters are facing increased documentation burdens, and Lithuanian finance personnel are increasingly reluctant to take responsibility for the effects of any such charge, sometimes even adding it back for tax purposes regardless of substance.

The law specifically states that taxpayers should demonstrate that services were actually rendered, normally meaning objective tangible evidence such as reports or travel documents. There is also a benefit test, which appears to be an either/or rather than a cost-to-benefit comparison. Duplication of services is not permitted, which may inadvertently lead to difficulties in services that support or build on existing resources. Also of note is the non-deductibility of costs related to services that are deemed to arise from merely being a participant in a group, possibly referring to the benefits of centralised purchasing and similar functions, although there is yet little practical experience of how this rule will be applied.

Benchmarking study

Our experience shows that the tax authorities very thoroughly test benchmarking studies in terms of comparability of activities, financial data (e.g. operating revenue or fixed assets) and functions performed by the transactional parties, taking into account industry sector and geographic location.

49.

Luxembourg

Introduction

In 2011, the Luxembourg tax authorities issued two circulars on transfer pricing for Luxembourg-based entities that are mainly engaged in intragroup financing activity. The first circular, L.I.R. n°164/2, was issued on 28 January 2011 to clarify the tax treatment for Luxembourg based-entities that are mainly engaged in intragroup financing activities financed by borrowings. On 8 April 2011, the Luxembourg tax authorities issued a second circular, L.I.R. n°164/2bis, to clarify the application of Circular L.I.R. n°164/2 for entities that are mainly carrying out intragroup financing activities (i.e. intragroup lending activities financed by borrowings).

Statutory rules and legal references

The statutory rule on transfer pricing is found in Article 56 of the Luxembourg Income Tax Law (LITL). This provides that where a transfer of profit is rendered possible by the fact that a Luxembourg taxpayer has a special economic relationship with a non-resident, then the tax authorities may estimate the financial result. It is to be assumed that this provision would be applied only in a situation where the transfer of profit was outside Luxembourg. For example, this might be the case if a Luxembourg company paid significantly more than the market rate for a service it received.

Another situation on intragroup financing that might be of concern to the Luxembourg tax authorities is where an advance agreement is to be sought from the tax authorities and such agreement is based on an assertion that one or more intragroup transaction flows will be undertaken at arm's length. In this respect, the Luxembourg tax authorities have now provided detailed guidelines, which are discussed in the following paragraphs.

Furthermore, if a shareholder receives an advantage from a company that the shareholder would not have received if there had not been a shareholding relationship, then this could be characterised under article 164 LITL as a hidden distribution. Again, this might occur in a case where a shareholder charged a Luxembourg company significantly more than the market rate for a service provided by the shareholder. Such a hidden distribution would result in an add-back to the taxable profits of the Luxembourg company, and also possibly an obligation to account for withholding tax on the deemed distribution. The rate of withholding tax on a hidden distribution of dividends is 15% of the gross amount received (thus 17.65% of the net amount), unless reduced under the application of a double tax treaty or the European Commission (EC) Parent-Subsidiary Directive. An abnormal advantage granted by a Luxembourg shareholder to an affiliate could be seen as a hidden contribution and taxed at the level of a Luxembourg subsidiary. However, profits corresponding to such hidden contribution could still be deductible against relevant accounting year expenses and offset against losses carried forward.

The Luxembourg legislation does not give further guidance on how any transfer of profit or advantage to a shareholder is to be quantified, or what constitutes an arm's-length arrangement.

However, it can reasonably be assumed that in any situation where the non-resident entity or shareholder is located in another Organisation for Economic Co-operation and Development (OECD) member country, then the Luxembourg legislation should be construed in conformity with the associated enterprises article of the relevant double tax treaty. Where the wording of such an associated enterprises article follows closely Article 9(1) of the OECD Model Tax Convention (which would normally be the case in double tax treaties concluded by Luxembourg), then further guidance given by the OECD on the use and interpretation of this article can be assumed to have authority, and hence the OECD Guidelines should be regarded as giving important guidance in the Luxembourg environment in the case of a dispute.

Intellectual property regime

As part of its commitment to boost and foster research and development (R&D) activities in Luxembourg, to encourage technical and scientific cooperation as well as technology transfer between the public and private sectors, and to stimulate new economic activities, the LITL includes a provision aimed specifically at encouraging R&D activities and the creation of intellectual property. The intellectual property rights covered under the regime are copyrights related to software, patents, trademarks, designs, models and domain names. A Luxembourg company or branch can benefit from an exemption of 80% of the income from intellectual property acquired or created after 31 December 2007. The 80% exemption applies to net income derived from the intellectual property and capital gains realised on the sale of intellectual property, resulting in an effective tax rate of 5.72% for 2012. Deductible expenses include (amongst others) R&D costs, depreciation and impairment of the value of the intellectual property.

In the case of self-developed patents used by the taxpayer in its own activity, it would receive an 80% notional deduction of a deemed net income from a third party as consideration for the right to use the said patent. Further, full net wealth tax exemption is available for the qualifying intellectual property rights.

One of the conditions to be fulfilled is that the intellectual property should not have been acquired from a person who is assimilated to an 'affiliated company'. Company A is considered as affiliated to Company B in the meaning of the law if:

- it directly holds at least 10% of the share capital of B
- B holds at least 10% of its share capital, and
- at least 10% of the share capital of A and of B is directly held by a third company.

For the disposal of the intellectual property, the valuation could be determined according to any well-accepted method for the valuation of intellectual properties or the available market value. In the case of small- and medium-size enterprises, they are entitled to value the intellectual property at 110% of the expenses that have reduced their tax base for the tax year of the disposal and of any previous tax year.

The regime thus addresses two objectives. It allows a full deduction of all R&D expenses for projects that do generate any commercial results. However, successful R&D projects are not penalised through excessive taxation once they come to fruition.

Luxembourg

In addition to the tax incentives, other non-tax incentives are offered by the Luxembourg government. Any company, private research organisation or public organisation can benefit from incentives (generally subsidies or interest-rate subsidies) ranging from 25% to 100% to finance an R&D project.

Transfer pricing guidelines in case of on-lending activity

Circular L.I.R. n°164/2

On 28 January 2011, the Luxembourg tax authorities issued the Circular L.I.R. n°164/2 (the circular) providing guidance on intragroup lending activities financed by borrowings. In the context of the circular, two enterprises are deemed to be related where one enterprise participates directly or indirectly in the management, control or share capital of the other; or if the same persons participate directly or indirectly in the management or in the share capital of both companies. The term intragroup financing transaction refers to any activity consisting of granting loans or cash advances to related companies.

The scope of the circular applies to entities that are ‘principally’ engaged in intragroup financing activities. The circular, however, does not provide guidance on when an entity is ‘principally’ engaged in intragroup financing activities. The circular further states that an arm’s-length remuneration should be determined for a Luxembourg entity carrying out such intragroup on-lending transactions in accordance with OECD Guidelines. A functional analysis is to be carried out to determine the remuneration of each entity based on the functions performed and taking into account the assets utilised and risks borne.

Moreover, the circular mentions that a company should have sufficient equity to assume the risks in connection with its financing transactions and that such equity should be effectively used if the risk related to the financing materialises. The minimum equity at risk should amount to 1% of the nominal value of the granted financing or 2 million euros (EUR).

In addition to the equity requirements, companies falling under the scope of the circular are also required to satisfy certain substance requirements in order to be considered to have real substance in Luxembourg.

Luxembourg companies that are mainly engaged in intragroup financing activities must also prepare a transfer pricing study to justify the arm’s-length compensation.

Circular L.I.R. n°164/2bis

On 8 April 2011, the Luxembourg tax authorities issued an additional circular (L.I.R. n°164/2bis) to clarify the application of the Circular L.I.R. n°164/2. This additional circular clarifies that confirmations obtained by the tax authorities before 28 January 2011 regarding the arm’s-length nature of intragroup financing activities will no longer have effect as from 1 January 2012. Taxpayers must comply with the requirements set out in the 28 January 2011 circular (L.I.R. n°164/2) and file a request in this respect with the Luxembourg tax authorities.

Tax audits and resources available to the tax authorities

When transfer pricing issues arise, they will be dealt with by the tax bureau that normally handles the taxpayer’s affairs. However, the transfer pricing of all transactions and all industries is open to challenge, and in the event that the tax

authorities seek to adjust a taxpayer's tax return, then the burden of proving that the adjustment is not valid lies with the taxpayer.

Transfer pricing adjustments

A local tax inspector (there is no central Luxembourg team of transfer pricing auditors) can scrutinise all transactions of all sectors of business and have the power of investigation, including requesting information from third parties. Should such an audit result in an amendment of the taxpayer's tax return, the burden of proof is reversed, and it will thus be up to the taxpayer to prove the arm's-length nature of the transaction targeted by the tax authorities. Potential adjustments could result in penalties of 0.6% per month on the tax assessed for the taxpayer. However, there is a very limited experience of litigations.

In practice, the Luxembourg tax authorities may accept compensating adjustments under certain conditions:

- The adjustment has been made by the other tax authority on sound technical grounds with supporting documentation to evidence the calculation and adjusted pricing of the transaction, rather than on an overall ad hoc basis.
- The adjustment does not result in a loss for the Luxembourg company, especially in cases where the Luxembourg company had been characterised as a low-risk entity and therefore remunerated on a cost-plus basis.
- Year of accepting an adjustment:
 - The adjustment is effected only for open tax assessment years and not where the assessment has been completed.
 - Where the adjustment was made by the other tax authority for a completed assessment year, it may be possible to make an adjustment for the prior year in the year the assessment is yet to be completed in Luxembourg.
 - Where the financial statements of a year have been signed and filed, without the inclusion of the adjustment, but the return is yet to be submitted, the adjustment only in the return may be acceptable.
- In all of the above-mentioned situations, if the adjustment is made only on the tax return for any period without a corresponding accounting adjustment, the Luxembourg tax authorities are likely to require both that the financial statements of the first subsequent period for which accounts have not yet been signed and filed show a prior-year adjustment to reflect the aggregate transfer pricing adjustments, and that the settlement between the parties is made to implement the amended pricing.

It is yet to be tested whether the tax authorities would accept a compensating adjustment in cases where a minimum taxable profit has been agreed on transactions as part of a unilateral tax agreement.

Elimination of double taxation

Most of the tax treaties concluded by Luxembourg provide for an exchange of information procedure and contain mutual agreement procedure (MAP) provisions.

With the law passed on 24 April 1993 and subsequent amendments, Luxembourg approved the adoption of the EU arbitration convention and follows the EU Council Code of Conduct for the effective application of the arbitration convention.

Luxembourg

Availability of comparable information

Luxembourg companies are required to make their annual accounts publicly available by filing a copy with the local court. However, the accounts do not necessarily provide much information on potentially comparable transactions or operations because they do not normally contain much detailed financial information.

Advance pricing agreements (APAs)

While there is no procedure for obtaining a formal APA, the tax authorities are quite flexible in this area, and advance agreements in writing can be obtained on an individual basis. For entities which are mainly engaged in financing activities, the tax authorities provide binding information only if the companies have real substance in Luxembourg and if minimum equity is effectively at risk related to the transaction. Such written confirmation is limited to five years. Administrative circulars on the calculation of the cost-plus tax basis for coordination centres have been withdrawn.

50.

Malaysia

Introduction

Transfer pricing is a key area of focus for the Malaysian Inland Revenue Board (MIRB). Malaysian transfer pricing legislation and regulations are based on the arm's-length principle in the Organisation for Economic Co-operation and Development (OECD) Guidelines. Recent developments include the introduction of the Income Tax (Transfer Pricing) Rules 2012 (TP Rules 2012) and Income Tax (Advance Pricing Arrangement) Rules 2012 (APA Rules 2012) in May 2012, and the revised Malaysian Transfer Pricing Guidelines (Malaysian Guidelines) and Advance Pricing Arrangement Guidelines (APA Guidelines) in July 2012. The Malaysian Guidelines provide taxpayers with further guidance on the application of the arm's-length principle espoused in Section 140A of the Malaysian Income Tax Act, 1967 (MITA) and the TP Rules 2012, and the extent of documentation required to be maintained by taxpayers with related party transactions.

Given the focus by the MIRB, multinational companies (MNC) should ensure that their transfer pricing practices are consistent with the arm's-length principle, and that appropriate documentation is maintained as required under the TP Rules 2012 and Malaysian Guidelines.

Statutory rules

Legislative reference to transfer pricing in Malaysia can be found in Section 140A of the MITA, which was introduced on 1 January 2009. This provision is established to empower the Director General to make adjustments on transactions of goods, services or financial assistance carried out between associated persons based on the arm's-length principle.

The key provisions of Section 140A can be summarised as follows:

- Section 140A(2) requires that the arm's-length price be determined and applied where a person enters into a transaction with an associated person for the acquisition or supply of property or services.
- Section 140A(3) allows the Director General to substitute transfer prices that are not arm's length for any related-party property or services acquired.
- Section 140A(4) allows the Director General to disallow any interest, finance charge, or other consideration payable for losses suffered in respect of all excessive intercompany financial assistance in relation to fixed capital, thereby introducing the concept of thin capitalisation.

The TP Rules 2012 were introduced on 11 May 2012, with retrospective effect from 1 January 2009. The Rules apply to controlled transactions for the acquisition or supply of property and services, and specifically address the method and manner in which compliance with the arm's-length principle should be demonstrated.

Malaysia

The MIRB issued the revised Malaysian Guidelines on 20 July 2012. The revised Guidelines supersede the Guidelines previously issued in July 2003, and provide detailed guidance to taxpayers on how to comply with the requirements of Section 140A and the TP Rules 2012.

The salient features of the TP Rules 2012 and Malaysian Guidelines are further discussed in the following paragraphs.

Documentation requirements

The TP Rules 2012 require taxpayers to prepare contemporaneous transfer pricing documentation to justify the arm's-length nature of their related party transactions.

To comply with the contemporaneous documentation requirement under the TP Rules 2012, taxpayers should have transfer pricing documentation in place upon:

- developing or implementing a controlled transaction, and
- where the transaction is reviewed and there are material changes, the documentation should be updated prior to the due date for furnishing the tax return for that year of assessment (i.e. seven months after the taxpayer's financial year end).

Transfer pricing documentation is not required to be submitted with the taxpayer's tax return. However, the documentation should be made available to the MIRB within 30 days of the MIRB's request.

The TP Rules 2012 provide a list of documents required to comply with contemporaneous transfer pricing documentation requirements. The list, however, is not meant to be exhaustive, and the MIRB could request for more documents, depending on the specific circumstances of the taxpayer.

The list of documents required under the TP Rules 2012 is as follows:

- Organisation structure (including an organisation chart covering persons involved in the controlled transactions).
- Nature of the business/industry and market conditions.
- Details of the controlled transactions (e.g. parties involved, nature, terms and pricing).
- Assumption, strategies and information regarding factors that influenced the setting of pricing policies.
- Comparability, functional and risk analysis.
- Selection of the transfer pricing method.
- Application of the transfer pricing method.
- Documents that provide the foundation for or otherwise support or were referred to in developing the transfer pricing analysis.
- Index to the documents.
- Any other information, data or document considered relevant in determining the arm's-length price (such as official publications, studies, market research, technical publications, agreements and correspondence).

Further details on information that should be included in the transfer pricing documentation may be found in the Guidelines.

In the context of a transfer pricing audit or tax audit, the MIRB may also seek information from a treaty partner under the ‘Exchange of information’ article, which facilitates the process of reviewing a taxpayer’s compliance with the arm’s-length principle.

Scope of the Malaysian Guidelines

The Guidelines are applicable to controlled transactions between associated persons, where at least one party is assessable or chargeable to tax in Malaysia, i.e. cross-border and domestic related party transactions are within the scope of the Guidelines. The Guidelines also cover transactions between a permanent establishment (PE) and its head office or its other related branches.

Meaning of ‘control’ and ‘associated persons’

The Malaysian Guidelines refer to the definition of ‘control’ in Section 139 of the MITA, which defines control as both direct and indirect control. The Guidelines further refer to Section 2(4) of the MITA, where the definition of a related company is provided in the context of holding and subsidiary companies. A ‘controlled company’ is defined in Section 2(4) as one having not more than 50 members, and is controlled in the manner described by Section 139, by not more than five members.

The Guidelines have a wider definition of ‘associated companies’ than the MITA. Under the Guidelines, “two companies are associated companies with respect to each other if one of the companies participates directly or indirectly in the management, control or capital of the other company; or the same persons participate directly or indirectly in the management, control or capital of both companies”.

Thresholds

The Guidelines have introduced a threshold to ease the compliance burden on taxpayers. The thresholds are as follows:

- Gross income exceeding 25 million ringgit (MYR), and total amount of related party transactions exceeding MYR 15 million.
- For financial assistance, the Guidelines are only applicable if the financial assistance exceeds MYR 50 million. Financial assistance rendered by financial institutions (primarily covering banking institutions) is excluded from the scope of the Guidelines.

Taxpayers who fall beneath the thresholds may opt to provide a ‘condensed’ version of transfer pricing documentation under the Rules and Guidelines, and apply any method other than the five methods prescribed in the Guidelines (i.e. the OECD methods) to justify the arm’s-length nature of their related party transactions.

The Guidelines need not be applied to domestic controlled transactions, where it can be proven that any transfer pricing adjustments made under the Section 140A will not alter the total tax payable by both parties.

However, these thresholds do not apply to PEs.

Methods for determining the arm’s-length price

The TP Rules 2012 require taxpayers to determine their transfer prices in accordance to the five methods prescribed under the OECD Guidelines:

Malaysia

- Comparable uncontrolled price (CUP).
- Resale price method.
- Cost plus method.
- Profit split method.
- Transaction net margin method (TNMM).

The TP Rules 2012 and Malaysian Guidelines state a preference for the traditional transactional methods (i.e. the first three methods). Transactional profit methods (i.e. the profit split method and TNMM) should be applied only when the traditional transactional methods cannot be reliably applied. However, in any given case, the most appropriate method (i.e. the method that requires the least adjustments and provides the most reliable measure of the arm's-length price) should be selected.

The MIRB may accept any method other than the prescribed methods, provided that the method provides results in accordance with the arm's-length principle.

Comparability analysis

Comparability factors

A comparability analysis is required in the application of all transfer pricing methods. An uncontrolled transaction is deemed comparable if the following attributes of the controlled transaction and uncontrolled transaction are sufficiently similar, or reasonably accurate adjustments can be made to eliminate any differences:

- Characteristics of the property or services.
- Functions performed, assets employed and risks assumed.
- Contractual terms.
- Economic circumstances.
- Business strategies.

Tested party

In performing a comparability analysis, the MIRB does not accept foreign tested parties where information is neither sufficient nor verifiable.

Comparable period

The arm's-length price should be determined by comparing the results of the controlled transactions with the results of uncontrolled transactions on a year-on-year basis.

The period used should be comparable e.g. when assessing the results of a tested party for the financial year ended 31 March 2010, data for the financial year 2009 for a comparable company with a financial year end of 31 December would be more comparable than data for the financial year 2010.

Arm's-length range

The MIRB refers to both the range, and point in a range, that will provide the most reliable estimate of an arm's-length price. In practice, the MIRB generally uses the median as reference of the arm's-length price.

Separate and combined transactions

Transfer prices should ideally be set on a transaction-by-transaction basis. However, the Guidelines recognise that where transactions are so closely linked (or continuous) that they cannot be evaluated on a separate basis, determination of transfer pricing

based on bundled transactions may be considered. In such cases, the Guidelines require taxpayers to demonstrate that it is normal industry practice to set one price for a combination of transactions, or that there is insufficient reliable data to set the price for each transaction individually.

It is generally accepted that group intangibles associated with the product or service provided cannot be disaggregated and are bundled into a packaged deal with all associated costs being included in the price of the product. As such, it is reasonable to assess the arm's-length nature of related party transactions in such instances on a consolidated basis.

Re-characterisation of transactions

Under the TP Rules 2012, the MIRB may re-characterise a controlled transaction where:

- the economic substance of the transaction differs from its form, or
- when viewed in totality, the arrangements made in relation to the controlled transactions differ from that which would have been adopted by independent persons behaving in a commercially rational manner.

Losses

Taxpayers are expected to maintain contemporaneous documentation to justify that losses incurred are commercially realistic, and is not a result of their controlled transactions.

Business restructuring

The MIRB recognises that it is commercially rational for a multinational group to restructure in order to obtain tax savings. However, a reduction in profits is acceptable only if the taxpayer is able to justify that there is a reduction in the level of functions performed, assets employed and risks assumed. As such, taxpayers undertaking business restructuring exercises should ensure that defence documentation is prepared to justify a reduction in profits.

Specific transactions

The TP Rules 2012 and Malaysian Guidelines provide specific requirements when applying the arm's-length principle in relation to the following specific transactions.

Intra-group services

The MIRB regularly scrutinises payments of management fees/intra-group service fees to parent companies or affiliates. Under the TP Rules 2012, taxpayers with intra-group service fee payments are required to justify:

- that intra-group services have been rendered, and that the taxpayer has received the benefits from these services, and
- that the charge for the intra-group services is at arm's length.

The TP Rules 2012 also state that an intra-group services charge will be disregarded if it involves:

- shareholder activities
- duplicative services
- services that provide incidental benefits or passive association benefits, and

Malaysia

- on-call services.

The Guidelines further clarify the exclusion of on-call service charges, by stating that there are exceptional circumstances where on-call services could be considered as chargeable services. However, it must be proven that an independent person in comparable circumstances would incur the charge to ensure the availability of such services when the need for them arises.

The Guidelines state a preference for the direct charge method when charging for intra-group services. However, where the direct charge method is impractical, the indirect charge method may be used. Taxpayers should ensure that the allocation key used is appropriate to the nature and purpose of the intra-group service. The analysis undertaken in arriving at the choice of allocation key(s) must be documented.

The MIRB will not accept sales as an allocation key, unless the taxpayer can justify the correlation between sales and the costs incurred in providing the service/benefits derived from the service.

Cost contribution arrangements (CCA)

Cost contribution arrangements (CCA) are defined under the Guidelines as a framework agreed among business enterprises to share the costs and risks of developing, producing and obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights.

In practice, if a service arrangement does not result in any property being produced, developed or acquired, the principles for dealing with intra-group services will apply even if the arrangement has been described as a CCA.

Allocation of costs in a CCA must be made at arm's length. In addition, where there is an entry, withdrawal or termination by a party in a cost contribution payment, there should be payments made to the relevant parties based on the arm's-length value of the transferred interest/reallocation of interests in the cost contribution arrangement.

Intangible properties

Where the legal ownership of the intangible does not vest with the person who developed the intangible property, the developer should receive an arm's-length consideration for the development of such property. Under the Guidelines, this could be in the form of a cost reimbursement plus an arm's-length mark-up, or lump-sum compensation equal to the value of the intangible property if the developer bore all the expenses and risks associated with the development.

Where the person who is not the owner of a trademark or trade name undertakes marketing activities (and bears the costs and risks associated with these activities) in excess of an independent comparable person, the person should be entitled to an arm's-length share of the intangible-related returns from the owner of the trademark or related intangibles.

Intra-group financing

Under the TP Rules 2012, the MIRB may impute/adjust the interest rate on intra-group financing transactions if the interest rate is not at arm's length. The Guidelines consider the CUP method to be the most reliable method to determine the arm's-length interest rate. When determining the arm's-length interest rate, appropriate indices such as the

Kuala Lumpur Inter Bank Offered Rate (KLIBOR), prime rates offered by banks and/or specific rates quoted by banks for comparable loans can be used as reference points. Adjustments are then required on those rates to arrive at the arm's-length interest rate applicable to the intra-group financing transaction under review.

Legal cases

No legal cases concerning transfer pricing have been decided by the courts to date. However, there are cases currently being heard by the courts. Most of the cases involving disputes on transfer pricing issues have been settled out of court, and the details have not been published.

Burden of proof

Under the Self-Assessment System, the burden of proof lies with the taxpayer to clear any alleged non-compliance with transfer pricing legislation. The intention of the Rules and Guidelines are to assist taxpayers in their efforts to determine arm's-length transfer prices and at the same time comply with the local tax laws and the administrative requirements of the MIRB.

In this connection, upon a tax audit or enquiry, taxpayers must be able to substantiate that their transfer prices have been determined in accordance with the arm's-length principle as prescribed under the TP Rules 2012 and Malaysian Guidelines.

Tax audit procedures

Form C

In submitting their annual tax returns (i.e. Form C for companies), all taxpayers that have transactions with their related parties are required to complete Section N to declare their related party transactions for the year in the following categories:

- Total sales to related companies in Malaysia.
- Total sales to related companies outside Malaysia.
- Total purchases from related companies in Malaysia.
- Total purchases from related companies outside Malaysia.
- Other payments to related companies in Malaysia.
- Other payments to related companies outside Malaysia.
- Loans to related companies in Malaysia.
- Loans to related companies outside Malaysia.
- Borrowings from related companies in Malaysia.
- Borrowings from related companies outside Malaysia.
- Receipts from related companies in Malaysia.
- Receipts from related companies outside Malaysia.

In addition, if the taxpayer is a controlled company, it must disclose the details of its five main shareholders in Part P of Form C. The information provided is used as one of the resources by the MIRB in deciding whether the company is a potential target for a transfer pricing audit or tax audit. As the disclosure of related party transactions is part of the taxpayer's income tax return, failure to properly disclose information on its related party transactions could result in an incorrect tax return.

MNE and JCK Forms

The MIRB issued the Form MNE (Pin 2/2012) (MNE Form) and Form JCK (TP/1/2011) (JCK Form) in July and December 2011. The MNE Form addresses cross-

Malaysia

border related-party transactions, while the JCK Form addresses domestic related-party transactions.

These forms are sent to selected taxpayers and are generally required to be completed within 30 days. The MIRB generally requests for completion of the MNE and JCK Forms for the last two to three years of assessment. These forms enable the MIRB to use a more targeted approach in identifying taxpayers for audits based on the complexity of their related-party transactions, and the level of compliance with transfer pricing legislation (e.g. availability of contemporaneous transfer pricing documentation). The Forms require taxpayers to disclose the following information:

- Information on related parties (names and locations of holding company, ultimate holding company and subsidiaries, and names of Malaysian affiliates).
- Quantum of related-party transactions (sale and purchase of finished goods, materials and other assets, receipt or payment of royalties/licence fees, receipt or payment of management fees, receipt or payment of research and development fees and other service fees, rental or leasing of assets, receipt and payment of interest and guarantee fees, and any other related-party transaction).
- Quantum of interest bearing loans and trade credit provided/received, and quantum of interest free loans provided/received. In addition to amounts borrowed or loaned during the year, the closing balance as at year end is also required to be disclosed.
- Characterisation of business activity (e.g. toll, contract or full-fledge manufacturer).
- Industry code which is relevant to the taxpayer.
- Whether the taxpayer has prepared transfer pricing documentation for the relevant year.

Selection of companies for audit

The Multinational Tax department in the MIRB principally focuses on four segments, namely, transfer pricing desk audits, transfer pricing field audits, advance pricing arrangements (APAs)/mutual agreement procedures (MAP) and transfer pricing policy-making. The selection of taxpayers for a transfer pricing audit is normally undertaken by the team located in the MIRB headquarters.

Transfer pricing/tax audits can be triggered by a number of factors, including:

- Information disclosed in Form C.
- Information disclosed in the MNE and JCK Forms.
- Outstanding tax enquiries.
- Sustained losses.
- Use of tax havens.
- Comparison of various financial ratios achieved by a similar company within the same trade or industry.
- Fluctuations in profits from year to year.
- Desk audit referrals.
- Company's past compliance record.
- Third-party information.
- Company is in a specific industry currently targeted by tax authorities.
- Company is in the process of liquidation.
- Company has not been tax audited in the past six years.

Other relevant information from public sources, such as newspaper reports, can also trigger audits.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Pursuant to the MITA, the taxpayer must keep and retain in safe custody sufficient records for a period of seven years from the end of the year to which any income from that business is related. This enables the MIRB to readily ascertain income from the business for each year of assessment or the adjusted loss from the business for the basis period for any year of assessment.

The MIRB has the right of full and free access to all buildings, places, books, documents and other papers for the purposes of enforcing the provisions of the MITA. The MIRB may make requests for information with which the taxpayer must comply with within a negotiated time frame.

The audit procedure

As part of the Self-Assessment System, the MIRB is expected to carry out tax audits, including transfer pricing audits, on taxpayers. One distinguishing factor under the Malaysian regime is that the transfer pricing review process tends to be carried out in conjunction with a field audit, whereby there is greater scrutiny of transactions, as opposed to the practice in other established countries where documentation review is generally carried out via a desk audit.

Desk audit

The transfer pricing audit process is generally initiated by a request for financial and management information, such as statutory accounts, tax computations, management accounts and transfer pricing documentation. The MIRB carries out a review of these documents and decides whether a more detailed review is required.

In straightforward cases, the MIRB corresponds with the taxpayer or requests a meeting to discuss any issues and work towards a closure of the case.

Field audit

If the MIRB's initial findings from the desk audit review warrant a field visit, the MIRB informs the taxpayer accordingly of the purpose of its visit, the officers who will carry out the audit process, the duration of the visit and the documents that need to be made available for their review. Generally, field audit visits are carried out by four to six tax officers within a one-week period. The officers examine any financial documents, supporting documents and agreements that are linked to a taxpayer's business operations. As part of the field visit, the officers also conduct interviews with the key personnel of the taxpayer's business to have a better understanding of the functional and risk profile of the company and the pricing basis adopted. At the end of the field audit, the MIRB summarises its initial findings and arranges for a follow-up meeting at its office to discuss the case.

The MIRB is cognisant of taxpayers' concurrent business obligations; therefore, the process is fairly structured, with a reasonable timeframe provided for the submission of documents and information.

Malaysia

Revised assessments and the appeals procedure

If a taxpayer is not satisfied with a transfer pricing adjustment or assessment, the available avenues of appeal mirror the normal tax appeal procedures. To appeal, the taxpayer must file an appeal with the MIRB within 30 days of receiving the Notice of Assessment. This culminates in the MIRB agreeing to the appeal or routing the matter to the Special Commissioners. Failing at that level, the ultimate decision resides in the High Court (or Court of Appeal) if the taxpayer or the MIRB so desire to proceed to such authority.

Before proceeding with the appeals process, the taxpayer is required to pay the assessed tax and penalties within 30 days of receiving the Notice of Assessment.

An alternative avenue available to taxpayers via the double-taxation treaties is the MAP which is a mechanism that caters to equitable tax treatment on transactions that involve multiple tax administrations. In some instances, MNCs recognise the need for the use of this type of dispute-resolution procedures to ensure the elimination of double taxation. Currently, Malaysia has concluded 70 double-tax agreements globally.

Additional tax and penalties

There are no specific provisions for non-compliance with Section 140A or the TP Rules 2012. The Guidelines, however, specify the penalty rates applicable on additional tax payable resulting from transfer pricing adjustments under different circumstances. The penalty rates are summarised below:

Penalty structure	
	Penalty rate
If there is no contemporaneous transfer pricing documentation	35%
If transfer pricing documentation is prepared, but not according to requirements in the Guidelines	25%
If taxpayer does not fall under the scope of the Guidelines, and has not prepared contemporaneous transfer pricing documentation	25%

Resources available to the tax authorities

The MIRB has a dedicated department, i.e. the Multinational Tax department that specialises in transfer pricing audits. This has been further enhanced with the setting up of separate transfer pricing teams in the various tax audit assessment branches of the MIRB across the country.

With the additional disclosure information requested in Parts N and P of the Form C, and the MNE and JCK Forms, the MIRB has the information to make a reasonable selection of companies for a tax or transfer pricing audit. Additionally, the MIRB digitises the information disclosed by companies in their tax returns. This electronic database of information allows the MIRB to effectively identify companies for audit, conduct trend analyses of a company's results as well as benchmark the company's performance against its industry.

The majority of the tax officers are experienced in handling tax investigations and tax audits. The officers are continually updating their knowledge through dialogues with other tax administrations in the region, in addition to attending and participating in

training sessions conducted by foreign and international tax authorities/bodies, such as the OECD.

Use and availability of comparable information

Tax authorities

The MIRB generally obtains comparable information from their internal database. Each year, companies are required to submit their tax returns and other associated work papers to the MIRB. This forms part of the comparable information available to the tax authorities, in addition to information obtained from other tax audits performed in the taxpayer's industry and via the information disclosed in the MNE and JCK forms.

Taxpayers

As a starting point, the taxpayer should determine whether internal comparable information can be found within the company. In the event internal comparable information is unavailable, the MIRB expects companies to carry out an external comparable study using local comparables. Foreign comparables will be considered by the MIRB only if the taxpayer is able to provide persuasive evidence as to the unavailability of local comparables.

The search for potential local comparables can be carried out using public directories and databases. Most Malaysian companies (private and public), except for exempt private companies, are required to lodge their statutory financial statements at the Companies' Commission of Malaysia (CCM). Information at CCM is available to the public. The process of retrieval of such information is done manually and is therefore time consuming.

Risk transactions or industries

No particular industry is more at risk to being tax audited than another. Past experiences indicate that the MIRB generally targets a particular industry or industries for a certain period of time, due to the similarities in issues generally faced by companies in a specific industry.

The tax authorities are beginning to focus on the following related-party transactions as part of their audit selection:

- Sales and purchases of goods, assets and services.
- Transfer and use of know-how, copyrights and trademarks.
- Advertising and marketing activities which indicates development of marketing intangibles locally.
- Financial assistance.
- Cost-sharing arrangements.
- Intra-group management and administrative services.
- Unusual economic transactions and arrangements.
- Research and development expense allocation.
- Sale, purchase and other commission payments.

Other issues that may alert the tax authorities include:

- Reduction of profits in a post-tax holiday period.
- Losses made on the sale of products or assets to related companies.

Malaysia

- Physical delivery of goods and invoicing to customers that are performed by different group companies located in different tax jurisdictions.
- Consistent losses or very low profits compared with other independent comparables.
- Constantly fluctuating profit margins.
- Significant differences in sales or purchase prices on transactions between related companies and independent third parties, frequent changes in prices on transactions between related companies.

Limitation of double taxation and competent authority proceedings

In addition to the limited agreements dealing with the taxation of international traffic of ships and aircraft, Malaysia has a fairly extensive network of comprehensive double tax agreements modelled on the OECD convention.

Most Malaysian treaties have the automatic relief, and this is a standard article – not a limitation issue. Malaysia's treaties generally contain an 'Associated Enterprise' article and a MAP article.

Advance pricing arrangements

The APA process in Malaysia needs to be initiated by a request from a taxpayer for a unilateral, bilateral or multilateral APA.

The MIRB is now encouraging taxpayers to apply for an APA. The APA Rules 2012 were introduced on 11 May 2012, and the APA Guidelines were issued by the MIRB on 20 July 2012 to provide further guidance to taxpayers on the APA process in Malaysia.

There are a few APAs currently in negotiation with the tax authorities. APAs in Malaysia are currently largely focused on unilateral APAs, but the MIRB highly encourages applications for bilateral/multilateral APAs.

Applicants and scope

A taxpayer with cross-border related party transactions may apply to the MIRB for an APA under Section 138C of the MITA. This includes companies, partnerships, individuals, corporation soles and permanent establishments.

Thresholds

The MIRB will consider an application for an APA only if:

- the taxpayer is assessable to tax under the MITA
- the taxpayer has a turnover exceeding MYR 100 million
- the value of the proposed covered transaction is i) for sales, exceeding 50% of turnover, ii) for purchases, exceeding 50% of total purchases, or iii) for other transactions, if total value exceeds MYR 25 million
- all covered transactions must relate to chargeable income, and
- for financial assistance, the value of financial assistance must exceed MYR 50 million.

Process

The APA application process in Malaysia consists of five stages: pre-filing meeting(s), formal submission, processing of the APA, signing of the APA, and filing of annual compliance reports.

Pre-filing meeting

A written request for a pre-filing meeting must be made to the MIRB 12 months prior to the commencement of the proposed period of the APA via Form APA 1 (Pin 1/2011) for a unilateral APA application or Form 2 (2011) for a bilateral APA application. Pre-filing meetings are held between the tax authorities and the taxpayer to discuss the feasibility of an APA. Issues that are discussed include:

- Nature of APA (unilateral, bilateral or multilateral).
- Nature and scope of proposed covered transaction(s).
- Proposed transfer pricing methodology and critical assumptions.
- Description of the proposed comparables and expected range of results.
- Period of the APA.
- Documentary requirements.
- Extent of information required.
- Possible need for an independent expert.
- Roll-back.
- Possible costs involved.
- Taxpayer's obligations as a result of the APA.
- Other relevant issues.

The written request for a pre-filing meeting must include submission of the taxpayer's contemporaneous transfer pricing documentation covering the following:

- Names, addresses and tax file references of the taxpayer and other parties to the proposed APA.
- Proposed covered transaction.
- Period covered by the APA.
- Details of the taxpayer (ownership structure, organisation chart and operational aspects of the business).
- Nature of the taxpayer's business, industry environment and worldwide organisational structure.
- Functional analysis of each party to the covered transaction, details and analysis of the proposed transfer pricing methodology and its rationale.
- Information and analysis required to produce the arm's-length result for the covered transaction.
- Description of the critical assumptions, and the events taken into account when considering the said assumptions.
- Any other necessary information including proof of similar applications/notifications by the taxpayer's related party for the application of a bilateral or multilateral APA.

The MIRB will notify the taxpayer of the outcome of the pre-filing meetings within 14 days from the last pre-filing meeting for a unilateral APA, and 30 days for a bilateral/multilateral APA.

Malaysia

Formal submission

A formal submission must be lodged with the MIRB via Form APA 1 (Pin 1/2011) for a unilateral APA application or Form 2 (2011) for a bilateral APA application within two months of receiving the notification.

Processing and signing of the APA

Generally, the MIRB will conduct site visits in its process of analysing and evaluating an APA application. The MIRB will also request for meetings with all the parties involved to understand the facts and circumstances underlying the application, and to agree on the transfer pricing methodology to be applied. The taxpayer will be notified by the MIRB upon conclusion of the review process.

The time required to process an APA application varies from case-to-case. Unilateral APAs generally require six to 12 months to conclude, while bilateral/multilateral APAs may require one to two years.

Filing of annual compliance reports

The taxpayer is required to file annual compliance reports subsequent to the conclusion of an APA with the MIRB. The report should contain the following:

- Copy of the taxpayer's audited financials (and its related party for a bilateral/multilateral APA).
- Detailed report and analysis of the covered transactions.
- Description of any material changes in financial or tax accounting methods/principles employed for that year of assessment in respect of the covered transactions, or an affirmative statement to the contrary.
- Description of any failure and reasons for failure to meet a critical assumption, or a statement to the contrary and a statement as to the continued relevance of the critical assumptions.
- All relevant information and computations necessary to support the application of the transfer pricing methodology.
- Analysis of any compensating adjustments required and the relevant tax computations.
- Other items as may be appropriate to the particular circumstances of the taxpayer and the foreign entity (for a bilateral/multilateral APA).

The APA may be revised in the event that the taxpayer fails to meet any critical assumptions in the APA with both parties' consent. An APA may also be revoked in cases of non-compliance by the taxpayer, or if the taxpayer makes any misrepresentations, fraud, omissions or misleading or false statements.

Liaison with customs authorities

Information obtained by the income tax authorities is confidential and may not be exchanged with the customs authorities. However, copies of import/export documents on the taxpayer's business premises can be requested by the MIRB in the course of a tax audit.

OECD issues

Malaysia is not a member of the OECD. However, Malaysia has adopted the arm's-length principle and the transfer pricing methodologies endorsed by the OECD Guidelines.

Joint investigations

Malaysia would partake in a joint investigation of a multinational group with another country if both countries would benefit from the investigation. Joint investigations involving the Malaysian authorities have taken place in the past.

Thin capitalisation

Thin capitalisation was introduced via Section 140A(4), with effect from 1 January 2009. This provision allows the Director General to disallow any interest, finance charge, other consideration payable for or losses suffered in respect of all excessive related party financial assistance in relation to fixed capital. However, the MIRB has deferred the implementation of thin capitalisation rules until 31 December 2012.

51.

Mexico

Introduction

Mexico did not apply international standards to its transfer pricing legislation until 1997. However, in December 1996, the Mexican Congress enacted significant tax reform, introducing the arm's-length principle, controlled foreign company legislation, and other anti-avoidance measures. Several minor reforms regarding transfer pricing have been enacted since that time, and the detailed rules included in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines must be applied in Mexico since Mexican Income Tax Law (MITL) specifically requires the application of these Guidelines to the extent consistent with the MITL and any applicable treaty. In addition, the Mexican transfer pricing tax authorities have become relatively sophisticated in a short period.

Statutory rules

Most of the specific transfer pricing rules are included in Articles 86 (Sections XII, XIII and XV), 215, 216 and 216-BIS of the MITL. These rules require taxpayers to produce and maintain documentation demonstrating that gross receipts and allowable deductions for each fiscal year arising from inter-company transactions are consistent with the amounts that would have resulted had these transactions taken place with unrelated parties under similar conditions. Moreover, documentation of arm's-length nature of inter-company transactions should be completed on a transactional basis.

The documentation requirements in Article 86 Section XII of the MITL include the following elements:

- General information such as the name of the company, address, taxpayer identification number, name of the related parties and a description of the taxpayer's ownership structure covering all related parties engaged in transactions of potential relevance.
- An overview of the taxpayer's business, including an analysis of the economic factors that affect the pricing of its products or services, such as a description of the functions performed, assets employed and risks borne by the taxpayer for each type of transaction.
- A description of the controlled transactions and the amount of the transactions (including the terms of sale) for each related party on a transactional basis according to Article 215 of the MITL.
- A description of the selected methodology applied as established in Article 216 of the MITL, including information and documentation of each type of inter-company transaction.

This annual documentation requirement does not apply to corporations and taxpayers engaged in business activities with annual gross receipts that do not exceed 13

million Mexican pesos (MXN) (approximately US dollar [USD] 1 million) during the previous fiscal year. In the case of taxpayers providing professional services, the annual documentation requirement also does not apply if the gross receipts from those services do not exceed MXN 3 million (approximately USD 230,000). In any event, upon audit these smaller taxpayers will still need to prove the inter-company transactions are at arm's length upon audit.

All inter-company transactions between related parties, including domestic and foreign-related parties, must be reflected at arm's-length prices for income tax purposes, including transfers of tangible and intangible property, services, rental or licensing of assets, loans and transfers of shares (whether publicly traded or not), and applies to both domestic and foreign transactions entered into by individual and corporate taxpayers. The annual documentation requirements for inter-company transactions performed with foreign-related parties are more extensive than for inter-company transactions performed between Mexican entities.

Taxpayers are required to determine tax obligations and file returns on a calendar-year basis for income tax purposes. There is no specific deadline for preparing transfer pricing studies. Nevertheless, a Supreme Court case decision in 2007 held that the deadline to comply with the transfer pricing documentation requirement is the date the corporation files its income tax return (normally no later than 31 March of the following applicable calendar year), and failure to do so could result in the disallowance of deductions pertaining to payments to related parties. There are no sizeable immediate penalties in case of failure to prepare the documentation; however, there is an important penalty reduction inducing taxpayers to prepare contemporaneous documentation, which is covered in the penalty section below.

Moreover, the federal tax code obliges most taxpayers to have their financial statements audited by a certified independent public accountant (CPA) in Mexico. The independent accountant must file the audited financial statements with the tax authorities along with a statutory tax audit report (*dictamen fiscal*) that includes an opinion as to whether the taxpayer has complied with its federal tax obligations, which is usually required to be filed by June following the end of the calendar year, except in case of holding companies of groups that consolidate for tax purposes, whose deadline is normally in July. However, in previous years, these deadlines have occasionally been extended. All inter-company transactions (domestic and cross-border) also should be disclosed in appendix of *dictamen fiscal*. If the transfer pricing documentation has not been prepared, such failure must be disclosed by the independent accountant in the *dictamen fiscal*.

The Tax Administration Service (TAS) may request the documentation as early as January of the following year, but in practice the documentation is not likely to be requested before the issuance of the *dictamen fiscal*. We are aware of situations in which the TAS has requested the transfer pricing documentation after the tax return was filed and before the *dictamen fiscal* is due, but this is unusual.

The transfer pricing documentation is considered part of the taxpayer's accounting records. The MITL imposes the obligation to maintain the documentation as part of the accounting records and to identify related party transactions with non-residents. As in the past, the transfer pricing documentation must be kept at the tax domicile of the taxpayer.

Mexico

It should be noted that the annual transfer pricing documentation is not filed with the tax authorities. Rather, it must be prepared and maintained by the company, in general, for five years. In the course of a tax audit, the taxpayer must make the transfer pricing documentation available upon request.

The MITL does not explicitly require taxpayers to produce documentation regarding 'domestic' related party transactions, but these transactions must be reported on an arm's-length basis, and this is ordinarily proved based on the preparation of a transfer pricing study. Consequently, in practice, it is considered that taxpayers must prepare transfer pricing documentation to establish comparability and the propriety of the domestic related party transfer pricing methods to satisfy the requirements of an independent accountant, who would provide the *dictamen fiscal*.

Taxpayers are required to report arm's-length transfer pricing for income tax filing purposes, notwithstanding that the actual prices used in transactions between related parties might be different.

The law defines related parties as parties that are directly or indirectly managed, controlled or owned by the same party or group of parties. A permanent establishment (PE) and its home office, other establishments, and their related parties, as well as their PEs, are deemed to be related parties.

Unrelated taxpayers entering into a special contractual joint venture agreement known as an *asociación en participación* are also considered to be related parties for transfer pricing purposes in Mexico.

The tax authorities are entitled to make an adjustment if a taxpayer fails to comply with the obligation to report arm's-length amounts in the income tax return.

Article 216 of the MITL specifies the following six transfer pricing methods:

1. Comparable uncontrolled price (CUP) method.
2. Resale price method (RPM).
3. Cost plus (CP) method.
4. Profit split method (PSM).
5. Residual profit split method (RPSM).
6. Transactional net margin method (TNMM).

Both traditional transactional methods (one through three) and profit-based methods (four through six) as described in the OECD Guidelines are acceptable in Mexico.

In 2007, the best method rule was included in the MITL and applies for all transactions between related parties. For this purpose, taxpayers are first required to consider the CUP method and may apply the other methods only if the CUP method is not appropriate. This effectively places the burden on the taxpayer to prove and document the reasons for not applying this method. The law also provides a second preference to apply the RPM and/or the CP methods, implicitly imposing the burden of documenting why these methods were not appropriate if a profit-based method is used. The law also clarifies that the RPM, CP and TNMM methods shall be considered as being met when it is established that both the revenue and costs are separately shown to be arm's length.

In this regard, the Supreme Court of Justice recently ruled that the best method rule does not infringe on a requirement in the law that such tax regulations should not create excessive retroactive burden given the laws and hierarchy of laws in place when the taxpayer carried out the transaction.

In addition to the obligation to pay income tax in accordance with the arm's-length principle, taxpayers have four important transfer pricing-related obligations: to prepare and maintain annual transfer pricing documentation; to file an information return on transactions with non-resident related parties with the timely filing of their income tax return for the previous fiscal year, as Appendix 9 of the DIM – multiple information return (information return); to meet special reporting requirements for the transfer of shares and quotas of Mexican companies between related parties; and starting in fiscal year 2009, taxpayers have to fill out three different questionnaires in the *dictamen fiscal*.

Dictamen fiscal

The following taxpayers must file a *dictamen fiscal*:

- Companies that obtained gross receipts in excess of MXN 34,803,950 during the prior fiscal year (approximately USD 2.9 million).
- Companies or groups of companies whose net worth (calculated pursuant to the Mexican Assets Tax Act) during the prior fiscal year exceeded MXN 69,607,920 (approximately USD 5.8 million).
- Companies with at least 300 employees in every month of the prior fiscal year (1 January – 31 December).
- PEs that fall in any of the above scenarios described under (1), (2) or (3).
- Companies involved in or arising from a corporate division or a merger during the year of the transaction and during the subsequent year.
- Entities authorised to receive deductible charitable contributions.
- Companies in the liquidation period if they had the obligation during the prior fiscal year.

Significant additional transfer pricing information is required to be disclosed by the independent accountant issuing the *dictamen fiscal*. These provisions are designed to require the CPA to take on more responsibility toward compliance with transfer pricing obligations to help the tax authorities identify potential transfer pricing contingencies.

This miscellaneous rule requires disclosure of the transfer pricing method in the *dictamen fiscal*, and the CPA must state whether the transaction was reflected on an arm's-length basis, whether a tax adjustment was made to comply with the arm's-length standard (specifying where it is recorded in the general ledger and in what part of the book tax reconciliation it is reflected), and a statement as to the tax year in which the transaction was registered as a cost, expense or income for accounting purposes. The miscellaneous rule also requires disclosure of the tax identification numbers of the individuals preparing or advising on the transfer pricing report for the applicable year (and incidentally the tax identification numbers of other tax advisors).

These rules require disclosure of information on advance pricing agreements, favourable resolutions issued by the tax authority on inter-company transactions, affirmation of the existence or not, of transfer pricing studies for both domestic and international transactions, and an affirmation of previous filing of informative return on foreign-related party transactions (Appendix 9 of the DIM).

Mexico

Specific questions must be answered regarding the deduction of pro rata expenses from abroad, management fees, back-to-back loans, derivative financial transactions, thin capitalisation, *maquiladoras* with bonded warehouses, the transfer pricing method applied for *maquiladoras* under Article 216-BIS of the Mexican income tax law and transfer pricing data relating to the flat tax law for *maquiladoras*.

The CPA is required to state whether the taxpayer owns or uses intangible assets and must specify the principal intangible assets it uses, grants or owns. The independent accountant must state whether all of the inter-company transactions have been reflected in the accounting records.

2010 Presidential Decree on *dictamen fiscal*

On 30 June 2010, the Mexican Tax Authority (MTA) announced a series of administrative measures through a Presidential Decree aimed at allowing the Mexican taxpayers to comply with their tax obligations with greater ease. Those rules are effective as of 1 July 2010 and the filing of the *dictamen fiscal* (statutory tax audit report) is now optional in most cases for future fiscal years (non-profit entities, public administration entities and companies involved in certain transactions [e.g. mergers and spin-offs] will still have to meet tax audit report requirements). In practice, all multinationals have opted to continue filing the *dictamen fiscal*. Nevertheless specific questionnaires, similar to the ones included in the *dictamen fiscal*, have to be completed when the *dictamen fiscal* is not presented.

With regard to the impact of the Presidential Decree on transfer pricing obligations, the optional post-filing certification does not release taxpayers from the obligation to prepare and maintain transfer pricing documentation, as this obligation is separately established under the MITL.

Information return

Article 86, Section XIII, establishes all corporations and individuals engaged in business activities are required to file an information return on transactions with non-resident related parties. This information return is due on the same day of the tax return filing date, within the three-month period following the end of the calendar year for corporations, and by the end of April for individuals. Taxpayers that file a *dictamen fiscal* may file their information return along with it (referred to as Appendix 9 of the *Declaración Informativa Múltiple* [DIM] for its acronym in Spanish).

Appendix 9 of the Information Return requires a confirmation of the existence of transfer pricing documentation for each inter-company transaction, the amount of the transaction, the type of transaction, the gross or operating margin obtained by the tested party for one of the transactions, the transfer pricing method used for each transaction, the taxpayer identification number of the related party, and the country of residence and address at the tax domicile of the related party.

Unlike the obligation to prepare transfer pricing documentation, all corporate taxpayers and individuals engaged in business activities must file this information return irrespective of the amount of gross receipts. *Maquiladora* (see *The maquiladora industry* [Other regulations] section) companies with a valid advance pricing agreement (APA) ruling from the TAS and those that comply with Article 216-BIS of the MITL are not obligated to comply with such filing but only for its *maquiladora* operations.

Failure to comply with this filing may result in fines and in the disallowance of the deduction of all payments made to non-resident related parties. Additionally, failure to file the information return must be disclosed in the *dictamen* fiscal. The fines range from MXN 54,410 to MXN 108,830 (approximately USD 4,185 to USD 8,372), and these penalties are in addition to those that could apply in case of a tax deficiency.

Because compliance is a requirement for the deduction of payments to non-residents and payments to resident-related parties are not subject to this requirement, it might be possible to argue that the disallowance of the deduction is inconsistent with the non-discrimination provisions of Mexico's tax treaties. (Mexico's tax treaties include a provision such as that in paragraph 4 of Article 24 of the OECD's Model Tax Convention on income and on capital). Nevertheless, it should be noted that the obligation to file remains in any case.

Both the *dictamen* fiscal and the information return are used by the TAS in identifying and scheduling transfer pricing audits.

Transfer of stock

Mexican law imposes income tax on income derived by non-residents on the sale of stock or quotas issued by Mexican resident companies. In this case, a special 'tax report' prepared by a Mexican independent public accountant must be filed certifying compliance with tax obligations on the share or quota transfer unless the transaction is exempt under a tax treaty. This obligation applies even if the transaction qualifies as a tax-deferred reorganisation under domestic law.

The special 'tax report' on the alienation of shares must include a report on the value of the shares, and the independent accountant must state which valuation methods were taken into account, and why. For example:

- Inflation-adjusted capital of the entity.
- Present value of future cash flows (income approach).
- The last quote in case of publicly traded stock.

In the first case, the information must include details on the amount of the historical capital and the corresponding adjustments. In the second case, the regulations under MITL require detailed information on the name or names of the methods used for the discounted value of the cash flows, discount rates, and the existence of residual values, the number of projected time periods and the economic sector of the company whose stock was alienated. In any case, the independent accountant is required to explain in the report the reasons for the selection of one of these three alternatives. Compliance with these provisions effectively requires a detailed appraisal of the company, and it should be noted that there is not a *de minimis* rule for small transactions or small companies. Moreover a detailed tax basis calculation must be determined and opined on.

Legal cases

As a result of several transfer pricing audits, a few petitions have been filed before the courts. The Federal Court of Administrative and Fiscal Justice (Tax Court) has recently ruled that the tax examiners outside the *Administración General de Grandes Contribuyentes* (General Administration of Large Taxpayers), the office in charge of the

Mexico

largest taxpayers of the country, are now entitled to make transfer pricing assessments. Please note that more court rulings are expected.

As mentioned before, the Supreme Court of Justice, on the basis of two separate interpretations of the law, recently ruled that the best method rule does not represent a retroactive burden versus prior laws affirming that the preferences listed for the transfer pricing methods contained in said article are legal and constitutionally valid, and that taxpayers must abide by it in when documenting their transfer prices.

Burden of proof

Assuming the taxpayer prepares and submits the transfer pricing study to the tax authorities upon request, in the case of a transfer pricing audit; taxpayers do not bear the burden of proof except in the case of transactions with tax havens. If the TAS determines an adjustment is in order, it is required to demonstrate that the taxpayer failed to comply with its obligation to report arm's-length amounts in the income tax return. It should be noted that any notice of deficiency must state the facts on which it is based and the applicable law, and must include an explanation of how the law was applied to the facts. Failure to comply with these requirements will result in an invalid notice of deficiency by the tax authorities.

In the context of litigation relating to a transfer pricing assessment when the taxpayer submitted the transfer pricing study during the tax audit, the tax authorities have the burden of proving that the taxpayer's transfer pricing study was incorrect. On the other hand, the burden is shifted to the taxpayer when no study is presented. As a general rule, an assessment not challenged within the 45 working-day period becomes final. Under the competent authority procedure there is an exception to this time limit (*see explanation below*).

Any transaction with an entity resident or located in a low-tax jurisdiction will automatically be presumed to be a transaction with a related party and will also be considered not to take place at arm's length. In these cases, the taxpayer has the burden of proof to demonstrate that the transaction was entered into with an unrelated party, or that the transaction was at an arm's-length price.

Tax audit procedures

There is no extensive history on tax audits prior to 1997 involving transfer pricing issues.

In this regard, it is important to mention that there have been a relatively important number of recent, specific transfer pricing audits aimed at specific industries including pharmaceutical, retail, tourism, automotive, and mining with relatively large settlements. The issues addressed in these audits are profit margins, portfolio sales to related parties, intermediate services, royalty payments, profitability of presumed PEs, deemed transfers of intangibles, tax-deductibility of guarantee fees and conventional payments, and government concessions. In recent times tax authorities are focusing restructurings, loan arrangements and on services provided by foreign-related parties.

We should note that attorney-client privilege does not exist in Mexico. Although professional service providers are required by law to maintain confidentiality with respect to client information, this duty to maintain confidentiality does not apply when the law (under statutory authority) imposes the obligation to produce a report. In

tax audits, the law states that the tax authorities may request all kinds of documents pertaining to the audit from the taxpayer or third parties (including lawyers and accountants). In these situations, the general obligation to maintain confidentiality is overridden by a request made by the tax authorities.

Documents prepared in anticipation of litigation are not protected, but taxpayers and their advisers may refuse to provide documents that are not relevant to the tax audit.

In theory, transfer pricing may be reviewed using regular procedures; under this scenario the tax authorities would initiate the informal procedure through a summons of the company's CPA, and if the information provided is not sufficient, they would be able to apply any verification procedure established by the Mexican Fiscal Code, including specific requests of information, on-site verifications, etc. The TAS has a specialised group, *Administración Central de Fiscalización de Precios de Transferencia* (General Administration of Large Taxpayers), that performs the transfer pricing examinations of large taxpayers, and the specific faculties for this team to review transfer pricing issues were published on 22 October 2007.

Moreover during an on-site examination, the taxpayer is under obligation to provide all the information that demonstrates compliance with tax obligations, including transfer pricing documentation. Failure to comply with a request might trigger the disallowance of deductions, the imposition of fines or, in more grave circumstances, the imprisonment of the representatives of the company. However, it should be noted that during an on-site examination, taxpayers are merely under obligation to allow the examination to take place and to provide the books and records. Taxpayers are not required to produce special reports for the tax authorities or to actively participate in the proceedings.

A taxpayer opposing a tax audit might be subject to a presumptive assessment or imputation of income and the value of its assets and activities. The tax authorities are also entitled to search the company's premises and seize the required information.

Outside the scope of the specific requests of information and the on-site tax audits, the tax authorities have broad power to obtain information from alternative sources, including through one of the most effective ones used in recent times, the exchange of information with countries with whom Mexico has signed tax treaties.

If a taxpayer does not comply with an information request during an audit, the TAS may impose fines that range from approximately MXN 12,240 (approximately USD 942) to MXN 36,720 (approximately USD 2,825) and take other measures to secure the information.

During the examination, the tax authorities may request information and must be allowed access to the accounting records of the company. All findings must be documented and witnessed in writing. In the course of the examination the audit cannot be completed without providing to the taxpayer a written statement of findings.

It is legally possible to obtain and use information from foreign authorities without the permission of the taxpayer.

In transfer pricing cases, a two-month period must be allowed between the last partial written record (*última acta parcial or oficio de observaciones*), which is the

Mexico

first document of the examination made available to the taxpayer, and the final determination. A one month extension is available upon request.

As a general rule, tax examinations must be completed within 12 months. This limit does not apply to certain audits, including transfer pricing cases, which have a two year rule. The statute of limitations on being able to make tax assessment is generally five years for all federal tax matters, including transfer pricing cases. The running of the period is suspended during an on-site audit (no suspension applies in the case of other types of examinations) or if the taxpayer files a petition before the courts.

Revised assessments and the appeals procedure

A transfer pricing adjustment may be appealed before the tax administration (*recurso de revocación*) or a lawsuit may be filed before the Tax Court. It is not necessary to use the appeals procedure within the administration before going to the Tax Court. In either case, the taxpayer has a 45 working day term to appeal the determination by the TAS.

In some cases, the administrative appeal is not filed it is considered the TAS will not change its determination. Nevertheless, regarding transfer pricing issues, we have observed that the administrative appeals process is a viable option which provides the taxpayer an additional opportunity to carry out further negotiations with the TAS; moreover, the taxpayer is not obligated to provide any kind of bond until the tax administration has reached a conclusion regarding the administrative appeal. This exception for payment of a bond also applies for competent authority procedures.

Please note that if the case goes directly to the Tax Court the taxpayer is required to provide a guarantee (bond, deposit, and/or mortgage) for the amount of the deficiency and an estimate of the additions to the tax of one year.

The Tax Court is an autonomous administrative court of original jurisdiction. It is divided into sections that hear cases within its territory. One of its divisions (*Sala Superior*) is higher within the hierarchy and is in charge of important cases, regardless of territorial considerations. In any case, the Tax Court can only decide whether a determination by the tax authorities was made according to the law; therefore, it cannot change the amount of the adjustment made by the tax authorities or determine that a third alternative must be followed. The Tax Court will only affirm or reverse the assessment made by the tax authorities. The federal courts (Court of Appeals) may review judgments made by the Tax Court. The federal courts are vested with the authority to review legal and constitutional issues.

Determinations made by the courts are not binding except for the parties involved in the litigation. A holding by a court of law may become mandatory precedent only under limited circumstances (involving a reiterated position of the court) and even in such cases, it is mandatory only for lower-tier courts and not for the TAS. Individual court determinations may be treated only as persuasive authority to those that were not involved in the case.

Within the Tax Court, there is no subject matter specialisation, and therefore, in principle, any division of the court may hear a transfer pricing case. Nevertheless, the *Sala Superior* may decide to hear any case involving an amount of at least MXN 100 million (approximately USD 7.69 million). It also has been pre-established that the

Sala Superior will hear any transfer pricing case where the statute is construed for the first time.

Limitation of double taxation and competent authority proceedings

Double taxation relief is granted by corresponding adjustments under tax treaties. Mexican law requires approval of the adjustment in order to allow the Mexican taxpayer to file an amended tax return. Should these conditions be met, a tax refund may be obtained. Under most tax treaties entered into by Mexico, the corresponding adjustment may be denied in case of fraud, gross negligence or wilful default. Mexico has not implemented this rule.

The corresponding adjustment for domestic transfer pricing cases is not regulated. This means that taxpayers may elect to report the adjustment through an amended tax return for the year in question. However, it should be noted that there are certain restrictions on the filing of amended tax returns; one of them is the requirement to file the competent authority procedure established in Article 217 of the Income Tax Law.

Most tax treaties entered into by Mexico contain time limits for notice of a competent authority procedure (e.g. 4.5 years with the United States), and a ten-year period for the implementation of any agreement is usually included. In all cases it will be important to take into consideration the specific time limit included in the applicable tax treaty.

As a final step in the dispute resolution process between competent authorities of tax treaty countries, there is a possibility of an arbitration procedure. Although this is not presently mandatory, it could be a valid resource that should be evaluated.

Resources available to tax authorities

The Mexican government also has implemented important institutional changes aimed to improve the efficiency of law enforcement. A specialised group performs transfer pricing audit examinations.

Taxpayers must submit significant information to the TAS in planning and conducting its examinations, including the information return on payments to non-residents, the information return on main suppliers and clients, and the information return on international transactions between related parties.

Mexico is actively exchanging tax information and best audit practices with its treaty partners, especially with the United States. The exchange of information may be automatic, upon specific request or spontaneous in nature.

Joint investigations

The TAS is vested with the authority to participate in simultaneous tax examinations with another country under the exchange of information provisions included in tax treaties.

Use and availability of comparable information

Comparable information is required to determine arm's-length prices and should be included in the taxpayer's transfer pricing documentation. However, there is frequently

Mexico

little reliable financial information publicly available on Mexican companies. Therefore, after receiving potential local comparables reliance is often placed on foreign comparables with a proper evaluation of market adjustments.

The tax authorities have the power to use confidential information of third parties. However, the taxpayer has limited access to this data through two designated representatives who must agree to be personally liable to criminal prosecution if the data is disclosed.

Anticipated developments in law and practice

In law

As part of the tax reform undertaken by the Mexican government, in 2007 the Ministry of Finance created a new tax regime defined as IETU for its acronym in Spanish. The tax could be considered as a flat tax or alternative minimum tax. The new flat tax law was effective since 1 January 2008, and replaced a prior asset tax law. Taxpayers will continue to be liable for regular income tax based on existing legislation and may also pay the supplemental flat tax. The flat tax is generally calculated by applying a 17.5% rate on cash basis taxable amounts, which consists of the difference between authorised cash payments and certain gross taxable income collected. This flat tax is due to the extent the computation exceeds the regular income tax calculation. An important rule disallows a flat tax deduction for royalties paid to related parties in determining taxable income for flat tax purposes. Moreover, all related and unrelated party interest income and interest expenses are ignored for flat tax purposes.

According to flat tax law, the payments effectively made for, among others, (1) the acquisition of goods (in lieu of cost of sales or depreciation), and (2) the receipt of independent services should be deductible for flat tax purposes to the extent they are related to the income-generating activity of the taxpayer. In this regard, taxpayers are required to comply with the deductibility requirements established in the income tax law in order to deduct those payments for flat tax purposes.

From a transfer pricing perspective the Mexican companies that carry out transactions with related parties resident in Mexico or abroad must comply with the same transfer pricing regulations established in the current income tax law, including the arm's-length standard and the documentation requirements.

In practice

During recent years the International Tax Division and the Transfer Pricing Central Administration established important audit programmes to address mainly the following tax issues: (a) intangible assets migration derived from corporate restructurings, (b) profitability of presumed PEs, (c) inter-company debt arrangements, and (d) cross-border services that have been deducted as management fees or other services, including issues concerning pro rata charges, proving services among others. These kinds of audit programmes are likely to increase. Some of the issues that will probably be included in the new programmes contemplate fees for technical services, commission payments and royalty payments. Controversial issues probably will include the use of multi-year averages for the tested party, the use of secret comparables and the protection of confidential information during court proceedings.

General transfer pricing concerns

Some taxpayers document their related party transactions through the development of an aggregate profitability analysis (e.g. the U.S. comparable profits method) while the TAS expects a transactional profitability analysis when using the transactional net margin method (TNMM) operating profit analysis. Also, the lack of comparability in economic analyses and use of inappropriate profit level indicators (ROCE, Berry ratio, MOTC, etc.) are issues that TAS has disputed in its reviews.

The TAS is also challenging about the taxpayer's failure to use internal comparables (e.g. CUP method) with appropriate adjustments, and the selection procedures used to accept or reject independent comparable companies, as in some cases the search cannot be replicated by TAS.

Specific transfer pricing topics

In the area of interest expense, the TAS is concerned about the lack of non-tax business reasons to enter into a loan. There is also concern that the loan may not be based on reasonable cash flow expectations of the borrowing company and the TAS may seek to verify whether credit terms are comparable to those that would be agreed upon with or between independent third parties in a comparable transaction.

In terms of royalties, there is concern that there are companies paying royalties for intangible assets that are not used and do not generate a profit for the Mexican taxpayer. The TAS maintains that royalty payment must be consistent with the operation of the company and should be proportionate to (or commensurate with) the profit margin earned by the company and must be agreed based upon the arm's-length principle.

In terms of inter-company service charges involving allocations (e.g. management fees, IT support) there is a concern that these fees typically use a mechanical or arbitrary calculation for the charge, as well as not meeting strictly indispensable standards for business expenses. Pro rata allocations are considered non-deductible in Mexico, and there is a concern that the services are not being provided and that a benefit is not being received. Moreover, there is close scrutiny to ascertain that there is no duplication of expenses and that stewardship expenses are not being passed down to the Mexican subsidiary.

In terms of local inter-company transactions, there is concern that not all companies are documenting the arm's-length nature of the transactions in a transfer pricing study. These transactions are being scrutinised.

In terms of reorganisations, the business reasons, exit taxes, disruption or cancellation payments, permanent establishment and foreign trade issues, among others, are being closely reviewed.

Additional tax and penalties

Several consequences follow a transfer pricing adjustment. At the outset, an adjustment is made by making an assessment of the gross receipts and deductions that would have arisen in uncontrolled transactions. In cases where two or more comparables are found, a range will be used. The range must be adjusted using statistical methods, and the adjustment is made to the median of such a range. It should be noted that an adjustment by the tax authorities is possible only if the prices

Mexico

used by the taxpayer or the margin in the controlled transaction are outside such a range.

As a consequence of the assessment, many tax attributes might need to be adjusted. For instance, if the adjustment turns losses into profits, the amount of net operating losses will decrease, and if the price of an inter-company transfer of a fixed asset changes, the depreciable basis in such property will change. Also, the foreign tax credit limitation may increase if the taxable income increases as a consequence of an adjustment to an international operation, and the amount of the net after tax earnings account (or CUFIN for its acronym in Spanish) will increase as a consequence of any increase to the taxable income. Withholding taxes and estimated payments also might require an adjustment.

Constructive dividends may be subject to a corporate level tax triggered in case the distribution does not arise from the CUFIN. The tax is calculated by applying the corporate tax rate to the amount of the transfer pricing adjustment grossed up by 1.3889 from 2007 to 2009 and 1.4286 from 2010 to 2012.

In addition to the aforementioned changes, the amount of the adjustment to the taxable income is itself often treated as a constructive dividend. Moreover these may be an impact on value-added tax customs duties.

There are no separate penalties applicable to transfer pricing tax adjustments. Instead, the regular penalties for failure to pay are regularly imposed. These penalties range from 55%-75% of the inflation-adjusted amount of the assessment. The penalty is reduced to 50% if the payment is made during the audit and prior to the notice of deficiency. Where the amount of a loss is reduced, the penalty ranges from 30%-40% on the difference between the reported and the actual loss, to the extent a portion of any portion of the misstated loss is utilised. Besides the penalties and the inflation adjustment, late payment interest (termed surcharges) also is imposed.

A 50% reduction in penalties is applicable if a Mexican taxpayer meets the contemporaneous transfer pricing documentation requirement. There are no rules designed to determine the degree of compliance with the documentation requirements.

Other regulations

In general

The statutory rules have not been extensively regulated. Some rules deal with technical issues such as the documentation that must be attached to an application for an APA. These requirements are discussed in detail in the APA section, below.

The regulations under the MITL require the use of the interquartile range for the resale minus, cost plus and TNMM methods, and state that inter-company transactions will be deemed to be in compliance with the arm's-length standard if they are within that range, but if the taxpayer's price, amount of compensation or profit margin is out of the interquartile range, the median of said range shall be deemed the price or amount of compensation that would have been used by independent parties.

These regulations require the use of a specific point within the range if the available information allows a more specific determination. According to the regulations,

other statistical methodologies may be used under competent authority or if they are authorised under general rules issued by the TAS.

The maquiladora industry

Maquiladoras are mainly companies that assemble or manufacture using temporarily imported raw materials and components on consignment for subsequent export. Typically, a *maquiladora* uses machinery and equipment consigned by the non-resident using its services. The term *maquiladora* originally referred to a particular customs regime facilitating temporary imports and reducing costs for such imports such as customs fees, value-added taxes, etc. However, this customs regime was combined with another similar regime (PITEX) in 2006, and the new scheme applicable to both is now termed the IMMEX programme.

Maquiladora models according to the Article 3 of the IMMEX decree are classified as follows:

- Controlled group: holding company and one or more subsidiaries.
- Industrial companies which have an industrial process of transforming goods for export.
- Services: companies that provide services related to the export or consulting services.
- Shelter: foreign companies provide technology and raw materials without operating them.
- Outsourcing: Performs contract or toll manufacturing operations through third parties registered in the IMMEX programme.

The *maquiladora* regime has helped Mexico become a strategic destination for investors, and has contributed to Mexico's strong position when compared to other low-cost labour territories.

Prior to 1995, *maquiladoras* were regarded as cost centres and were not required to report significant profits. However, since 1995 the government has required *maquiladoras* either to report arm's-length profits or to meet a safe harbour. These alternatives were regulated by administrative rules subject to annual renewal.

Failure to comply could result in a transfer pricing adjustment and the application of PE rules to the non-resident principal providing detailed instructions to, and exercising general control of, the *maquiladora*.

The tax reform in 2003 brought significant changes to the special transfer pricing rules for *maquiladoras*. Transfer pricing options for *maquiladora* companies are now provided in Article 216-BIS of the MITL.

The MITL establishes that foreign companies operating through a *maquiladora* will not be deemed as having a PE in Mexico, provided that they are residents of a country that has a tax treaty in place with Mexico, that all the terms and requirements of the treaty are satisfied and, eventually, that the mutual agreements that Mexico and its applicable treaty partner may have are observed. This provision applies only if *maquiladoras* comply with any of the following options:

- Prepares and maintains transfer pricing documentation determining an arm's-length level of profitability for the *maquiladora*, and adding to the result of this

Mexico

analysis 1% on the net book value of the machinery and equipment (M&E) owned by the foreign-related company that is used by the *maquiladora* in its activities.

- Reports taxable income of at least the higher of the following values (safe harbour):
 - 6.9% of assets used in the *maquiladora* activity (including the inventories and fixed assets owned by the foreign-related party). Such value must be determined under the principles of the old Asset Tax Act, which requires inflation adjustments and takes into account the statutory depreciation rates. All the assets used in the *maquiladora* operation during the fiscal year must be taken into account for the calculation. The only assets that may be excluded from the calculation are those leased at arm's length to the *maquiladora* by a Mexican resident or a non-resident related party, except if they were previously owned by the *maquiladora*. Property leased at arm's length from related parties that used to be property of the *maquiladora* may be excluded only if the *maquiladora* disposed of the property at an arm's-length price. The value of assets used for *maquila* and non-*maquila* operations may be taken into account rateably only with an authorisation from the TAS; or
 - 6.5% on operating costs and expenses of the *maquiladora*. The costs must be determined under Mexico's generally accepted accounting principles except for the following items:
 - a. The total amount of purchases is used instead of the cost of goods sold.
 - b. Tax depreciation is used instead of accounting depreciation.
 - c. Extraordinary or non-recurring expenses (under Mexico's generally accepted accounting principles).
 - d. Inflation adjustments.
 - e. Financial charges.Both calculations are subject to a number of exemptions and special rules. The result of those special rules might differ significantly from the numbers in the books of the company.
- Prepares and maintains transfer pricing documentation considering a return on the net book value of M&E owned by the foreign-related company that is used by the *maquiladora* in its activities. In this case the corresponding return must be adjusted to recognise that the financial activities (and associated risks) for the procurement of such M&E are not carried out by the *maquiladora*.

As of 2003, APAs for *maquiladoras* are elective and the APA also provides PE insulation upon approval.

Additionally, on 30 October 2003, a Presidential Decree was published in the Mexican Official Gazette, by which various benefits for taxpayers are provided. Specifically, Articles 10th, 11th and Fourth Transitory provide important tax benefits applicable for the *maquiladora* industry with the main purpose of promoting its competitiveness.

The decree establishes that *maquiladora* companies are entitled to apply a partial income tax exemption. Such exemption will be calculated based on the difference in income tax resulting from the application of the percentages established in Section II of Article 216-BIS of the MITL (the higher between the 6.9% on assets and 6.5% on operating costs and expenses, 'safe harbour'), and 3% on the corresponding assets or costs. For purposes of calculating the aforementioned benefit, *maquiladora* entities may exclude the value of inventories used in their manufacturing operations. This benefit would be applicable for all *maquiladoras* as long as they are in compliance with the rest of the requirements established under Article 216-BIS.

The new Mexican flat tax (referred to as the IETU for its acronym in Spanish), which was enacted on 1 October 2007, and which became effective on 1 January 2008, has triggered concern in the marketplace due to its anticipated impact on Mexican business. In an effort to address some of these concerns, the Mexican Executive Branch issued a decree on 5 November 2007, (effective 1 January 2008). The decree grants relief to specific categories of taxpayers, such as those that operate in the *maquiladora* industry.

The decree provides that the *maquiladoras* will be entitled to an additional credit against the IETU which, in principle, should generally yield an effective tax rate of 17.5% (16.5% in 2008 and 17% in 2009) on the taxable income as determined under any of the existing transfer pricing methodologies of the MITL relative to *maquiladoras*.

Taxpayers desiring to use the cost plus self-assessment option to determine the taxable income floor for purposes of arriving at the credit would need to adjust the return on foreign-owned assets to 1.5% in order to compute this credit under this option. This *maquiladora* tax credit will be available from 2008 to 2013.

Advance pricing agreements

APAs have been included in the law as a legal possibility since 1997. They are issued as unilateral 'rulings' under domestic law or as bilateral determinations under the competent authority procedure. APAs approve a methodology and not a specific result. Pre-filing meetings on a no-name basis are possible.

As of 2012, APAs covered up to five fiscal years: the current fiscal year, the three subsequent fiscal years and a one-year roll-back.

Bilateral APAs are also possible with treaty country residents under the competent authority procedure, and in these cases tax authorities are entitled to waive late payment interest. Bilateral APAs may be issued for more than five years because they are not subject to the limitations described above. Unlike rulings on international tax issues, the TAS is not required to publish APAs.

The law provides that APAs should be resolved in a maximum period of eight months. In practice, most APAs take longer.

The office in charge of APAs is the *Administración Central de Auditoría de Precios de Transferencia*. This is the same office that performs international examinations.

As anticipated above, under general rules issued by the TAS, the information and documentation requirements for an APA application are substantial:

- Power of Attorney of the legal representative.
- Name of the company, tax domicile, tax identification number and country of residence of the taxpayer, and the person or persons with equity interest in the taxpayer.
- Certified copy of the corporate book of the taxpayer where the shareholders are registered.
- The names of the related parties in Mexico or elsewhere that have a contractual or business relationship with the taxpayer.

Mexico

- A description of the principal activities, including the place where the activities are undertaken, describing the transactions between the taxpayer and its related parties.
- Organisational chart of the group; must include shareholding percentages.
- Balance and income statement as well as a breakdown of costs and expenses incurred by the taxpayer for the three prior years to the period to be covered by the APA; or if taxpayer is under the obligation to file a *dictamen fiscal*, the audited financial statement with the report issued by the registered CPA.
- Tax returns of the taxpayer, including amended returns for the past three years.
- Copy in Spanish of all the contracts and agreements between the taxpayer and its related parties (resident and non-resident related parties).
- Beginning and closing date of the fiscal years of the related non-resident entities with which a contractual or business relationship exists, or the indication that they use a calendar year.
- Currency used in the main transactions.
- The transactions to be covered by the APA.
- Detailed description of activities undertaken by the company and its related parties with which it has a contractual or business relationship, including a description of the assets and risks assumed by such person.
- The method or methods proposed to determine the price or amount of consideration in transactions undertaken with related residents and non-residents, including criteria and other elements for considering that the method applies to the mentioned transaction or company.
- Information on comparable transactions or companies, the adjustments made to the comparables and the explanation of rejected comparables and adjustments.
- Financial and tax information corresponding to the fiscal years for which the ruling is requested, applying the method or methods proposed. (This requirement is basically a forecast of the financial statements and tax returns).
- A disclosure stating whether the non-resident related parties are involved in a transfer pricing examination elsewhere. (It is also necessary to disclose whether the taxpayer's related parties have filed a legal remedy regarding a transfer pricing case, or if they have been involved in transfer pricing litigation. In case there is a final determination, the main points of the holding must be explained).

The fee for an APA is MXN 11,238 (approximately USD 864). Once the APA is issued, an annual report must be filed with the TAS. The fee for the APA's annual review is MXN 2,247 (approximately USD 173). Should the critical assumptions change, the APA may be ended.

Recently, a number of important tax rulings have been conditioned to an APA.

OECD issues

Mexico is a member of the OECD and has accepted the revised recommendation of the council on the determination of transfer pricing between associated enterprises. In general, the Mexican transfer pricing rules are consistent with OECD Guidelines.

Under a reservation made on Article 9 of the Model Tax Convention on Income and Capital, Mexico reserves the right not to insert paragraph two (corresponding adjustment) in its tax conventions. However, most Mexican tax treaties provide for a corresponding adjustment if the adjustment made by the other state is arm's length.

As from January 2002, the OECD Guidelines are a mandatory interpretative source of the transfer pricing provisions of the Income Tax Act to the extent they are consistent with the MITL and tax treaties.

New OECD Guidelines

The OECD recently approved the 2010 version of its OECD Guidelines. Under the latest version of the OECD Guidelines, taxpayers in Mexico should expect to see increased challenges by the tax authorities with regard to the comparability of data used to support the transfer pricing analysis. The impact of the changes is also likely to be felt in the planning and implementation of transfer pricing policies.

In addition, a nine-step process has been added to the OECD Guidelines which will need to be followed by taxpayers. In practice, taxpayers will need to have a process that is reliable and transparent, i.e. one that the MTA can examine, follow and test when necessary. Consequently, the OECD Guidelines may have an important impact on documentation for some companies in Mexico.

Finally, the tax authorities are adhering closely to the restructuring provisions in audit disputes.

Liaison with customs authorities

The TAS is in charge of the enforcement of both tax and customs law. General tax examinations undertaken by the TAS include all federal taxes including income tax, value added tax, assets tax and customs duties. Therefore, values used for the purposes of payment of customs duties and other customs information are available for tax purposes. Similarly, any information submitted for tax purposes is also available for customs purposes. During an on-site audit all aspects of taxation are usually reviewed by the same team (including customs duties).

Thin capitalisation

As of 1 January 2005, Section XXVI is incorporated to Article 32 of the MITL, which establishes the procedure to be followed in determining the interest portion corresponding to loans that shall not be deductible.

In 2007, thin capitalisation rules were modified. For purposes of determining the annual average liabilities, all liabilities are now considered. The new rules clarify that the disallowance applies only to interest on debts with related parties resident abroad. The definition of related parties stated in Article 215 of the MITL is applicable. Moreover, the taxpayer can compare the liabilities multiplied by three, to either the (1) equity (following Mexican generally accepted accounting principles), or (2) the sum of the tax basis equity accounts (Account of Contributed Capital or CUCA for its acronym in Spanish, plus the CUFIN balances).

When the debt of Mexican taxpayers exceeds three times its shareholder's equity, the interest generated by excess debt will not be deductible. In calculating the debt-to-equity ratio mentioned above, the amount of the related and unrelated party loans contracted by the company must be considered, with the exception of certain mortgages.

The thin capitalisation rules are not applicable to companies belonging to the financial sector, which comply with the capitalisation rules pertaining to their sector.

Mexico

Furthermore, Mexican entities that have an excessive debt-to-equity ratio due to loans with related parties can apply for an APA ruling from the TAS on the arm's-length nature of the loan in order to maintain the excessive ratio. An authorisation is also possible for excesses attributable to unrelated party loans, if the arm's-length nature of the taxpayer's operations with its related parties is also reviewed by the tax authorities.

These formalities to have the non-deductible excess interest waived will require the certification of an independent accountant.

52.

Moldova

Introduction

The arm's-length principle has been set forth in Moldovan tax law since 1998. Transfer pricing regulations, however, are currently at an initial development stage.

According to the 2013 – 2015 Medium Term Tax Policy of the Moldovan Government, formal transfer pricing documentation requirements are expected to be introduced in the Moldovan tax law starting from 2014.

Statutory rules

As a general rule, under Moldovan tax provisions, transactions concluded between related persons are taken into consideration only if the interdependence of these persons does not influence the outcome of the transaction. The arm's-length principle applies to transactions with both resident and non-resident related parties.

With reference to the transactions carried out by Moldovan companies with related parties, Moldovan tax law provides the following specific provisions:

- No deduction is allowed for losses incurred on the sale or exchange of property, performance of work or supply of services between related parties, carried out either directly or through intermediaries (regardless of whether the transaction price corresponds to the market value).
- No deduction is allowed for expenses incurred in relation to related parties if they do not correspond to the justified market price and do not represent necessary and ordinary business expenses.

Besides transactions with related parties, taxpayers have to follow the market value for the following operations performed with third parties in non-monetary form:

- Alienation of capital assets.
- Granting donations.
- Non-qualified reorganisation of the company.
- Distribution of company profits.

Definition of related parties

In accordance with Moldovan tax law, a company is considered the taxpayer's related party if one of the following conditions exists:

- The company controls the taxpayer.
- The company is controlled by the taxpayer.
- Both the company and the taxpayer are under common control of a third party.

Moldova

From a tax perspective, control is the ownership (either directly or through one or more related persons) of 50% or more in value of the capital or voting power of one of the companies. For this purpose, an individual will be treated as owning all equity interest that is owned directly or indirectly by members of his or her family.

Two individuals are related parties if they are spouses or relatives up to the fourth degree.

Transfer pricing methods

Moldovan tax law does not list any specific transfer pricing methods.

Legal cases

We are aware of a legal case brought in front of the Supreme Court of Justice, when Moldovan Tax Authorities (MTA) challenged the deductibility of expenses by claiming a violation of the arm's-length principle. In this specific case, MTA performed a TP adjustment by applying the comparable uncontrolled price method. However, the taxpayer argued that he was not a related party to the service provider during the period when the service agreement was valid. The Court held the taxpayer's position and the taxpayer was allowed to deduct the respective services expenses.

Burden of proof

Currently, Moldova has no formal transfer pricing documentation requirements. Nevertheless, domestic tax law provides that taxpayers have the burden of proof over the arm's-length value of transactions with related parties.

Tax audit procedures

Transfer pricing audits are expected to follow the general procedure applicable to tax audits.

Taxpayer liabilities can be subject to a tax inspection only within the statute of limitation period – four years from the last date established for the submission of the corporate income tax (CIT) return.

However, no tax inspection can be performed on the accuracy of calculation and payment of CIT liabilities for fiscal periods up to 1 January 2007, except for cases where voluntary requests are made by the taxpayer (e.g. for refund purposes).

Under the Moldovan tax law, the Moldovan tax authorities (MTA) can perform scheduled inspections only once a calendar year for the same taxes and duties which refer to the same fiscal periods.

Legal entities must be notified of the inspection in writing at least three working days before the scheduled inspection. The duration of a tax inspection cannot exceed two calendar months. In exceptional cases, MTA's management can decide to extend the period by no more than three calendar months or to stop the inspection.

The results of the tax inspection are recorded in the minutes of the tax inspection. Based on these minutes, MTA issue a decision on the specific case, which can be appealed according to the procedure described below.

Revised assessments and the appeals procedure

If the MTA determines that the taxable income declared in the CIT return is underreported, it may assess additional fines.

Decisions issued by MTA, as well as actions performed by its officials, can be appealed by taxpayers via the submission of a preliminary petition within 30 days.

Preliminary petitions are examined within 30 days of being submitted and decisions issued thereof can be contested at the Main State Inspectorate of the Ministry of Finance or appealed in the competent court of law within 30 days. No state duties are paid for appeals against MTA decisions.

Additional tax and penalties

Starting with 2012, the 0% CIT rate was replaced with a 12% rate.

Current tax law does not provide for any specific fines for the violation of transfer pricing regulations. However, failure to comply with transfer pricing rules may result in underreporting of CIT liabilities, which consequently triggers a fine of 30% (100% for tax evasion) of the diminished CIT liabilities.

Use and availability of comparable information

Under Moldovan law, the primary sources of information on market prices are public and statistics authorities and bodies regulating price formation.

If information from these sources is not available, the alternative sources include:

- Information on market prices published or made public through the mass-media.
- Official data or data made public on quotations (transactions registered) set at the nearest stock exchange to the seller's (purchaser's) headquarters. When no transactions have been registered at this stock exchange or the sales (purchases) took place at a different stock exchange, the information on quotations set at the last stock exchange should be used, as well as information on quotations set for state securities and state bonds.

In addition, according to the tax law:

- taxpayers also have the right to present data on market prices from other sources to the MTA, and
- the MTA have the right to use such information only if there are reasons to consider it trustworthy.

Risk transactions or industries

No specific industry or transactions are considered to have a higher level of risk than any other. Nevertheless, MTA tend to investigate the deductibility of the expenses related to consultancy services rendered by non-resident related parties. Therefore, sufficient back-up documentation should be made available to confirm that the services were actually rendered for the benefit of the local entity.

Moldova

Limitation of double taxation and competent authority proceedings

The avoidance of double taxation principle is not mentioned under the Moldovan tax law.

Nevertheless, taxpayers might benefit from more favourable tax regimes which are provided in the double tax treaties (DTTs) concluded by Moldova with other countries. As of 1 January 2012, Moldova has 45 DTTs in force, which are based on the Organisation for Economic Co-operations and Development (OECD) Model Tax Convention on Income and on Capital.

The 'Associated Enterprises' article of the DTTs allows MTA to adjust taxpayer's taxable income if the transaction with its related party was not at arm's-length value.

Note that the Commentaries to the OECD Model Tax Convention on Income and on Capital should be used by the MTA and taxpayers as a guidance on the interpretation of DTTs and, correspondingly, also for the purposes of the tax administration.

Advance pricing agreements (APA)

No APA or binding tax rulings are provided under the 2012 Moldovan tax law.

Liaison with customs authorities

To date, the Moldovan tax and customs authorities do not cooperate jointly on transfer-pricing-related issues.

The majority of customs value investigations to date were related to the adjustment of the customs value according to Article 8 of the WTO Customs Valuation Agreement, as well as to the adjustment of the transaction values according to the reference prices registered for goods traded under commercial relations between contracting parties in foreign trade and for identical and/or similar goods, which have been previously valued.

Adjustments of customs values with royalties, licence fees and transport expenses were among the most often performed by Moldovan customs authorities, so far.

However, subject to the implementation in Moldova of more rigorous transfer pricing regulations, we expect that eventual further transfer pricing adjustments could lead to investigations and adjustments in customs as a result of the exchange of information between tax and customs authorities or as a result of their reflection in the business transactions.

OECD issues

Moldova is currently not an OECD member country and the domestic law does not provide for any reference to the possibility of applying the OECD Transfer Pricing Guidelines.

Joint investigations

Based on the information available, no records indicate that MTA has been involved in joint investigations on transfer pricing issues.

Thin capitalisation

According to Moldovan tax law, there are no thin capitalisation rules (i.e. debt-to-equity ratios).

Nevertheless, interest expenses incurred by the taxpayer for the benefit of individuals and legal entities (except financial institutions, micro-financing organisations and leasing companies) are deductible within the limit of the weighted average interest rate applied for loans granted by the banking sector to legal entities for a period of up to 12 months and over 12 months, in the section of MDL and foreign currency (values are set by the National Bank of Moldova and published on its official website). The exceeding amount of interest expense should be treated as CIT non-deductible, regardless of whether it is paid to a related party or not.

53.

The Netherlands

Introduction

Transfer pricing legislation has existed in the Netherlands since 1 January 2002. In addition to providing specific transfer pricing rules, the implementation of transfer pricing documentation requirements was meant to shift the burden of proof from the Dutch tax authorities to the taxpayer. This legislation is based largely on the Organisation for Economic Co-operation and Development (OECD) Guidelines, with some modifications to reflect Dutch business practices. In the past, transfer pricing disputes have usually been dealt with informally and resolved by negotiation between the tax authorities and the taxpayer. Consequently, there is at the moment little relevant case law. Multinational enterprises (MNEs) are experiencing an increase in the number of transfer pricing queries, which will force those companies to focus more on transfer pricing.

Statutory rules

Since 1 January 2002, specific transfer pricing provisions have been included in Article 8b of the Dutch Corporate Income Tax Act. This article is largely drafted in accordance with Article 9 of the OECD's Model Tax Convention.

The basic features of the transfer pricing legislation are as follows:

- Codification of the arm's-length principle.
- A widening of the scope of the transfer pricing legislation through a broader concept of 'control' between affiliated businesses that are directly or indirectly participating in the capital, management or supervision of another company, as long as there is sufficient influence on the prices charged between the companies involved. The level of control and influence is not quantified in the law. This legislation applies to transactions where one party controls the other or both parties are under common control.
- A requirement to maintain data in the administration that demonstrates the arm's-length nature of the transfer prices and how these prices have been derived.
- A strict interpretation of the documentation requirements implies that taxpayers should prepare the relevant documentary evidence when the intragroup transactions take place. Although this is a prudent approach, the tax authorities effectively allow taxpayers four weeks to respond to any request to provide transfer pricing documentation, or three months where particularly complex transactions are involved.

Where there is an understatement of the taxable income reported by a Dutch group company because of non-arm's-length related party transactions, the tax authorities make an upward adjustment to the taxable income of that company. Under certain conditions, the understatement may also be treated as a hidden dividend distribution,

attracting the appropriate withholding tax. Any surplus profit reported by a Dutch group company because of non-arm's-length related party transactions may be treated as an informal capital contribution by the parent company. The Dutch group company can claim a notional deduction for the amount of the informal capital contribution for Dutch corporate income tax purposes.

Innovation Box

The Innovation Box is a Dutch corporate tax facility that allows Dutch taxpayers to benefit from a favourable effective tax rate with respect to income derived from qualifying intellectual property (IP). Both resident and non-resident taxpayers can benefit from this facility. The effective tax rate in the Innovation Box is 5%.

The key benefits of the Innovation Box regime are as follows:

- Income from (non-trademark) intangibles will be taxed at an effective corporate income tax rate of 5%.
- No limit to attribute income to intangibles under the Innovation Box.
- Innovation losses are deductible against the normal corporate income tax rate.
- The scope is broad; it is not linked only to (legally) patented intangibles. It provides opportunities for software companies and similar type of companies.
- To a certain extent the development of intangibles can take place outside the Netherlands.
- The Dutch tax authorities are eager to discuss cases where the Innovation Box can be applied.

For IP to qualify for the Innovation Box, it needs to meet the following cumulative conditions:

- IP developing test:
 - The Dutch entity legally owns patents, or
 - The Dutch entity has obtained research and development (R&D) declarations.
- IP economic ownership test:
 - The IP should be economically owned by the Dutch entity.
- New IP:
 - The Innovation Box is available for newly developed IP. For existing IP which is subject to continual improvements by further R&D, the Innovation Box can be gradually implemented.

Other regulations

Other regulations have been issued to cover certain specific circumstances. Those that concern transfer pricing issues are detailed below.

Decrees and resolutions

The decrees and resolutions issued by the Ministry of Finance give guidance on the interpretation and application of Dutch tax law in certain specific situations. They are intended to ensure a consistent application of the tax laws, and, consequently, the tax authorities are bound by them. A taxpayer, however, has the right to appeal to the courts on any provision in the decrees or resolutions.

Details of the relevant decrees are set out below.

The Netherlands

Transfer pricing decree (IFZ2001/295)

This decree of 30 March 2001 on 'Transfer prices, the application of the arm's-length principle and the OECD Guidelines provides guidance on the Dutch tax authorities' interpretation of the OECD Guidelines and clarifies how certain issues should be approached in practice.

The issues dealt with in this decree include the following:

- Application of the arm's-length principle in practice: The taxpayer should demonstrate that its transfer prices meet the arm's-length standard.
- Application of various transfer pricing methods: Particular attention is given to the cost plus method and the practical implications.
- Administrative approach for avoiding and resolving disputes about transfer pricing: Insight is given to the policies and procedures applied by the Dutch government in relation to mutual agreement and arbitration procedures.
- Arm's-length fee for financial services.
- Allocation of profit to headquarters and permanent establishments (PEs): The arm's-length principle is also applicable in determining the tax base of foreign taxpayers.

Amendments to the transfer pricing decree (IFZ2004/680M)

This decree of 21 August 2004 is intended as a clarification of the 30 March 2001 decree with respect to the following subjects:

Intercompany services/head office expenses

Some clarification is given on the activities that are considered shareholder activities. In addition, the decree provides guidance on the determination of an arm's-length fee for services. It allows a fee based on cost for support services that meet certain criteria, thus providing a practical approach for common, low value-added services.

Contract R&D

In the decree of March 2001, the tax authorities explicitly referred to performing contract R&D from a Dutch tax perspective. In addition, a guideline now defines the manner in which these activities should be remunerated. The decree indicates that if ultimate decision making related to the R&D, the costs and risks of these activities, and the economic ownership of the developed assets lie with the principal, then the cost plus method is an appropriate method for remunerating the contract R&D activities.

Cost contribution arrangements

To end further discussions as to whether the cost contribution paragraph in the March 2001 decree was completely in accordance with the arm's-length principle, this paragraph has been revoked, and it is explicitly stated in the amendments that the OECD Guidelines apply.

Valuation of intangible assets

According to the Ministry of Finance, there are circumstances under which non-related parties would not agree on a fixed price for a transfer of an intangible asset but would include a price adjustment clause indicating, for example, that the price of the intangible asset depends on future income. In the August 2004 decree, it is stated that an agreement on the transfer of an intangible asset is assumed to include a price adjustment clause, if such a clause would have been agreed on between independent parties operating under similar conditions.

Withholding taxes

The decree recognises that some countries levy withholding taxes on service fees, even if this is not allowed under the tax treaty between that country and the Netherlands. This is especially true for mixed contracts (i.e. contracts consisting of a service and a royalty component). For payments under these contracts, withholding tax might be levied on the entire fee, even though only withholding tax on the royalty component is allowed under the tax treaty. The decree states that withholding taxes cannot be credited against Dutch corporate income tax if these taxes conflict with the applicable treaty clause.

Advance pricing agreement (APA) decree (IFZ2004/124M)

On 11 August 2004, the Ministry of Finance published a decree (this decree is an update of the original decree IFZ2001/292M) titled 'Procedure for dealing with requests for upfront certainty on transfer prices to be used in cross-border transactions (advance pricing agreements)'. The decree provides guidance on how the OECD Guidelines on APAs are applied in the Dutch practice.

Details about the procedures to be followed and the information given in an APA request are provided in the APA section, below.

Decrees on financing companies (IFZ2004/126M and IFZ2004/127M)

The regime for Dutch finance companies is applicable to back-to-back intercompany loans and intercompany licensing transactions.

Under this regime, a Dutch finance or licence company must meet the following requirements:

- The company must incur economic risk.
- The company must have sufficient operational substance.

These requirements are further elaborated in two decrees published by the Ministry of Finance in 2004. The first decree, issued on 11 August 2004 (IFZ2004/126M), focuses on companies involved in intercompany finance activities, and is an update of the original decree of 30 March 2001 (IFZ2001/294 M) on this subject. The second decree, also issued on 11 August 2004 (IFZ2004/127M), contains questions and answers on the decree's application.

The importance of the regime lies in what happens if the requirements are not met. In such a case, interest and/or royalties paid and received are not included in the Dutch tax base. In addition, the Dutch tax authorities may spontaneously exchange information with local tax authorities of the countries to which the loan/licence is granted. This will likely result in an increase of withholding tax on these payments, which can subsequently not be offset in the Netherlands, as the interest and royalty are not included in the Dutch tax base.

In addition to the specific requirements for Dutch finance companies, the decrees also set out how the compensation for back-to-back intercompany loans and intercompany licensing transactions need to be established and documented. This needs to be done on a case-by-case basis and the compensation typically needs to consist of a handling fee component and a risk premium.

The Netherlands

It is also possible to obtain a unilateral APA in the Netherlands in which the Dutch tax authorities confirm (i) that the requirements are met, and (ii) that the remuneration applied (a spread determined on a case-by-case basis) is at arm's-length. Depending on the structure, this can be a fairly straightforward process.

Decree on mutual agreement procedures (MAP) and EU Arbitration Convention (IFZ2008/248M)

The decree seeks to give guidance for taxpayers and improve the efficiency of the process for resolving disputes, and it relates both to MAPs initiated under double tax treaties and the arbitration convention for transfer pricing disputes within the European Union (EU).

Decree on attribution of profits to permanent establishments (IFZ2010/457M)

On 15 January 2011, the Dutch State Secretary of Finance issued a decree on how the Dutch tax authorities apply the OECD publications on the attribution of profits to PEs. The Dutch approach for the attribution of profits to a PE generally follows the OECD recommendations: the PE should be seen as a legally distinct and separate enterprise. In the first step of this approach, assets and risks are attributed to the head office or the PE based on a functional analysis. Subsequently, free capital and loans are allocated to the PE. Finally, interest is determined for the loans that have been attributed to the PE.

With regard to capital allocation, the State Secretary expresses a strong preference for a capital allocation approach (based on the company's capital position). When it comes to attributing interest to the loans allocated to the PE, the State Secretary expresses a strong preference for the 'fungibility approach' (pro rata allocation of interest costs).

Under the new Article 7 of the OECD Model Tax Convention, executive and administrative expenses should be allocated to the PE with an at arm's-length markup. The State Secretary has indicated that for the applicability of treaties containing the old Article 7, both methods of attributing costs to the PE (i.e. with or without an at arm's-length markup) are considered to be acceptable. In addition, royalty charges between the head office and a PE can be acceptable if the development cost have been attributed to one part of the enterprise.

Advance tax rulings (ATRs)

Effective from 1 April 2001, the former Dutch ruling practice was converted into an 'APA/ATR' practice. Reference is made to the 2004 decrees on APAs and finance companies.

ATRs typically deal with issues like the applicability of the participation exemption, hybrid loans and the existence of a PE.

Legal cases

There are relatively few court cases on transfer pricing issues since most disputes are solved through compromise. One reason is the ability to obtain an APA (historically unilateral advance rulings) from the Dutch tax authorities on the arm's-length nature of certain transfer pricing arrangements. Currently, the Dutch tax authorities are a strong advocate of bilateral or even multilateral APAs. Another factor may be that the burden of proof in transfer pricing disputes historically lies with the tax authorities, and the confidence of the tax authorities in this regard may have been a relevant factor.

This is illustrated by a Supreme Court decision of June 2002, which involved a Japanese parent with a distribution subsidiary in the Netherlands (Supreme Court, 28 June 2002, No. 36 446). The Dutch subsidiary sold a certain product at a loss for a lengthy period of time while the remaining product range was profitable. The transfer prices for all products were set by the parent company without clear evidence of negotiations. The Dutch tax authorities challenged the arm's-length nature of the transfer price for the loss-making product, arguing that a third party would not have continued selling this product under these conditions. The High Court argued that the tax inspector wrongfully looked at only the loss-making product. Also, the court held that the tax inspector had the burden of proof and failed to demonstrate that third party distributors would not have agreed to the pricing arrangements for the transactions under review. The Supreme Court upheld the decision of the High Court and decided in favour of the taxpayer.

From this Supreme Court decision, one may conclude that the burden of proof rests with the tax authorities even if a taxpayer reports a profit margin that is relatively low and differs from the industry average. The Supreme Court also ruled that for the arm's-length test, certain transactions can be aggregated and a particular product may be unprofitable if the overall result for the company represents a fair return on the capital employed and the business risks incurred.

On 13 September 2002, the State Secretary of Finance issued a decree (IFZ2002/830M) on the consequences of this Supreme Court decision. In the decree, it was concluded that the Supreme Court decision results in a heavy burden of proof for the tax authorities for the years before 1 January 2002.

In October 2005, the Supreme Court ruled on a case (Supreme Court, 14 October 2005, No. 41 050) which dealt with the issues of dual residency and the existence of a PE. A MNE with a head office located in the Netherlands operated its group financing function through a company located and incorporated in Belgium. The Supreme Court ruled that since a significant part of its core activities were on a day-to-day basis performed by the Belgian employees, the company should not have had dual residency and was therefore not subject to Dutch corporate income tax. Moreover, the involvement of the Dutch head office had not exceeded a normal level of involvement within a group, and as a result it could not be concluded that the Belgian group company had a PE in the Netherlands.

In the Netherlands, the tax authorities increasingly not only focus on the arm's-length nature of the conditions of a transaction, but also on the arm's-length nature of the transaction itself. An example in relation to the aforementioned is the case ruled by the Supreme Court in May 2008.

In May 2008, the Supreme Court ruled on a case (Supreme Court, 9 May 2008, No. 43 849) where a loan had been issued by a company to its parent company and where subsequently the lender was faced with a default on that loan. The court ruled that if and to the extent a supply of funds occurs on terms and under conditions such that a third party would not have assumed the debtors risk, it must be concluded that the supplier of the funds had accepted the debtors risk with the intent to serve the interests of its shareholder.

The Netherlands

Burden of proof

Since 2002, taxpayers have a legal obligation to maintain certain transfer pricing documentation. To the extent that this requirement is not met, the burden of proof is ultimately transferred to the taxpayer.

In general, there are no statutory provisions to indicate how the burden of proof is divided between the taxpayer and the tax authorities. The allocation of the burden of proof between the parties is at the discretion of the court. However, in practice and as a result of Dutch case law, if the company's revenue is adjusted upwards because of transfer pricing issues, the burden of proof usually lies with the tax authorities. On the other hand, the burden lies with the taxpayer to prove the deductibility of expenses.

In transfer pricing cases, the burden of proof transfers to the taxpayer if the pricing arrangements are unusual (e.g. if comparable uncontrolled prices (CUP) are available but not used, or goods or services are provided at cost or below cost). The burden of proof is also transferred to the taxpayer, and will be more onerous, if the taxpayer refuses to give information requested by the tax authorities where there is a legal obligation to do so, or if the requisite tax return is not filed. Finally, the court sometimes allocates the burden of proof to the party best able to provide the evidence.

Tax audit procedures

Selection of companies for audit

There are no clear criteria as to how companies are selected for a transfer pricing investigation, but a company bears an increased risk of such an investigation if one of the following situations occurs:

- The company has suffered losses for a number of years.
- The company is involved in transactions with related parties in tax havens.
- The company shows fluctuating results from year to year.
- The company closes.
- The company's activities are reorganised.
- The results of the company are lower than the average for the industry.
- The company pays substantial royalties or management fees.

The Dutch tax authorities conduct centrally coordinated transfer pricing investigations for certain industries, such as the pharmaceutical and automobile industries.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

In accordance with the General Tax Act, a taxpayer can be compelled by the tax authorities to give access to all books and other documentation relevant to the determination of the facts of the company's tax position. If a taxpayer does not provide the requested information to the tax authorities, the burden of proof is transferred to the taxpayer. In addition, failure to comply can be considered a criminal offence, which could ultimately result in penalties or even imprisonment.

Transfer pricing legislation does not give a clear indication as to exactly what the minimum requirements are in terms of documentation. However, in the explanatory memorandum on the legislation, reference is made to the OECD Guidelines in this respect. The decrees of March 2001 and August 2004 also provide some guidance on

the documentation that should be maintained. It is understood that the documentation should include the following:

- A summary of the relevant intragroup transactions.
- A functional analysis.
- An industry analysis.
- A summary of the transfer pricing methods and margins used, including evidence that the methods have resulted in an arm's-length outcome.
- Details on the company's strategies, including critical assumptions.
- Intragroup arrangements, including the trading conditions.

With respect to requests for information about foreign group companies, which can affect the Dutch company's tax position, the situations set out below can be distinguished.

A Dutch company with a majority shareholding in a foreign company

In this situation, the Dutch tax authorities can require the Dutch company to provide information on, and give access to, the books and records of the foreign subsidiary. If the requested information is not provided, the burden of proof transfers to the taxpayer.

A Dutch company with a foreign parent company or fellow subsidiary

The Dutch tax authorities can request a Dutch company to provide information on its foreign parent company or fellow subsidiary. However, a taxpayer is not obligated to provide this information if the parent company or fellow subsidiary is resident in either the EU or a country with which the Netherlands has a tax treaty that includes a provision for the exchange of information. In this case, the information should be requested directly from the tax authorities. If this process fails, no tax treaty exists or the treaty does not include an exchange of information article, the Dutch tax authorities can request access to the books and records of the foreign parent company or fellow subsidiary. If the requested information is not provided, the burden of proof transfers to the taxpayer.

The audit procedure

Transfer pricing matters usually are an integral part of a general state audit. The Dutch tax authorities aim to audit every company at least once every five years and larger companies once a year. A state audit comprises an onsite examination of the company's books, which usually covers a number of years, taking into account the five-year period within which the tax authorities may statutorily reassess taxes. This period is extended with the extension period granted for filing the tax return. Historically, the tax authorities concentrated largely on examining intragroup charges for service fees and royalties. Recently a lot of attention has been focused on the transfer pricing of goods, the treatment of intangible assets and the allocation of head office costs by Dutch MNEs. These may be examined through separate transfer pricing state audits, as the Dutch tax authorities are more active in this area.

The conduct of the taxpayer during the investigation, particularly with respect to requests for information from the tax authorities, could have an effect on the outcome of the dispute and size of the adjustment. Transfer pricing disputes between the Dutch tax authorities and the taxpayer are usually solved through negotiation rather than

The Netherlands

litigation. Note, however, that an additional assessment is the most likely outcome, since most disputes are solved through compromise.

Furthermore, the Dutch tax authorities tend to enhance the relationship with the taxpayer through so-called horizontal monitoring, which is to pursue an effective and efficient method of working based on mutual trust, understanding and transparency. As a result, the tax audits shift from tax audits performed by the Dutch tax authorities afterwards (reactive) to having upfront assurance from the Dutch tax authorities (proactive) whereby more and more is focused on internal risk and control processes of the company (Tax Control Framework).

Revised assessments and the appeals procedure

The taxpayer may appeal against the revised assessment and should do so within six weeks of the date when the additional assessment was raised. The tax authorities should make a formal decision on the appeal within six weeks after this period. If the tax authorities are not able to give a decision within this term, they may extend the period for another six weeks at most. The tax authorities cannot just reject the appeal without first providing an explanation for the decision.

If the tax authorities reject the initial appeal, the taxpayer can file an appeal with the District Court against the decision. This appeal must be filed within six weeks of the tax authorities' formal decision. To speed up the decision process, if there is mutual consent between the taxpayer and the tax inspector, the appeal to the tax inspector can be bypassed by sending the appeal directly to the District Court. This is then treated as an appeal with the District Court.

There is no ultimate time limit within which the District Court must make its decision. Following its decision, the taxpayer or the tax authorities can file an appeal with the Dutch High Court within six weeks. Once the High Court has made a decision, the taxpayer or the tax authorities may appeal the decision on points of law to the Supreme Court. Such an appeal must also be filed within six weeks of the High Court's decision. The Supreme Court is the final court; its decision is binding, and no further appeal is permitted. There is no ultimate time limit within which the High Court and the Supreme Court must make their decision. To speed up the decision process, and with mutual consent between the taxpayer and the tax inspector, the appeal to the High Court can be bypassed by sending the appeal directly to the Supreme Court. Generally, a taxpayer will want to avoid litigation since it can be a very time-consuming and costly exercise.

Additional tax and penalties

The Dutch legislation does not provide for specific transfer pricing penalties. Nevertheless, the existing penalty rules are applicable on any additional tax resulting from transfer pricing adjustments. The penalties vary from 25% to 100% of the additional tax, depending on the degree of the intent to avoid tax or gross negligence of the taxpayer. Penalties are not deductible for corporate income tax purposes. Note that transfer pricing adjustments do not often result in penalties, because the taxpayer's position is usually more or less defensible and therefore is not strictly considered as tax avoidance. However, an additional tax assessment results in interest charges.

Resources available to the tax authorities

Transfer pricing enquiries are conducted by the local tax inspector and the tax auditor, usually in consultation with specialised accountants from the Transfer Pricing Co-ordination Group. This group is dedicated to transfer pricing and includes people from the Ministry of Finance and the tax authorities. Its main task is to prepare policies for those instances of incorrect application of the arm's-length principle. In addition, the group should be consulted by the tax authorities and the Ministry of Finance on any transfer pricing issue (including allocation of profit between head office and PE), and it should guarantee a consistency in dealing with transfer pricing matters. Transfer pricing cases dealt with by the local tax inspector should also be reported to this group. This particularly applies to the following scenarios:

- Cross-border transactions with related entities established in tax havens.
- Proposed transfer pricing audits.
- Cross-border transactions that are, or will be, assessed as part of an industry examination.
- A request by a taxpayer for a corresponding adjustment in the area of transfer pricing as a result of a (proposed) adjustment at a related entity in another state.
- If it is likely that a mutual agreement or arbitration procedure will be started.
- A cross-border transfer of intangible assets within a group.
- A request for advance certainty on the extent of the documentation requirements of Article 8b of the Corporate Income Tax Act.

The group reviews (interim) reports, provides binding advice to the local tax inspector and also operates as a help desk for staff members of the tax authorities. This binding advice does not relate to APA requests because the local tax inspectors should involve the centralised APA/ATR team for these.

Use and availability of comparable information

Use of information

As indicated above, the principles in the OECD Guidelines have been accepted by the Netherlands and are generally applied. Since the OECD Guidelines recommend the use of comparable information, a comparables study is an appropriate means to justify a transfer pricing policy. Furthermore, the reference to comparables in the explanatory notes on the transfer pricing legislation make it evident that comparables information is a crucial element in defending transfer prices in the Netherlands. The tax authorities have access to their own comparables data, and they also use commercially available databases (*see below*). According to the transfer pricing legislation and their explanatory notes, it is, strictly speaking, not mandatory for a taxpayer to perform a comparables study (i.e. benchmarking) to support its transfer pricing policy. On the other hand, in the absence of a comparables study, it is likely that the Dutch tax authorities will perform such a study themselves. It is therefore advisable for a taxpayer to perform a comparables study to support the arm's-length nature of its pricing arrangements. In case of an APA, a comparables study is required as part of the information to be provided to the tax authorities. (*See the APA section for more information*).

Availability

Dutch companies are required to file their statutory financial statements in full or abbreviated form (depending on the size of the company) with the local chamber of

The Netherlands

commerce. This information is compiled on a publicly accessible database and may be used by other companies in similar situations to justify or defend a pricing policy.

The tax authorities can also obtain and use all information that is publicly available, including external databases, to support its position. In addition, the tax authorities may use information (e.g. gross margins or net operating profit margins) obtained from corporate income tax returns and state audits. However, such information is rarely used as evidence before the courts because the tax authorities might be compelled to disclose the underlying financial information and this might put the tax authorities in breach of their confidentiality obligations.

Risk transactions or industries

No transactions or industries are excluded from the scope of the transfer pricing legislation. Historically, the Dutch tax authorities have primarily focused on intragroup charges like royalties, management fees, commissions and interest payments, as well as intragroup transactions with low-tax countries and intragroup transactions involving intangible assets.

Since the introduction of the transfer pricing decrees and the legislation, there is a tendency for more queries to be raised concerning the transfer prices and margins of goods, as well as the allocation of head office costs and related service charges by Dutch MNEs. In addition, the Dutch tax authorities are increasingly becoming sophisticated in the area of intercompany financial transactions, including the arm's-length nature of the interest rates applied on group loans, cash pooling and credit guarantees.

Limitation of double taxation and competent authority proceedings

Most tax treaties for the avoidance of double taxation concluded by the Netherlands include provisions for a mutual agreement procedure (MAP). Moreover, the Netherlands has concluded a treaty containing an arbitration clause with approximately 23 countries, including the treaties with Japan, Switzerland and the United Kingdom. In the Netherlands, a request to initiate the MAP should be filed with the Dutch Ministry of Finance, generally within three years of the tax assessment with the adjustment that results in double taxation. The Dutch Ministry of Finance has issued a decree on the application of MAP procedure or EU arbitration procedure (*see also Other regulations section, above*) to provide guidance for taxpayers and improve the efficiency of the process for resolving disputes. No information is available on the number of requests made as the Ministry of Finance has not disclosed this information. The use of the competent authority procedure had increased significantly over the last years. Most cases are solved within a period of two to three years. Additionally, it is understood that it is part of the Dutch treaty policy to include an arbitration clause in future tax treaties.

Advance pricing agreements

As indicated previously, there are formal procedures in the Netherlands for setting pricing policies in advance through a unilateral or bilateral APA. The authority for the APA procedures lies in the amended APA decree published by the Ministry of Finance on 11 August 2004, which replaces the 30 March 2001 decree. APAs may include transfer pricing methodologies covering different types of related party transactions or specific transactions, including transfers of tangible or intangible property, financing

and licensing activities and the provision of services. APAs may cover all the taxpayer's transfer pricing issues or may be limited to one or more specific issues.

Since the publication of the 2004 decree, the number of APAs concluded by the Dutch tax authorities has increased significantly. An APA request requires a certain amount of detail to be disclosed to the tax authorities. However this is not materially different from the documentation that the taxpayer must maintain under the transfer pricing documentation requirements.

The information to be provided to the tax authorities by the taxpayer as part of an APA request generally includes, among other things, the following:

- Details on transactions, products and agreements relating to the proposal.
- Details on the entities and PEs involved.
- The relevant jurisdictions.
- Details on the worldwide group structure, history, financial data, products, functions, risks and (in) tangible assets involved.
- A description of the proposed transfer pricing method, including a comparables analysis.
- Details on the critical assumptions applied in the proposal and the implications of changes therein. This would allow a certain flexibility in the actual application of the APA, provided that the critical elements (e.g. market share or value chain) fluctuate within a certain predetermined range.
- The accounting years involved.
- General information on the market conditions (i.e. industry analysis).

The APA request needs to be filed with the tax inspector or directly with the APA/ATR team of the Dutch tax authorities (particularly in cases where the request concerns activities to be established in the Netherlands). In all cases, the inspector is obliged to present the request to the APA/ATR team of the Dutch tax authorities for binding advice (in cases of new policy after consultation of the Transfer Pricing Co-ordination Group). In the case of a bilateral APA request, the Dutch Ministry of Finance initiates the bilateral agreement procedure with the other country involved. In principle, an APA is applicable for a period of four to five years unless longer-term contracts are involved. Under certain conditions an APA can be applied retroactively, for example, as part of a conflict resolution during a state audit. The Dutch tax authorities are eager to make the APA regime work and, as a result, according to the Dutch State Secretary of Finance, the Dutch tax authorities maintain a professional, flexible and cooperative international reputation in this area. The APA decree of 11 August 2004 (IFZ2004/124M) entails various measures to further develop the APA practice and to streamline the filing process. These measures relate to the possibility of a pre-filing meeting, the introduction of a case management plan and the possibility of assistance by the tax authorities in identifying comparables data for small businesses (i.e. companies with a balance sheet total of less than EUR 5 million and with an average number of employees of less than 50).

The pre-filing meeting creates the potential to discuss the APA request with the APA team before it is actually filed. The benefit to the taxpayer is a clarification of the information that is likely to be required and specific elements likely to be pertinent to the formal APA request.

The Netherlands

In cooperation with the APA team, a joint case management plan (i.e. a work plan) can be prepared describing the process and timing between the filing and the completion of an APA request. The intention of this case management plan is to reduce the uncertainty for the taxpayer with respect to the handling process of the application. The case management plan should provide a realistic time frame for the completion of the request as agreed by both parties.

To decrease the administrative burden for smaller companies, the tax authorities, to the extent possible, give comparable financial information of independent enterprises. This assistance should make it easier for relatively small companies to file an APA request, as many small companies are reluctant to enter the APA process due to the administrative burden and related costs. The taxpayer still must provide the necessary information on the organisation and functional analysis of the company, as well as the rationale for the proposed transfer pricing method and mechanisms, for example.

Anticipated developments in law and practice

With the existence of specific transfer pricing legislation in the Netherlands and considering the increased awareness of the Dutch tax authorities with respect to transfer pricing matters, the most likely development is that, in practice, intragroup transactions will be reviewed even more closely and challenged even more frequently than is the case presently. This is also a result of the active approach to transfer pricing by the authorities of the most important Dutch trade partners, like Germany and the US. These developments will force MNEs to review their transfer pricing policies and carefully document them in order to defend their prices against future challenge.

Liaison with customs authorities

The exchange of information between the corporate income tax authorities and the customs authorities takes place as part of the daily routine of the Dutch tax authorities. The special customs valuation team based in Rotterdam now directly cooperates with the corporate income tax authorities throughout the process of an investigation for customs purposes. Also, combined customs and corporate income tax teams exist within other major offices of the Dutch tax authorities. In addition, the customs authorities have now implemented a database containing pricing structures and price levels for different industries.

In case of a customs valuation audit, the following information may be requested by the customs authorities:

- General information on the company.
- Available information on transfer prices.
- Annual accounts.
- Legal structure, including contracts and agreements in place.
- Specific information on the goods flow, invoicing structure (including retrospective price adjustments), special arrangements (e.g. tools, machines, goods or materials provided to the manufacturer – so-called ‘assists’), royalties, warranty and marketing.
- Reports of foreign customs audits.

A copy of the customs valuation report is usually forwarded to the corporate income tax authorities. In principle, any transfer pricing adjustments made for corporate income tax purposes should be reported to the customs authorities, unless the

adjustments relate to items that are not dutiable for customs purposes. A request for a refund of customs duties, in the event that the import prices are adjusted downwards, should be submitted within three years of the date of actual importation. In the event that the import prices are adjusted upwards, an adjustment should be reported to the customs authorities. The customs authorities then issue an assessment for the underpaid customs duties. The customs authorities can impose an additional assessment within three years of the date of actual importation. In cases where the customs authorities feel that the underpayment of customs duties was a deliberate action to avoid payment of customs duties, the period for assessing the duties may be extended to five years. Recently, the customs authorities have raised more queries on the intragroup purchase prices in situations where the group company purchasing the goods has little or no real economic risk. This may apply to distribution centres with a cost plus remuneration but which are still part of a buy/sell structure, or to low-risk distribution companies. In these situations, the customs authorities may attempt to argue that the intragroup purchase price, although in line with the transfer pricing policy, does not qualify as transaction value according to the customs valuation regulations. This is because the customs authorities believe the purchase prices do not represent normal market prices, due to lack of economic risk by the purchasing company. In addition, the customs authorities will verify whether there are additional payments with respect to the imported products (e.g. for royalties) and if so whether these should be included in the customs value and thus become subject to customs duties. Therefore, it is advisable to also consider customs valuation issues when implementing transfer pricing or corporate income tax arrangements (this is relevant only when the imported products are subject to an actual duty levy). Furthermore, if the customs authorities do not accept a transaction value, some questions need to be dealt with from a value added tax perspective (i.e. who may deduct the value added tax at import and what is the value added tax status of the service provider in the case of a cost plus arrangement).

OECD issues

The Netherlands is a member of the OECD, and according to the transfer pricing decrees of 30 March 2001 and 21 August 2004, the OECD Guidelines are directly applicable in the Netherlands. Also, the explanatory memorandum to the October 2001 proposals on the transfer pricing legislation, effective from January 2002, reconfirms the adoption of the OECD Guidelines by the Dutch tax authorities.

Joint investigations

In principle, the Netherlands could join with another country to undertake a joint investigation of a MNE for transfer pricing purposes. In the few circumstances when a joint investigation has taken place, it was usually initiated by the foreign tax authorities.

54.

New Zealand

Introduction

New Zealand enacted its transfer pricing legislation on 12 December 1995, with effect from the income year ending 31 March 1997. The Inland Revenue Department (Inland Revenue) issued transfer pricing guidelines in final form in October 2000.

The Inland Revenue does not intend to update these guidelines in the future. Instead, the Inland Revenue now relies on the latest 2010 Organisation for Economic Co-operation and Development (OECD) Guidelines, which are consistent with New Zealand's transfer pricing legislation and double taxation treaties.

Inland Revenue's current focus

The Inland Revenue is continuously fine-tuning its targeting approach in terms of taxpayers and risk areas. We have seen clear evidence of this in our dealings with the Inland Revenue and commentaries published by the Inland Revenue in the last few years. The Inland Revenue has expressed its views on the transactions it will monitor, expectations for New Zealand-based companies when expanding offshore and risk areas that foreign multinationals should be aware of when restructuring their New Zealand operations.

Over recent years, the Inland Revenue has lifted its game and sophistication in terms of transfer pricing enforcement. In this regard, the Inland Revenue has instigated a number of specific transfer pricing review programmes. In particular, it maintains a special focus and conducts comprehensive annual reviews on the top foreign-owned multinationals (with revenue in excess of 300 million New Zealand dollars [NZD]). The Inland Revenue has also recently signalled that it is likely to reallocate some resources to obtain greater coverage of the middle market (taxpayers with revenue between NZD 30 million and NZD 300 million), which includes the majority of the New Zealand subsidiaries or branches of offshore multinational corporations.

In August 2012, the Inland Revenue announced that its compliance review programme for 2012-2013 will continue to cover the full range of both inbound and outbound associated-party transactions, with a special emphasis on:

- arrangements to import offshore losses through nonmarket pricing
- inbound service charges
- the transfer of intangible property out of New Zealand, particularly where it is intended that the property is subsequently licensed back to the original property owner
- all financing arrangements in excess of NZD 10 million principal
- groups carrying above-average debt that may have been exposed to losses and asset write-downs, and

- non-arm's-length subsidies and support payments.

In addition, the Inland Revenue continues to focus on companies that have incurred losses over a sustained period. The Inland Revenue has indicated that further audit work is likely to occur where the company fails to lift its performance following a transfer pricing review by the Inland Revenue. Transfer pricing adjustments could follow.

The Inland Revenue has identified several key issues in relation to intragroup financing, including the pricing of interest and guarantee fees, and capital restructuring that result in a major reduction in New Zealand tax paid (*refer to Thin capitalisation section, below*). In particular, the Inland Revenue will be closely monitoring all inbound loans over NZD 10million, all outbound loans and the appropriateness of a non-investment-grade credit rating (Standard & Poor's BB or lower). In these cases, the Inland Revenue expects to see robust benchmarking supporting interest rates and guarantee fees. The Inland Revenue also suggests that businesses consider seeking binding rulings for new funding arrangements to minimise any uncertainty.

In addition to the focus areas discussed above, the Inland Revenue encourages taxpayers to enter into advance pricing agreements (APAs) as they produce significant time and cost savings for both tax authorities and multinationals in comparison with adversarial audits (*refer to Advance pricing agreements section, below*).

Inland Revenue also will continue to monitor business restructures. The Inland Revenue is aware that multinationals continuously alter their supply chains in their quest to maximise efficiencies in their networks. The Inland Revenue is looking closely at supply chain restructures, particularly a change from a standard-risk operation to a low-risk operation.

For the first time, the Inland Revenue has articulated what it considers are the key governance questions all businesses should address to manage their transfer pricing risks adequately, such as:

- Whether the entity knows the nature and extent of their cross-border associated party transactions.
- If the transactions are material, whether there is documentation supporting the transfer pricing, which is kept up-to-date.
- Whether the finance function has been fully involved in the documentation process and signed off the factual analysis as well as the final outcomes.
- Whether the business has considered applying for an APA and if not, why not.

These questions indicate the Inland Revenue's likely approach when it comes to reviewing a business's transfer pricing.

Inland Revenue's review mechanism

The main tool that the Inland Revenue uses in assessing taxpayers' compliance with the transfer pricing rules is its transfer pricing questionnaire. There are three versions of the questionnaire: one for foreign-owned multinationals, one for New Zealand-owned multinationals and one for New Zealand branches. They vary slightly; however, they ask the same main questions.

New Zealand

The questionnaire requires taxpayers to provide details of, among other things, their financial performance; the worldwide group's financial performance; the type and amounts of cross-border, associated-party transactions; the method or methods used to test the transactions; and whether documentation exists to substantiate the transfer prices. The version pertaining to foreign-owned multinationals also includes questions designed to assess taxpayers' compliance with the thin capitalisation rules. The questionnaire is a risk assessment tool and does not constitute notice of the commencement of a transfer pricing audit.

The Inland Revenue first issued the questionnaires as part of its transfer pricing risk review project (i.e. 'bulk' rounds of questionnaires sent to multiple taxpayers) and during general tax audits. The department issued two rounds of questionnaires in 2000 and a further round in December 2003. Since then, questionnaires have remained central to Inland Revenue's compliance programme as a means of scoping risks efficiently and effectively.

Taxpayers with potential transfer pricing issues receive the questionnaire as standard practice during a tax audit. We also have seen an increasing number of taxpayers being asked by the Inland Revenue to complete questionnaires during routine tax investigations. In many cases, a request for transfer pricing documentation has accompanied the issuance of the questionnaire during a tax audit. Inland Revenue auditors have received training specific to transfer pricing, and recent experience suggests an increasing number of auditors are making transfer pricing queries.

Some taxpayers have also received the questionnaire as a 'one-off', not as part of a specific review project or a tax audit. We suspect that in these incidences, the Inland Revenue is seeking to obtain an understanding of the transfer pricing issues and risks associated with a particular industry.

The types of response the Inland Revenue gives a taxpayer following submission of the questionnaire include 'no further action required', 'please provide further information' and 'please explain'. In the second of these responses, the Inland Revenue generally requests the taxpayer to complete a further questionnaire for a subsequent financial year. The third response usually entails the Inland Revenue requiring the taxpayer to explain the nature of a particular (and perhaps unusual) transaction or the reasons for a loss being incurred.

In addition, the Inland Revenue has indicated to some taxpayers that have received the questionnaire that it is maintaining a 'watching brief' of their transfer pricing practices. The department monitors the financial performance of these taxpayers by accessing publicly available financial statements from the New Zealand Companies' Office website.

Statutory rules

Sections GB 2 and GC 6 to GC 14 of the Income Tax Act 2007¹ (tax act) contain the current transfer pricing legislation. The transfer pricing legislation closely follows the current OECD Guidelines and the US Section 482 rules. Other features of the legislation are as follows:

¹ The relevant sections in the Income Tax Act 2004 are GD 13, FB 2 and GC 1. On 1 April 2008, the Income Tax Act 2007 superseded the Income Tax Act 2004. The purpose and intention of the provisions remain the same. The Income Tax Act 2007 applies to tax on income derived in the 2009 income year onwards.

- The basic principle is that of arm's length, as defined by the OECD Guidelines, using five permitted pricing methods: the comparable uncontrolled price (CUP), resale price, cost plus, profit split and comparable profits methods.
- The amount of arm's-length consideration must be determined by applying whichever method or combination of methods listed above will produce the most reliable measure that completely independent parties would have agreed on after real and fully adequate bargaining.
- The substitution of an arm's-length price applies only so as to increase New Zealand's tax base (GC 7 and GC 8)². The burden of proof as to the arm's-length nature of consideration rests with the commissioner of Inland Revenue (the commissioner), unless the commissioner can show that the taxpayer has not cooperated or can demonstrate another amount to be a more reliable arm's-length measure (GC 13(4))³.
- There are specific powers, in addition to those in the double taxation agreements (DTA), to allow compensating adjustments (GC 9 and GC 10⁴) and corresponding adjustments (GC 13(11))⁵.
- Section GB 2⁶ contains an anti-avoidance provision that includes arrangements entered into for the purposes of defeating the provisions of GC 6 to GC 14⁷.

In addition to these outlined provisions, Section YD 5⁸ stipulates the use of the arm's-length basis to apportion income between New Zealand and other countries in the case of branches and agencies.⁹

Guidance on applying New Zealand's transfer pricing rules

The following additional guidance on the application of the legislation is available from the Inland Revenue:

- A technical information bulletin, which deals with the introduction of the new legislation and provides an indication of how the Inland Revenue will interpret it; and
- Transfer pricing guidelines.

The Inland Revenue initially released draft guidelines in two parts: part one in October 1997 and part two in January 2000. No subsequent guidelines have been published since the 2007 rewrite of the Income Tax Act 2004.

The first part of the draft guidelines covered the arm's-length principle, transfer pricing methodologies, theoretical and practical considerations, principles of comparability, practical application of the arm's-length principle, documentation and the Inland Revenue's approach to administering New Zealand's transfer pricing rules. Part two of the draft guidelines covered the treatment of intragroup services, the treatment of intangible property and cost contribution arrangements.

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2 Income Tax Act 2004 Sections GD 13(3) and (4).

3 Income Tax Act 2004 Section GD 13(9).

4 Income Tax Act 2004 Section GD 13(10).

5 Income Tax Act 2004 Section GD 13(11).

6 Income Tax Act 2004 Section GC 1.

7 Income Tax Act 2004 Section GD 13.

8 Income Tax Act 2004 Section FB 2.

9 In relation to the apportionment of income to branches, the Inland Revenue has made an explicit reservation on the new article 7 of the OECD model tax convention. The new Article 7 will only apply if and when it is adopted in New Zealand's double tax agreements. The Inland Revenue has stated that this is unlikely to happen in the near future.

New Zealand

The Inland Revenue issued final transfer pricing guidelines (Inland Revenue Guidelines) in October 2000. The Inland Revenue Guidelines consolidate the draft guidelines previously issued, with no substantive changes. The Inland Revenue Guidelines specifically do not apply to permanent establishments and branches that are covered by Section YD 5¹⁰ of the tax act.

The Inland Revenue states that the Inland Revenue Guidelines are intended to supplement the OECD Guidelines rather than supersede them. In fact, the department fully endorses the comments set out in chapters one to eight of the OECD Guidelines. In its guidelines, the Inland Revenue indicates that the OECD Guidelines are relevant to DTA issues and issues not addressed by the Inland Revenue Guidelines.

The OECD Guidelines were revised in 2010. The Inland Revenue has noted that it will apply the revised OECD Guidelines but does not intend to update the Inland Revenue Guidelines to reflect the changes to the OECD Guidelines.

Taxpayers are also directed to guidelines issued by the Australian Taxation Office and the US 482 regulations, as long as these sources are consistent with the overall approach of the Inland Revenue. However, on issues concerning the administration of New Zealand's transfer pricing rules, the Inland Revenue Guidelines are stated as being paramount.

The comments in the Inland Revenue Guidelines dealing with the arm's-length principle and pricing methods are broadly consistent with the OECD Guidelines, except there is no explicit hierarchy for the transfer pricing methods. However, taxpayers must use the most reliable method.

In relation to the transfer pricing methods prescribed in New Zealand's tax act, a particularly interesting comment is made in the Inland Revenue Guidelines:

"... Inland Revenue does not consider that there is any practical difference between the TNMM [transactional net margin method] espoused by the OECD, the comparable profits method favoured in the US, and the profit comparison method adopted by Australia. It was also noted [previously in the Inland Revenue Guidelines] that the reference to 'comparable profits methods' in Section GD 13(7)(e) [of the tax act] is wide enough to encompass all three approaches" (the Inland Revenue Guidelines, paragraph 141)¹¹.

With respect to tested parties, the Inland Revenue Guidelines specifically allow taxpayers to benchmark the foreign party in particular circumstances where they believe that that is more appropriate to determine the most reliable measure of the arm's-length price. However, where a taxpayer does decide to use the foreign party as the tested party, it should be aware that the Inland Revenue is likely to also test the New Zealand party and, therefore, it is important there is some analysis in relation to the New Zealand operations. Specifically, the Inland Revenue is prepared to accept a foreign analysis provided that the analysis represents a fair application of the arm's-length principle and results in a return from the New Zealand operations that is, *prima facie*, commensurate with the operation's economic contribution and risks assumed.

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¹⁰ Income Tax Act 2004 Section FB 2.

¹¹ This reference provided by the Inland Revenue Guidelines refers to the Income Tax Act 2004. The relevant section in the 2007 rewrite is GC 13(2)(e).

The Inland Revenue recognises that applying the transfer pricing methods can often result in a range of arm's-length outcomes instead of a single arm's-length outcome. Where a range is established, the Inland Revenue considers that, rather than the entity applying statistical measures to the range, the more important issue is to assess whether the comparables used to construct the range are reliable.

New Zealand's transfer pricing rules do not contain an explicit statutory provision requiring taxpayers to prepare transfer pricing documentation. However, Sections GC 6 to GC 14¹² of the tax act require taxpayers to determine transfer prices in accordance with the arm's-length principle by applying one (or a combination) of the methods set out in Section GC 13(2)¹³ of the tax act. For an entity to demonstrate compliance with this requirement, the Inland Revenue considers it necessary to prepare and maintain documentation to show how transfer prices have been determined.

The Inland Revenue considers there are two reasons for making this assertion for documentation. The first is the burden of proof rule in Section GC 13(4)¹⁴ of the tax act. Under this section, the price determined by the taxpayer will be the arm's-length price, unless the commissioner can demonstrate a more reliable measure or the taxpayer does not cooperate with the commissioner's administration of the transfer pricing rules. If a taxpayer does not prepare documentation, there are two exposures. First, it is more likely the Inland Revenue will examine the taxpayer's transfer pricing in detail. Second, if the Inland Revenue substitutes a new transfer price as a result of the examination, the lack of documentation will make it difficult for the taxpayer to rebut that position.

The second consideration sustaining the Inland Revenue's view of documentation is the proposed application of the penalty provisions of the Tax Administration Act 1994 (Tax Administration Act) contained in the Inland Revenue Guidelines:

"In Inland Revenue's view, adequate documentation is the best evidence that can be presented to demonstrate that these rules have been complied with. If a taxpayer has not prepared any transfer pricing documentation, and Inland Revenue is able to demonstrate a more reliable measure of the arm's-length amount, Inland Revenue's view is likely to be that the taxpayer has, at a minimum, not exercised reasonable care (carrying a 20% penalty under Section 141C of the Tax Administration Act) or has been grossly careless (carrying a 40% penalty under Section 141C of the Tax Administration Act), in its determination of an arm's-length amount under Section GD 13" (the Inland Revenue Guidelines, paragraph 316)¹⁵.

The Inland Revenue accepts that the creation and maintenance of documentation impose costs on taxpayers. In the Inland Revenue's opinion, if a taxpayer has reached the conclusion on the basis of a sensible cost-benefit analysis that it is not prudent to pursue a full transfer pricing analysis, this would be strongly suggestive that the taxpayer has taken reasonable care. Of course, the Inland Revenue would expect to see a document explaining how the conclusion was reached. In respect of the issue of whether a taxpayer has an acceptable interpretation, the Inland Revenue considers that the taxpayer must have explicitly considered that its transfer prices are at least

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12 Income Tax Act 2004 Section GD 13.

13 Income Tax Act 2004 Section GD13(7).

14 Income Tax Act 2004 Section GD13(9).

15 This reference from the Inland Revenue Guidelines refers to the Income Tax Act 2004. The corresponding references for the Income Tax Act 2007 are GC 6 to GC 14.

New Zealand

broadly consistent with the arm's-length principle. In assessment of the risk of a potential transfer pricing adjustment, all of the following documentation is suggested at a minimum:

- An identification of the cross-border transactions for which the taxpayer has a transfer pricing exposure.
- A broad functional analysis of the taxpayer's operations to identify the critical functions being performed.
- An estimate of the business risk of not undertaking and documenting a more detailed transfer pricing analysis.
- An estimate of the costs of complying with the transfer pricing rules.

It is emphasised that this assessment will not preclude the Inland Revenue from substituting a more reliable measure of the arm's-length price. Where a cost-benefit analysis indicates the need for a full analysis, the Inland Revenue would expect to see all of the following documentation:

- Some form of functional analysis.
- An appraisal of potential comparables.
- An explanation of the process used to select and apply the method used to establish the transfer prices and why the taxpayer considers that it provides a result consistent with the arm's-length principle.
- Details of any special circumstances that have influenced the price set by the taxpayer.

It should be noted that these documentation requirements have no legislative authority and are not, therefore, binding on the taxpayer. Rather, they are an indication of the Inland Revenue's approach to an interpretation of New Zealand's transfer pricing rules.

The Inland Revenue Guidelines also consider cross-border transfers of intangible property, including any rights to use industrial property (such as patents, trademarks, trade names, designs or models), any literary or artistic property rights (copyrights, etc.) and any intellectual property, such as know-how or trade secrets.

The Inland Revenue acknowledges that the application of the arm's-length principle to transfers of intangible property can be problematic because appropriate comparable transactions can be difficult, if not impossible, to identify. Despite these difficulties, the Inland Revenue emphasises that applying the arm's-length principle is no different than for other types of property.

The Inland Revenue Guidelines also discuss the provision or receipt of intragroup services. Services can be either specific benefit or indirect. Specific benefit services are normally charged to the recipient entity directly. Indirect services should be charged using a cost allocation or apportionment approach.

The Inland Revenue Guidelines depart most significantly from the OECD Guidelines relating to both of the following:

- A detailed discussion of the different allocation methods that may be appropriate in the charging of indirect services.
- The provision of a safe harbour markup on cost of 7.5% in applying the cost plus method for non-core activity services and for services under the specified *de*

minimis threshold.¹⁶ A non-core activity is defined as an activity that is not integral to the profit-earning or economically significant activities of the group. This provision will relieve taxpayers from having to benchmark these services. However, it does not relieve their obligations to demonstrate the benefits derived from the services or prepare adequate transfer pricing documentation.

Cost contribution arrangements are also discussed in the Inland Revenue Guidelines. The Inland Revenue Guidelines emphasise that to satisfy the arm's-length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances. Cost contribution arrangements remain an evolving concept from a transfer pricing perspective. Taxpayers should clearly consider the Inland Revenue Guidelines on such arrangements if they are participating in or considering participating in one.

Legal cases

No court cases have arisen in connection with New Zealand's current transfer pricing rules. It should be noted, however, that even under the previous legislation, there were effectively no transfer pricing court cases in the 20 years prior to its repeal. The two main reasons for this are:

- The previous legislation was considered to be defective.
- Because most transfer pricing disputes were settled by negotiation, there was no need to proceed to court.

Burden of proof

In New Zealand, the burden of proof normally lies with the taxpayer, not the commissioner. However, Section GC 13(4)¹⁷ places the burden of proof on the commissioner where the taxpayer has determined its transfer prices in accordance with Sections GC 13(1) to 13(3)¹⁸ of the tax act.

Where the commissioner substitutes an arm's-length price for the actual price, the commissioner must prove one of the following:

- This is a more reliable measure.
- The taxpayer has not cooperated with the commissioner.

According to the Inland Revenue Guidelines, non-cooperation constitutes either of the following:

- Where the taxpayer does not provide the requested relevant information to the commissioner.
- If a taxpayer does not prepare adequate documentation and provide it to the Inland Revenue if requested.

The burden of proof rule is essential in the context of transfer pricing in New Zealand. Clearly, if taxpayers maintain quality documentation of transfer pricing and produce

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¹⁶ The Inland Revenue has recently updated the *de minimis* threshold from NZD 100,000 to NZD 600,000, effective 1 July 2010. This aligns the New Zealand threshold with that applied by the Australian Taxation Office, and therefore reduces compliance costs for multinational enterprises.

¹⁷ Income Tax Act 2004 Section GD 13(9).

¹⁸ Income Tax Act 2004 Sections GD 13(6) to 13(8).

New Zealand

it on request to the Inland Revenue, they will substantially reduce the risks of an intensive transfer pricing audit. And in any event, the burden of proof will fall on the commissioner to demonstrate that Inland Revenue has a more reliable measure of the arm's-length price.

Transfer of tax compliance work and records overseas

The Inland Revenue is becoming increasingly concerned about compliance issues with taxpayers whose accounting and tax functions are carried out offshore, especially in relation to the timeliness and quality of the taxpayers' tax records. Accordingly, the Inland Revenue continues to remind taxpayers that if it is necessary to keep and retain records outside New Zealand for commercial reasons, the business involved must apply to the Inland Revenue for approval to do so.

This is an important issue in a transfer pricing context, as in many cases New Zealand taxpayers rely on transfer pricing documentation prepared and maintained overseas to support New Zealand tax filing positions. We recommend that New Zealand taxpayers obtain this documentation for their own files and ensure that it specifically supports the New Zealand business concerned. Where New Zealand transfer pricing documentation is held by an offshore affiliate and not locally, an appropriate request for approval must be lodged with the Inland Revenue.

Tax audit procedures

The Inland Revenue will perform audits or investigations specifically for transfer pricing issues. Transfer pricing audits or investigations may also be combined with normal tax audits and investigations.

Selection of companies for audit

Whether a company or group is selected for investigation will depend on a variety of factors or situations, including:

- Previous transfer pricing disputes with the tax authorities, particularly if the authorities consider that these were unsatisfactorily resolved.
- The industry in which the company operates.
- Where an application for an advance pricing agreement has been withdrawn or unsatisfactorily resolved
- Following receipt of information passed to the tax authorities from overseas.
- Where there is evidence of transfer pricing disputes with other revenue authorities overseas.
- As a result of desk audits of returns and replies to correspondence seeking information.
- Inland Revenue risk assessment by reference to all of the following:
 - Level of profitability.
 - No evidence of negotiations with parent.
 - No economic or commercial basis for price.
 - Poor cooperation.
 - Limited transfer pricing documentation.

The Inland Revenue compliance programme focuses its resources on perceived risk to the New Zealand tax revenue base. A transfer pricing-specific review ultimately depends on the extent of tax risk perceived in the taxpayer's transfer pricing practices. The Inland Revenue Guidelines indicate that the Inland Revenue is likely to inspect

transactions involving an entity resident in a country in which New Zealand does not have a DTA more closely than transactions involving tax treaty countries.

Risk transactions or industries

The transactions which can be attacked are specified in Sections GC 6(2) and GC 6(3)19 of the Income Tax Act 2007. Particular types of payment or receipt that are likely to be targeted include payments of interest, management fees, royalties and other fees in relation excluded is share capital other than fixed-rate preference shares.

The Inland Revenue has indicated that as part of its compliance review programme for 2010-11, it will focus on ten industries that are considered high risk from a transfer pricing perspective, including the IT, pharmaceutical, energy, banking and insurance industries.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Information that tax authorities can request during investigations and the authorities' powers to enforce provision of the information are outlined in Sections 16, 17, 17A, 18, 19 and 21 of the Tax Administration Act. The most important are Sections 16 and 17, which give the Inland Revenue extensive powers, both to carry out investigations and to demand information.

The Inland Revenue Guidelines make it clear that the Inland Revenue expects New Zealand taxpayers on request to obtain information from overseas associated entities to justify the arm's-length nature of their transfer prices. Section 21 provides the Inland Revenue with further powers to require information, particularly in respect of information held offshore. Any information that is not produced in response to a Section 21 request will not be available to the taxpayer as part of his/her defence in any subsequent court action relating to such matters.

Effective 22 June 2005, taxpayers can claim a right of non-disclosure for certain tax advice in documents prepared by tax advisers. However, this right of non-disclosure can be claimed only in respect of 'tax advice documents'. The Inland Revenue has issued a standard practice statement (SPS 05/07) to provide guidance to taxpayers on this matter. The definition of 'tax advice documents' in the Inland Revenue's standard practice statement excludes transfer pricing reports.

Investigations in New Zealand are conducted by way of visits to the taxpayers' premises and interviews with relevant personnel. In some cases, these visits may be preceded by requests for the provision of documentation.

Usually in New Zealand, an investigation is decided through negotiation, but it may proceed to litigation if the issues raised cannot be resolved through negotiation. There is also a dispute resolution procedure that applies to transfer pricing disputes. This provides a form of dispute resolution that is primarily aimed at attempting to settle prior to an assessment. During this procedure, notice of intended assessment is given, followed by compulsory meetings. At the meetings, full disclosure of all relevant facts is required to be made, and it should be noted that any information not produced for these meetings is banned from any future court action.

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19 Income Tax Act 2004 Section GD 13(2).

New Zealand

Revised assessments and the appeals procedure

Appeals start with the dispute resolution procedure. After the taxpayer proceeds completely through the dispute resolution procedure, any further appeal would be heard by the courts.

Additional tax and penalties

New Zealand's tax legislation specifies penalties that may be applied to adjustments arising from transfer pricing issues. Determination of the penalties focuses on culpability. The shortfall penalties are:

- Not taking reasonable care – 20% of tax shortfall.
- Unacceptable interpretation – 20% of tax shortfall.
- Gross carelessness – 40% of tax shortfall.
- Abusive tax avoidance – 100% of tax shortfall.
- Evasion – 150% of tax shortfall.

These penalties can be adjusted up or down to reflect the taxpayer's level of cooperation with the authorities during the investigation and the existence or otherwise to any disclosures to the tax authorities. Penalties are not tax-deductible. In addition to the shortfall penalties, an interest charge (deductible) is automatically applied from the date on which the tax should have been paid to the date on which it is finally paid. The rate is adjusted from time to time to reflect economic circumstances.

Resources available to the tax authorities

The Inland Revenue has advised that transfer pricing will not be dealt with by a separate, discrete transfer pricing unit. Rather, all tax inspectors and auditors will be capable of handling transfer pricing issues. The inspectors will be supported by the International Audit Team and will also receive relevant data and particulars of any APA applications being sought. The Inland Revenue has economists available as part of its staff resources, and it is clear the department will not hesitate to contract with outside experts, both economists and industry experts, to assist with its deliberations.

Inland Revenue has recently restructured the International Audit Team to separate compliance and strategic activities. This will allow Inland Revenue to focus on long-term compliance issues and key risk areas such as those discussed above.

Use and availability of comparable information

That a transfer price is at arm's length would, in theory, be demonstrated by means of one or more of the prescribed methods in Section GC 13(2)²⁰ of New Zealand's tax act. In practice, unless either a CUP or sufficient data to apply a resale price method or cost plus method is available, justification of the pricing used would almost certainly depend on a comparison of net profit margins. In most cases, unless the taxpayer has information available regarding its competitors and/or CUPs or internal comparable transactions, the taxpayer would depend on information available from commercial databases. This information, likely to be an analysis of published annual accounts, would almost certainly force any defence to be based on the comparison of net profit margins.

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20 Income Tax Act 2004 Section GD 13(7).

In some cases, within particular industries, more detailed information is available, but this is the exception rather than the norm. Because of the small number of independent companies and large number of 'controlled entities', New Zealand taxpayers are often forced to look for comparable entities in foreign jurisdictions (e.g. Australia, the UK or the US). The Inland Revenue recognises that taxpayers may need to look overseas to find comparable data, which may need to be adjusted to ensure comparability.

Non-publicly available information

The Inland Revenue Guidelines raise the issue of the Inland Revenue's use of non-publicly available information. The Inland Revenue Guidelines state the Inland Revenue does not intend as a matter of course to use non-publicly available information in attempting to substitute an alternative measure of an arm's-length amount. The Inland Revenue concedes there are difficulties, including the likelihood that such information could not be provided to taxpayers whose transfer prices are under review because of the secrecy provisions of the Tax Administration Act.

However, the Inland Revenue does not rule out the possibility that non-publicly available information will be used in administering the transfer pricing rules because the New Zealand tax act requires that the most reliable measure of the arm's-length amount must be determined.

Use of hindsight

The Inland Revenue Guidelines make it clear that the use of hindsight is inconsistent with the arm's-length principle. However, the Inland Revenue Guidelines state that the use of hindsight may be valuable in appraising the reliability of comparables used. The Inland Revenue Guidelines provide an example of a newly developed intangible being difficult to value because of uncertainty as to its future value. Even if time does prove the intangible to be valuable, this is not grounds for automatically adjusting the transfer price.

Availability

The Inland Revenue could access information on other taxpayers, either during investigations into those taxpayers or through a direct request for information under Section 17 of the Tax Administration Act. The latter would enable the Inland Revenue to obtain precise information. Indeed, a recent comment from the head of the Inland Revenue's International Tax Policy Division indicated that such information might be used to select companies for audit, although it is uncertain whether, or under what authority, information obtained in this way could be used as the basis for transfer pricing adjustments.

As noted previously, the information available to taxpayers is likely to be limited to analyses of published accounts as found on commercial databases.

Limitation of double taxation and competent authority proceedings

The competent authority process in New Zealand operates in the way set out in a typical DTA, with nominated officers of the Inland Revenue acting as competent authorities for particular topics. The head of the International Tax Policy Unit is the competent authority for transfer pricing matters.

New Zealand

In addition to DTA provisions, specific provisions in the New Zealand tax act provide for both corresponding adjustments and compensating adjustments, but only in consequence of adjustments made in New Zealand, not in consequence of foreign adjustments.

Advance pricing agreements

APAs are available to taxpayers in New Zealand, and the Inland Revenue is keen to see a greater number of taxpayers seeking APAs. The Inland Revenue has established its APA programme under a broad framework using informal procedures and has stated it will not issue formal APA guidelines. The Inland Revenue considers that its flexible approach to APAs minimises the possibility of the process becoming too bureaucratic and enhances the efficiency of its APA programme. This flexible approach means that most unilateral APAs can be concluded within six months. New Zealand APAs are particularly efficient where APAs have previously been agreed by offshore affiliates with other revenue authorities (where the offshore affiliates are functionally similar to the New Zealand taxpayers).

The Inland Revenue concluded its first bilateral APA (with Australia) in 2001. Since then, the Inland Revenue has concluded several other bilateral APAs with Canada, Japan, Korea, Switzerland and the United States. The department is also party to a multilateral APA. The Inland Revenue has concluded over 81 APAs and is currently negotiating a number of others. Key areas covered by APAs that have been negotiated recently include distribution entities with large exposures, business restructures and complicated royalty structures.

The Inland Revenue expects to see a greater number of taxpayers seeking APAs, given the increase in its auditors' inquiries. The department is encouraging taxpayers to seek unilateral and bilateral APAs, particularly with Australia. The tax authority believes it is better for taxpayers to obtain APAs than run the risk of potentially costly and time-consuming transfer pricing audits. Its view is that given the subjective nature of transfer pricing, APAs are the best way for taxpayers to achieve certainty. As noted above, our experience with the Inland Revenue in relation to APAs has been positive. We believe this is attributable to the agency's informal approach to APAs and its pragmatic view on commercial realism.

Liaison with customs authorities

The Inland Revenue will normally obtain information from the customs authorities and, in fact, is expected to use customs specifically as a source of transfer pricing information. Indeed, customs officers are currently very active in checking the transfer price of goods, although this is ostensibly for customs duty purposes. However, customs has raised queries specifically for the purpose of actively sharing information with the Inland Revenue in relation to the price of goods being imported into New Zealand.

Although there is no legislation that directly requires transfer pricing adjustments to be reflected in returns made for customs or other indirect taxes, where transfer prices have been adjusted for income tax purposes, this may require customs to review the prices for customs duty.

The Inland Revenue has recently announced that it will work with the New Zealand Customs to better align their enforcement practices, taking into account developments overseas.

OECD issues

New Zealand is a member of the OECD. It has signed off on the OECD Guidelines and, as discussed previously, has stated express agreement with them.²¹ Further, Inland Revenue personnel are involved in a number of OECD committees dealing with transfer pricing issues.

Joint investigations

New Zealand would undoubtedly join with another country to undertake a joint transfer pricing investigation of a multinational group. To this end, there is a formal, but private, agreement already in existence between the New Zealand and Australian tax authorities. In the past, the tax authorities have traditionally cooperated informally with other tax authorities, either in providing information for other transfer pricing investigations or, in some cases, participating in joint audits or enquiries.

A mutual administrative assistance is designed to enable multiple countries to work together to counteract international tax avoidance and evasion by sharing information and undertaking joint tax audits. New Zealand is considering signing up to the convention. If it does so, the convention would give Inland Revenue the ability to enter into joint tax audits with tax authorities in other countries that are signatories.

Thin capitalisation

New Zealand introduced a thin capitalisation regime to apply from the beginning of the 1996-97 income year. The key features are as follows:

- The regime is fundamentally designed to deny a deduction for interest if a non-resident allocates an excessive proportion of its worldwide debt to its New Zealand operations. An apportionment of deductible interest is required where an entity's debt ratio (calculated as total debt/total group assets) exceeds both:
 - 60%,²²
 - 110% of the worldwide group's debt percentage.
- It is important to note that the use of debt-to-asset ratio differs from most thin capitalisation models, which monitor an entity's debt-to-equity ratio.
- The regime potentially applies to:
 - non-residents who derive New Zealand-sourced income,
 - New Zealand companies controlled by a single non-resident person (together with persons associated with that person), and
 - non-qualifying trusts that are 50% or more settled by non-resident persons.
- A concession exists for on-lent funds. One effect of this is to minimise the impact of the regime for financial intermediaries.

The thin capitalisation rules were extended in 2009 to include New Zealand companies that are controlled by New Zealand residents and have interests in controlled foreign companies (CFC), except where one of the following applies:

- The ratio of the New Zealand group assets to the worldwide group assets is at least 90%.

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²¹ The Inland Revenue has made an explicit reservation on the new article 7 of the OECD model tax convention. The new Article 7 (and any associated guidance issued by the OECD) will only apply if and when it is adopted in New Zealand's double tax agreements. The Inland Revenue has stated that this is unlikely to happen in the near future.

²² The 60% threshold only applies in relation to the inbound thin capitalisation rules (this threshold was reduced from 75% starting from the 2012 income year, i.e. 1 April 2011 for taxpayers with a 31 March balance date). In relation to the outbound thin capitalisation rules, the thin capitalisation threshold is 75%.

New Zealand

- The New Zealand group's interest deductions are less than NZD 250,000, and the New Zealand group does not have an interest in a CFC deriving rent from the CFC's country of residence.

Further concessions are available to taxpayers who do not fall below the above thresholds, subject to certain conditions.

Double taxation agreements (DTAs)

The new Turkey – New Zealand DTA came into force on 28 July 2011. In New Zealand, this DTA is effective for withholding taxes from 1 January 2012. For other provisions, the DTA is effective generally for income years beginning on 1 April 2012.

The Hong Kong – New Zealand DTA was concluded on 1 December 2010. This DTA came into force on 9 November 2011. The provisions of the DTA took effect from 1 April 2012.

New Zealand's DTAs with Chile and Mexico were updated to lower the withholding tax rates on certain transactions (applying retrospectively from 1 May 2010). The reciprocal withholding tax rate on royalties arising in Chile and New Zealand has decreased from 10% to 5%. The withholding tax rate for dividend payments arising in Mexico and New Zealand has decreased from 15% to either 5% or zero, depending on the size of the investor's shareholding in the company paying the dividend and certain other criteria.

The updated DTA between Canada and New Zealand was signed on 3 May 2012. The withholding tax rate on dividends will reduce from 15% to a maximum of 5% for an investor who holds at least 10% of the shares in the company that pays the dividend. The withholding rate on royalties has been reduced from 15% to 10% generally, with a further reduced rate of 5% for royalties relating to copyright, computer software and others. The updated DTA will come into force once both countries have given legal effect to it.

The Japan – New Zealand DTA has been updated and will include changes such as lower withholding tax rates on dividends, interest and royalties, and an arbitration provision to deal with taxpayer disputes. The DTA is now awaiting approval and signature by both governments. The DTA will come into force once both countries have completed their respective legal requirements.

Revised CFC rules

New Zealand's rules affecting the calculation of attributed CFC income were amended in 2009. The new rules apply from the 2009-10 income year for taxpayers with balance dates between 30 June and 30 September; for all other taxpayers, the rules apply from the 2010-11 income year.

The new CFC rules are less comprehensive than the old rules. For example, the new rules contain a worldwide exemption for CFCs with an active business. Under the new rules, inadequate pricing policies may no longer result in a zero sum game. Therefore, the Inland Revenue is more likely to scrutinise transfer prices in transactions involving CFCs. Inland Revenue recommends that taxpayers ensure they have sufficient documentation that transfer prices involving CFCs are in accordance with the arm's-length standard.

55.

Norway

Introduction

In Norway, the arm's-length standard for related party transactions is incorporated into the General Tax Act (GTA) 1999 Section 13-1. The GTA Section 13-1 (4) makes reference to the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines (TPG) and state that the TPG 'shall be taken into account'. The reference is to the guidance on the arm's-length principle and the transfer pricing methods. It is also assumed that the reference includes the OECD guidance on business restructuring. Transfer pricing documentation and reporting requirements became effective from fiscal year 2008.

The Norwegian tax authorities consider transfer pricing a priority and have considerable resources. It is fairly common for the tax authorities to pick test cases that are subject to extensive assessments. Such cases may easily end up in courts. Settlements have traditionally not been common, but are now more frequent during audits.

During the most recent years, the tax authority's focus has been inter alia on intra-group financing arrangements, intra-group services, business restructuring and commissionaire arrangements.

Norway does not have a general Advance Pricing Agreement (APA) regime, although a formal APA can cover certain transactions related to the sale of natural gas. Nevertheless, it is becoming more common to discuss complex cases with the tax authorities in advance of implementation or before assessment. In May 2011 PwC successfully concluded the first advance 'agreement' regarding the value of intellectual property and business activity to be sold by a Norwegian company to foreign affiliated companies. In December 2011 PwC negotiated and agreed with the tax authorities on behalf of a client the valuation of certain assets to be sold by a Norwegian company to a foreign affiliated company prior to the transaction being carried out.

Statutory rules

A general arm's-length rule is laid down in Section 13-1 of the GTA. The section provides that, where the income of a Norwegian taxpayer is reduced due to transactions with a related party, the authorities may estimate the amount of the shortfall in income or wealth. The following three conditions must be met for the tax authorities to adjust a taxpayer's taxable income or assets in accordance with the GTA Section 13-1:

- The parties involved in the transaction must have a direct or indirect community of interest.
- There must be an income or wealth reduction (compared with what the situation had been had the parties not been related).

Norway

- The income or wealth reduction must have occurred as a consequence of the relationship (the community of interest) between the parties. Where the related party is resident outside the European Economic Area (EEA), the legislation assumes that the relationship is the reason for any deviation from arm's-length income or wealth, and puts the onus on the taxpayer to prove otherwise.

The Supreme Court made some interesting statements regarding the burden of proof in the 1999 Baker Hughes case (*see Burden of proof, below*).

In addition, the substance-over-form principle is a general and important non-statutory principle in Norwegian tax law:

The starting point in Norwegian tax law is that transactions in accordance with Norwegian private law are respected. The application of the non-statutory general anti-avoidance rule (GAAR) is dependent on the tax authorities showing that the relevant transaction has little value besides the tax effects and that the main purpose behind the transaction is to reduce Norwegian taxes. Furthermore, the tax benefits gained by the transaction must be contrary to the legislative intent (i.e. the relevant transaction is clearly outside the range of situations the tax rule was meant for).

The objective of the GAAR is to find the underlying reality, thus substance prevails over form. (It is important to distinguish between this and so-called pro forma transactions, which are disregarded for tax purposes.)

Other regulations

Norway has specific legislation (in the Petroleum Tax Act) to deal with the pricing of petroleum for tax purposes. Taxation of income from the sale of crude oil produced on the Norwegian Continental Shelf is based on a so-called 'norm price', which shall be equivalent to the price at which it could be sold between unrelated parties in a free market (i.e. an arm's-length price). When establishing the norm price, a number of factors shall be taken into account, including 'the realised and quoted prices for petroleum of the same or a corresponding type with necessary adjustments for quality variations, transport costs, etc. to the North Sea area or other possible markets, delivery time, time allowed for payment and other terms'.

The price norm is decided individually for each field by a separate governmental board (Norm Price Board). The taxpayer will be taxed based on the relevant norm price irrespective of the actual sales price. The norm price is used both for internal and external transactions. So far, the norm price has been set only for crude oil but may also be set for natural gas.

Court cases and revenue practice

The Supreme Court and the lower courts have made a number of decisions concerning transfer pricing. Several of the large transfer pricing cases in Norway are related to the petroleum activity on the Norwegian Continental Shelf. Reference will also be made to current revenue practice.

Bareboat charter rate – pricing methods

Trinc and Trag – Supreme Court 1997

The Trinc and Trag case is primarily an important decision with respect to tax liability to Norway for a foreign oil drilling rig owner. The case also (particularly in the verdicts from the lower courts) contains interesting elements of transfer pricing.

Two foreign companies, Trinc and Trag, were controlled by the same owners. Trinc was the ownership company of a drilling rig, and Trag operated the rig under a bareboat charter. Trag operated the rig on the Norwegian Continental Shelf and was liable to tax in Norway for that activity. The companies had seemingly not used any specific pricing method, while the tax authorities used a cost plus method to set an appropriate bareboat charter rate. The court stated that no significant income reduction was required in order to adjust the income in accordance with the GTA Section 13-1. Further, the court stated that the tax authorities were entitled to use the cost plus method in a situation where it was difficult to find comparable transactions in the market, and that the discretionary elements used by the tax authorities in the cost plus calculation were acceptable. The taxpayer argued to no avail that the resale price method was more appropriate. The historic cost of the rig was used as a basis for the computation. This part of the case was not appealed to the Supreme Court.

Captive insurance issues

There are basically two issues regarding captive insurance. The first question is whether the captive provides real insurance. The second question, if the captive is accepted as providing real insurance, is to what extent the insurance premiums meet the arm's-length standard.

Amoco – Supreme Court 2002

The question was to what extent Amoco's captive represented real insurance. Through previous Supreme Court decisions (including Dowell Schlumberger 1995) it has been concluded that premiums paid to a captive insurance company will, in principle, be accepted as a deductible for income tax purposes. However, this is subject to two conditions:

- A formal insurance policy that transfers the risk from the insured to the captive must be in place.
- The captive must have the financial capacity to meet any claims under the insurance policy (i.e. there must be a real transfer of risk).

Regarding the latter, the tax authorities (in this case, the Oil Taxation Office) have focused on the exposure ratio (maximum payout for one accident/the captive's equity). In the Amoco case the exposure ratio was more than 100% (i.e. the captive could not even meet one maximum loss).

Contrary to the city court and Court of Appeals, the Supreme Court concluded that Amoco's captive insurance arrangement qualified as real insurance. The main reason for this was the fact that Amoco Norway had placed its insurance policy in an independent insurance company (fronting arrangement). The fronting insurance company had then reinsured all the risk with the Amoco captive company, and Amoco Corp. had guaranteed coverage from the captive to the fronting insurance company. Based on the fact that the fronting company would be in a position to cover any losses incurred by Amoco Norway, irrespective of the captive's financial position, the Supreme Court concluded that the risk effectively had been shifted from Amoco Norway to the insurer. Therefore, from a Norwegian perspective, this represented a true and valid insurance.

However, it should be noted that the Supreme Court in principle accepted the 'exposure ratio' as a key factor in order to test the captive's financial capability.

Norway

Therefore, it was also concluded that the Amoco captive in itself ‘clearly did not qualify as a true and valid insurance company’.

Agip – Supreme Court 2001

The Appeal Board for Petroleum Tax did not accept Agip’s insurance premiums as being in line with the arm’s-length standard. In order to find the ‘correct’ arm’s-length price, the Appeal Board made use of captive insurance premiums paid by other companies operating on the same petroleum field as comparables. The Appeal Board made the following statement:

“Within captive insurance it is difficult to find comparable rates between independent insurance companies. A comparison with rates paid by other companies on the same or similar fields will be relevant for the evaluation of whether an arm’s-length price exists, even if the comparable insurances are with captives. The key point is to thoroughly evaluate the comparability of the policies and to make any required adjustments in order to get a relevant basis for the comparison”.

The taxpayer argued that the comparisons and the adjustments made by the Appeal Board were not representative.

The Supreme Court’s conclusion was in line with that of the Appeal Board. The Supreme Court referred to the OECD Guidelines and concluded that the guidelines can and should be used as a supplement to the GTA Section 13-1, and that there is no conflict between the two. As the court found that insurance policies differ significantly from field to field, it was deemed acceptable to use other captive insurances (i.e. controlled transactions) on the same petroleum field as comparables.

With respect to transfer pricing methodology, the court stated that the OECD Guidelines cover several methods but that none of these methods was directly applicable in this particular case. The court then stated that in such a situation, the OECD Guidelines must be ‘adapted’ to the specific situation. Thus, the Supreme Court accepted that the Appeal Board had determined an arm’s-length insurance premium using a combination of several methods as well as its own discretionary judgment.

Financing of subsidiaries

In the nineties several cases regarding Norwegian parent companies’ financing of foreign subsidiaries were decided upon. The key issue was to what extent the Norwegian parent company and lender should charge interest on formal loans granted to foreign subsidiaries or whether the loans could be deemed as equity.

The first question is whether the capital injection represents a loan or equity. Based on a Ministry of Finance position from 1995 and the result from the court cases, the taxpayer’s actual treatment in the statutory accounts will be an important factor – even if it is not entirely decisive.

If it is established that the capital injection in reality represents a loan, the next question is whether (and to what extent) the foreign subsidiary would have been able to borrow money in the market, based on the subsidiary’s actual financial position (i.e. whether the subsidiary has borrowing capacity). To the extent the subsidiary has borrowing capacity; the Norwegian parent company will have to include interest income from the foreign subsidiary in its tax accounts.

In 2010 the Norwegian Supreme court ruled in the Telecomputing case. The Norwegian company Telecomputing had provided loans to a US subsidiary. The subsidiary had paid interest on the portion of the loans that was considered to be within the subsidiary's borrowing capacity. The part of the loan exceeding this borrowing capacity did not yield any interest. Later the entire loan was converted to equity, triggering a loss for the parent company. The parent company claimed tax deduction on the entire difference between the nominal value of the loan and the assumed fair market value of the shares. The tax authorities claimed that the portion of the loan exceeding the borrowing capacity should be characterised as equity, and that the deduction for the equity portion should be denied. The Supreme Court ruled in favor of Telecomputing, accepting that the total amount was to be characterised as a loan. Based on the Supreme Court ruling, the characterisation of nominal loan amounts will have to be based on an assessment of whether the loans – or the portion of the loans – predominantly resemble a loan arrangement or an equity arrangement. Lack of borrowing capacity for the borrower will not necessarily imply that the provided funds should be characterised as equity.

In the Bayerngas Norge AS case from March 2012 the lower court considered whether the interest margin on two intra-group loans were arm's length. The credit rating was a key factor. The court concluded that in the specific case it would be correct to base the rating on the companies Stand Alone Credit Profile and to 'notch' this up base on the group affiliation rather than to 'notch' down the parent company credit rating. The key question for the court was to what extent implicit parent company guarantees from the parent company impacts the credit rating. The court considers and determines the implicit support based on the specific fact pattern in the case. Certain factors are emphasised: Strategic importance, percentage of ownership, management's control, plans and attitudes, shared name, jurisdiction, mutual sources of capital, potential risk, history – support in other cases, parent company's capacity to provide support, ratio between investment and debt in subsidiary, and other owners. In the decision the court concludes that the stand-alone credit rating for the specific borrower could (at the best) be notched up 4 notches because of the implicit support. The judgment was not appealed and is legally binding. The decision is thorough and should be taken into consideration when assessing the credit rating of a Norwegian subsidiary.

Intra-group charges

In 2002, the Court of Appeals decided in the '3M case' on the tax deductibility of charges for inter-company services. The decision was appealed, but the Supreme Court dismissed it.

3M had for several years charged its local sales companies, including the Norwegian sales company, a license fee for various inter-company services and use of trademarks. The license fees ranged from 2% to 5% of actual turnover in each single sales company.

The Norwegian tax authorities disallowed the deduction for the license fees, as 3M Norway AS was deemed not to have provided sufficient documentation for services received. The tax authorities also charged 3M Norway a penalty tax, as they were of the opinion that the company had not provided sufficient information.

However, the city court, as well as the appellate court, concluded that the license fee was in line with the arm's-length principle. The court stated that as long as the OECD Guidelines accepted the indirect method for inter-company charges, it would also have to be accepted that detailed documentation could not always be given. In this

Norway

particular case the 3M group's accounting system was not designed to give a detailed breakdown/documentation for the various types of inter-company charges. The court further concluded that there was no doubt that the Norwegian subsidiary had received a number of significant services, and given the fact that the Norwegian subsidiary had shown good financial results over several years it was assumed that a third party also would have been willing to pay the same level of license fee.

In 2010, the Court of Appeals concluded that the Enterprise Oil Norge AS did not provide sufficient transfer pricing documentation to document a tax deduction for intra-group services provided by the foreign parent company. The parent company did not perform other operations than services to its subsidiaries. The Court of Appeals rejected Enterprise Oil Norge AS's tax deductions of NOK 141 million. With respect to the documentation requirements, the Court of Appeals stated: "The documentation requirements must depend on the actual circumstances of the situation, especially the reason why it may be necessary with further information. ... The OECD Guidelines should not be understood in a way that estimates, valuations or examples of services are sufficient to fulfill the documentation requirements." It should be noted that the calculation method for the costs related to the intra-group services was complicated. The court further emphasised that the company had not in a sufficient manner documented which activities were performed. The uncertainty that therefore was created was used against the taxpayer. The Norwegian Supreme Court did not admit the case, and the decision in the Court of Appeals is legally binding.

In recent tax audits, especially following the introduction of the specific transfer pricing documentation requirements, the Norwegian tax authorities tend to demand that a Norwegian service recipient documents its benefit from inter-company services in quite extensive detail.

Business restructuring – transfer of intellectual property

In September 2007, the Court of Appeals issued its verdict in the Cytec case. (Cytec's appeal to the Supreme Court was dismissed in January 2008). Cytec Norge AS (Norway) was originally a full-fledged manufacturer that was changed into a toll manufacturer in 1999. The customer portfolio, technology, trademarks and goodwill were apparently transferred to the related entity, Cytec Industries Europe (the Netherlands), free of charge. The appellate court found that Cytec Norge AS held intellectual property rights of considerable value prior to the 1999 restructuring, and that the Norwegian entity should have received an arm's-length remuneration for the transfer of these rights to the related Dutch entity. Hence, the court accepted the Norwegian tax authorities' calculation of such remuneration and the increased income.

Business restructuring – sale of shares

The Oslo District Court ruled in 2009 in the Tandberg ASA case regarding transfer of shares held by a Canadian group entity. The shares were sold to the Norwegian parent company, Tandberg ASA. In connection with the transaction, Tandberg ASA claimed losses for a write-down on a loan to the Canadian entity. The tax authorities challenged the loss, and also increased the taxable income of Tandberg ASA based on an assumption that the shares had been transferred at a lower than fair market value that represented taxable dividend.

Although the court ruled in favor of Tandberg ASA it is worth noticing the strong criticism by the court due to the fact that Tandberg ASA could not present a thorough valuation performed at the time of the transfer. The court clearly stated

that valuations performed at a later time could not be given the same weight as a contemporaneous valuation.

Principal models – commissionaire models and limited risk distributors

The Supreme Court delivered its decision on 2 December 2011 in the ‘Dell case’. The Irish company, Dell Products Ltd., had a commissionaire agreement with the Norwegian group company, Dell AS. Dell AS marketed and sold Dell products in the Norwegian market in its own name but for the risk and account of Dell Products Ltd.

The Appellate Court ruled – in line with the District Court – that Dell AS was in fact a dependent agent for Dell Products Ltd. with reference to article 5.5 of the Ireland-Norway income tax treaty of 2000. An important question in the case was whether Dell AS had the ‘authority to conclude contracts in the name of’ Dell Products. In the Norwegian version of the tax treaty, the phrase for ‘in the name of’ reads ‘på vegne av’, which literally translates to ‘on behalf of’. Based on its own interpretation, the Appellate Court developed its own test in order to conclude whether this was the case. The judgment resulted in some considerable debate and discussion on the international tax arena.

The Supreme Court found, in a very clear and unanimous judgment, that the Dell AS acting as a commissionaire did not create a permanent establishment for the non-resident principal Dell Products. The Supreme Court considered the Vienna-convention, the tax treaty between Norway and Ireland Art. 5 paragraph 5 in Norwegian and English language, the OECD Model Tax Treaty with commentaries and case law with special emphasis of the French Zimmer case from 31 March 2010. The Supreme Court also underlined the fact that that similar commissionaire arrangements are accepted by 15 other jurisdictions, among them Sweden, without any questions being raised related to permanent establishment for the commissionaire.

The conclusion of the Supreme Court was that the competent authorities in the tax treaty had chosen an arrangement where it is decisive whether the commissionaire legally binds the principal. Another criterion, the Supreme Court added, did not have support in the text of the treaty or in the Model Tax Treaty and a different interpretation could create substantial practical and legal technical difficulties. Dell Products won the case and the State had to pay the full costs of the proceedings.

In the June 2012 Appellate Court decision in the ‘VingCard case’, the court recognised the principal model as a business model for tax purposes, including limited risk allocation to the US distributor company. The court pointed out that the US distributor company was left with a limited profit which reflected the company’s role in the transaction, and that it should be possible for group companies to enter into such an agreement. It can be derived from the decision that a transfer pricing model which grants guaranteed return to a foreign distributor (return on sales method with a range) as well as true-up payments including year-end adjustments of the income of the distributor, could be accepted from a Norwegian tax perspective. The decision accentuates the importance of intra-group agreements in order to have a legal basis for the risk allocation. The Appellate Court decision is legally binding, as it was not appealed.

Cash pooling/group account system

The January 2010 Appellate Court decision in the ‘ConocoPhillips cash pool case’ provides an indication as to how far Norwegian tax authorities (in this case the Oil

Norway

Taxation Authorities) are prepared to stretch the theory of the arm's-length principle in practice:

Two Norwegian ConocoPhillips companies (in the following jointly referred to as ConocoPhillips Norway) were party to a cash pool arrangement. ConocoPhillips Norway had several accounts in different currencies. The sum of all these accounts constituted ConocoPhillips Norway's net position in the group's cash pool. More than 150 other group companies participated in the cash pool arrangement, and the total of the net positions of all companies constituted a so-called top account, which was placed in Bank of America. ConocoPhillips Norway was consistently in a net deposit position. Although ConocoPhillips Norway was able to document that an alternative standalone relationship with an external bank would have yielded a lower interest income on the Norwegian companies' deposits, the Court of Appeals ruled that in an arm's-length setup, an independent party in ConocoPhillips Norway's (net deposit) position would have received a larger part of the overall benefit of the cash pool arrangement. As a result, a higher interest rate was applied to ConocoPhillips Norway's net deposits for tax purposes, increasing the companies' taxable interest income to Norway. A key element in the appellate court's decision is the theoretical maxim that the arm's-length test shall be conducted by comparing the actual transaction to an otherwise identical transaction in which one imagines that there is no community of interest. The decision is controversial, especially because – as ConocoPhillips Norway unsuccessfully argued – independent parties never enter into such cash pool arrangements. The validity of the Oil Taxation Authorities' (and the Court's) arm's-length test is, therefore, questionable. However, the case was not admitted to Norwegian Supreme Court and the Court of Appeals decision is legally binding.

Intangibles – share of residual return for non-routine functions return

The September 2011 Oslo City Court decision in the Accenture case relates to deductibility of royalties paid by a Norwegian company (Accenture ANS) to a Swiss company (Accenture Global Services GmbH) for the use of intangible assets for the fiscal years 2006 and 2007.

The Tax Office decided that a part of the royalty payment in 2006 and 2007, respectively 44.9 million Norwegian kroner (NOK) and NOK 22.9 million was not deductible costs for Accenture ANS. The total royalty payments amounted to NOK 72.2 million in 2006 and NOK 102.1 million in 2007.

The parties based the royalty payments on a residual profit split method, which left Accenture ANS a base return of 4.45% of sales and Accenture Global Services GmbH the excess return of 7% of sales (only relevant if the surplus exceeded the base return). Benchmarking analyses supported the rates. In case the company's earnings exceeded the base return and the maximum royalty of 7%, any excess amounts were allocated to Accenture ANS.

In essence, the decision relates to the application of the residual profit split method and the distribution of the residual. The Norwegian tax authorities argued that the excess earnings (above 4.45%) occur as a combination of valuable intellectual property (IP) owned by Switzerland, and the use and development of the IP by Accenture ANS. Hence, as Accenture ANS performed non routine functions, it should be compensated with a share of the residual return that the group generated through its activities in Norway. Oslo City Court ruled in favor of the tax authorities. The judgment is appealed.

Attribution of income to permanent establishment – oil service industry

The Supreme Court decided on the attribution of income to a deemed permanent establishment of a Swiss company, Allseas Marine Contractors S.A. (AMC) on the Norwegian Continental Shelf in its June 2011 decision. As the double taxation treaty between Norway and Switzerland does not cover the Norwegian Continental Shelf, the decision is based solely on Norwegian domestic tax law. The court concluded that the gross income earned by AMC from the contract with the oil company for pipe laying services should be subject to taxation in Norway. The court did not accept the argument that the PE was to be considered as a service provider to the head office, which should be remunerated on a cost plus basis. Legal theorists and practitioners criticize the judgment. There are strong arguments to support a different outcome in case the OECD principles for attribution to permanent establishments are applied due to a tax treaty.

Burden of proof

The authorities carry the burden of proving that there is due reason to believe that income charged to tax in Norway has been reduced because of Transfer pricing. They must also demonstrate that such transactions took place with a related party.

Once the authorities have discharged this burden, if the related party is resident outside the EEA, Section 13-1 of the GTA assumes that the relationship is the reason for the income reduction and puts the onus of proving otherwise onto the taxpayer. However, a key Supreme Court case (Baker Hughes 1999) makes the following statement:

“Use of the GTA Section 54 (now GTA Section 13-1) will under any circumstances require that it is more likely than not that the income has been reduced”.

In Dowell Schlumberger, a 1995 Supreme Court case, the question of the obligation placed on taxpayers to cooperate with the authorities was tested. The case concerned deductions due in respect of payments to a related (captive) insurance company resident outside Norway.

The authorities argued that they required access to accounts and other information concerning the offshore company relevant to the question of whether it actually carried on the business of insurance. As the company had not provided such information and therefore had not substantiated its tax deductions, the court ruled that no tax deduction was allowed for insurance premiums paid. The court rejected claims that the information requested amounted to business secrets and, therefore, ought not be disclosed.

Tax audit procedures

Selection of companies for audit

Companies or groups might be selected for transfer pricing audit in several ways, and there is no specific guidance on how to select companies for an audit. An audit might be of a general nature such as an audit of the company as such (i.e. a combination of various tax issues), or the tax authorities might audit specific issues/areas.

Norway

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Under the Tax Assessment Act, the tax authorities have extensive powers to collect information relevant to settling the tax liabilities to Norway as well as to the level of income subject to Norwegian taxation. The authorities may request any information they believe to be relevant to the point in question, including information on the profitability and functions of all parties in a value chain.

There is also a general obligation on taxpayers to substantiate their tax position and to cooperate with the authorities in the provision of information relevant to deciding their tax liabilities.

If the taxpayer does not submit the requested information or does not cooperate in the provision of information, as in the Supreme Court case of Dowell Schlumberger (see Burden of proof, above), the tax authorities may base an assessment on the available facts.

The audit procedure

Investigations are conducted using correspondence, interviews and site visits, as appropriate. Once the investigation has been undertaken, the authorities complete a report that indicates any areas in which they disagree with the taxpayer. They then make proposals for a revised assessment. The taxpayer responds to this report in writing, rejecting any arguments or conclusions of the authorities with which she/he disagrees. Any supporting documentation is included in this response. The authorities then review the position in the light of the taxpayer's response and notify the taxpayer of their decision.

Audit period

The tax authorities may go back ten years but usually the audit period is three years. However, if correct and sufficient information has been provided in the tax return, the tax authorities may only change the assessment in disfavor of the taxpayer for the two previous years.

Revised assessments and the appeals procedure

If the taxpayer disagrees with the decision of the tax authorities, she/he may appeal to the appropriate Tax Appeal Board. For companies taxed by the Oil Taxation Authorities, there is a special appellate board for petroleum tax.

If the taxpayer disagrees with the appellate board's decision, she/he may take the case to court. Norway has three levels of courts (city/district court, Court of Appeals and Supreme Court) but no specialised tax court.

Additional tax and penalties

Norway uses an additional tax (penalty tax), which may be charged administratively under the Tax Assessment Act. The standard rate is 30% (rates of 45% or 60% may be used) of any tax not levied as a consequence of errors made by the taxpayer. Penalty tax is generally not used where the tax issue arises from different interpretations of laws and regulations. However, in situations where the taxpayer is or should be aware that the tax situation is uncertain, sufficient information about the transaction should be filed as a part of the tax return in order to avoid use of penalty tax. Ordinary interest

for late payment of tax also will be charged. Penalty tax is not tax-deductible. Basically, penalty tax is levied on a strict objective basis.

Resources available to the tax authorities

The Norwegian tax authorities are divided into five regions (North, East, South, West and Mid-Norway), which include several local tax offices. In addition, there are three central tax offices: the Central Tax Office – Foreign Tax Affairs (part of Tax West), the Central Tax Office for Larger Enterprises (part of Tax East), and the Oil Taxation Office. There is also the Tax Directorate, which is a central tax authority.

The central tax offices have a high level of competence and resources, and often pursue aggressive positions in transfer pricing cases. The local tax authorities often have limited resources and are usually not in a position to handle an extensive transfer pricing investigation, although there has been a development with larger resources allocated to the local tax authorities. On a regional basis, the resources are considerably larger, and in addition, the Tax Directorate often investigates transfer pricing issues and supports/assists the local tax authorities.

It is worth noting that the resources targeted at transfer pricing have increased considerably and are likely to be increased further over the coming years. It also should be noted that the tax authorities within the past few years have used a significant amount of resources in developing various IT solutions. As a result, it is easier for the tax authorities to extract relevant information and also to follow up more closely with respect to transfer pricing issues.

Use and availability of comparable information

Use

Where the taxpayer is involved in the offshore oil industry, Norway has specific legislation that deals with the pricing of petroleum (Petroleum Tax Act) for tax purposes, as noted above (see Other regulations).

In respect of all other commodities and services, the brief provisions of Section 13-1 of the GTA lay down the arm's-length principle and its application and as mentioned above there is a reference to the OECD Transfer Pricing Guidelines.

Availability

Basically, the published annual accounts of companies are the only information available in Norway about the businesses of third parties. For some business sectors, statistical data concerning gross profits is also published, but this is not detailed to the degree of discussing individual companies. Some tax offices also issue a yearly overview of the tax assessment on an anonymous basis.

A potential problem in this area is the fact that the tax authorities may compare data/pricing used by other taxpayers, without being able to give any detailed information regarding the data the taxpayer is compared against (hidden comparables). Thus, in such situations a taxpayer may find it difficult to prepare an appropriate defence.

Benchmarking

While Norwegian tax authorities previously were skeptical towards benchmark studies in general, they now vigorously test benchmarks supplied by taxpayers and also carry out own benchmarks. Due to the financial crisis from 2008 it is to be expected that

Norway

benchmarks which rely on companies in Greece, Italy, Portugal and Spain will be subject to specific scrutiny.

The Appellate Court's decision from June 2012 in the Vingcard case is of interest also from a benchmarking perspective. The Appellate Court accepts a true-up payment to an US sales subsidiary based on the application of the TNMM method where the target return on sales margin is supported by a benchmark study. The court dismisses allegations from the tax authorities to the benchmark study, including that the comparables do not operate in the same industry as the tested party. The court assumes that no independent entities operate in the same industry as the tested party and that the comparables can be used as a representative range. Most important, the decision ensures a clear case law basis for the acceptance of the TNMM and benchmark studies for Norwegian tax purposes. At the same time, based on the decision, extraordinary circumstances related to the business of the tested party (affecting income and/or costs of the company) must be considered when applying the TNMM method. If not adjusted for, such circumstances may lead to lack of comparability and hence affect the arm's-length nature of the applied method.

Risk transactions or industries

The Transfer pricing focus in Norway is on a wide range of topics such as the financing of business operations (thin capitalisation and interest levels), on intra-group service arrangements, distribution, agency and commissionaire arrangements, intangibles attribution of income to permanent establishments, etc.

In two cases, the Tandberg case (District Court March 2009) and Dynea case (Appeal Court June 2009), Norwegian tax authorities aggressively pursued their claim that inter-company share prices were not arm's length, and in a third, the Telecomputing case (Appeal Court October 2009), they similarly challenged the calculation of loss on an inter-company receivable. Although the taxpayer prevailed in all of these cases, the fact that they were tried before the courts is a strong indication of Norwegian tax authorities' general aggressiveness on transfer pricing and their willingness to go to trial in transfer pricing cases.

Limitation of double taxation and competent authority proceedings

Generally, in order to hinder or limit double taxation, the GTA provides for a tax credit system for direct and indirect foreign taxes paid by a Norwegian taxpayer or its subsidiaries. Tax treaties signed post-1992 generally is based on the credit method. Older tax treaties typically are based on the exemption method.

Double taxation arising due to a transfer pricing issue often will have to be handled through a competent authority process. The competent authority in Norway is the Ministry of Finance. The authority for specific cases is, however, delegated to the Tax Directorate.

Advance pricing agreements (APAs)

As of yet, there are no general formal APA procedures enacted in Norwegian legislation. There is one specific exception, however: Transactions involving the sale of gas may be covered by APAs in accordance with the Petroleum Tax Act Section 6 (5).

A general system of binding advance rulings has been introduced, but issues with respect of transfer pricing will not be handled.

There is an increased focus with the tax authorities to achieve and enhanced relationship with taxpayers and requests for advance clearance in transfer pricing cases are frequently welcomed.

Documentation requirements

According to the Tax Assessment Act section 4-12, with corresponding regulations, qualifying taxpayers are obligated to file a high-level statement on the type and extent of all inter-company transactions and outstanding accounts in a standardised form. The form is to be submitted together with the tax return. Taxpayers who own or control at least 50% of another entity or are at least 50% owned or controlled by another entity are obligated to file the form unless their total inter-company transactions amount to less than NOK 10 million and the total outstanding accounts amount to less than NOK 25 million.

The tax authorities also may request the taxpayer to present transfer pricing documentation. The documentation shall provide sufficient basis for the tax authorities' assessment of whether the Norwegian taxpayer's inter-company transactions are in accordance with the arm's-length principle. The transfer pricing documentation must be presented to the tax authorities within 45 days after the request. Taxpayers subject to file the high-level statement will also be subject to the transfer pricing documentation requirements, unless on a consolidated basis they have fewer than 250 employees and either a turnover of less than NOK 400 million or a total balance of less than NOK 350 million (excluding inter-company turnover/balance items). Taxpayers subject to a special tax under the Petroleum Tax Act or that are involved in transactions with jurisdictions with which Norway does not have a double tax treaty will be subject to the documentation requirement regardless of the number of employees or the consolidated turnover or balance level.

All inter-company transactions shall be addressed in both the high-level statement and the transfer pricing documentation. It should be noted that transactions between Norwegian entities are also to be covered by the high-level statement and are subject to the documentation requirements. In addition, transactions between a Norwegian PE and its foreign head office shall be covered, as shall transactions between a Norwegian head office and its PE abroad.

If the taxpayer fails to submit the high-level statement and/or the more extensive documentation in accordance with the regulations, then the tax authorities may estimate the appropriate tax. Breach of the regulations covering the high-level statements and documentation may cause the taxpayer to lose the right to appeal a decision and from presenting additional information during a subsequent court case.

Liaison with customs authorities

The tax and customs authorities cooperate with the tax authorities in transfer pricing investigations. While transfer pricing adjustments agreed for corporation tax purposes normally would not be reflected in the returns for customs duty or VAT purposes, there is a high risk that information exchanged between the different authorities might lead to further investigation and adjustments.

Norway

OECD issues

Norway is a member of the OECD and has approved the OECD Guidelines. Traditionally, Norwegian tax authorities have seemingly had a preference for the cost plus method in transfer pricing issues. It has, therefore, often proved difficult to get full acceptance for other methods such as the profit split or the transaction net margin method. However, the tax authorities currently seem to be developing a more varied approach, and lately have signaled that they may apply the profit split method.

The GTA Section 13-1 (4) makes reference to the OECD Transfer Pricing Guidelines. These shall 'shall be taken into account'. The reference is to the guidance on the arm's-length principle and the transfer pricing methods. It is also assumed that the reference includes the OECD guidance on business restructuring.

Joint investigations

Norway has in a number of cases been involved in joint transfer pricing investigations with other Nordic countries, and there is nothing to prevent Norway from undertaking joint investigations with the authorities of any other country.

Thin capitalisation

Formerly, specific legislation for companies engaged in the exploitation of petroleum resources on the Norwegian Continental Shelf provided for a debt-to-equity ratio of 4:1, based on the balance sheet in the financial statements. This legislation was repealed effective 1 January 2007.

Norway currently has no statutory rules on thin capitalisation. Thin capitalisation issues are decided based on the general arm's-length standard in the GTA Section 13-1. The equity level is subject to a specific evaluation, and the 20% equity level formerly applied to petroleum companies cannot be considered as a 'safe harbor'.

In a 2004 Court of Appeals decision the Norwegian taxpayer (Scribona) was considered thinly capitalised. When the tax authorities computed how much of the interest deduction should be denied, they based their computation on an equity ratio of 15% of the total capital in the company. In addition, the court confirmed the general view that a thin capitalisation evaluation has to be based on several elements and that the crucial question is whether an independent lender (normally a bank) would have been willing to finance the taxpayer under the current circumstances.

It should also be noted that the Norwegian Company Act has certain requirements regarding the equity level of a company, even if this has no direct relevance for tax.

The Norwegian tax authorities have challenged the capital structure in several leveraged buyout transactions performed by private equity investors in the last few years. As part of the financing of the buyouts, the investors used equity and a shareholder loan in addition to loan financing from third parties. In several tax audits the authorities have claimed that there is no remaining loan capacity beyond the loan financing from third parties. As such, the authorities have not accepted interest on shareholder loans as tax deductible. It should be noted that some of these cases have been subject to settlements with the authorities during the audit process.

56.

Oman, The Sultanate of

Introduction

Although the Omani tax law does not have detailed transfer pricing regulations, it does have provisions which imply that transactions between related parties should be conducted in a manner that is consistent with the arm's-length principle. It is expected that these provisions would allow the Secretary General for Taxation (Secretary General) to re-allocate revenues and expenses in transactions between related parties so as to reflect the returns that would have resulted if the parties were independent or unrelated. Finally, the Secretary General may use its discretion to examine a taxpayer's records and to request underlying documentation. As such, the Secretary General can scrutinise related-party transactions, re-allocate/adjust revenues and expenses, disregard transactions, and/or reclassify a transaction whose form does not reflect its substance.

Statutory rules

Tax law

In May 2009, Oman issued a new tax law, the Royal Decree No. 28/2009 (the Omani Tax Law), which was effective from tax year 2010. The Omani Tax Law had provided for the Minister responsible for Financial Affairs to issue Executive Regulations. In early 2012, the Executive Regulations were finally published to take effect from 1 January 2012 and to apply to all accounting years ending after January 1, 2012. These Executive Regulations shall be considered an inseparable part of the Omani Tax Law and they provide clarifications and specify guidelines and rules in relation to the provisions of the Omani Tax Law.

Transfer pricing legislation

As such, the Omani Tax Law contains no detailed transfer pricing rules or guidelines. However, transactions between related parties and the arm's-length principle are explicitly addressed in the Omani Tax Law.

Related parties

Articles 125, 132 and 133 of the Omani Tax Law provide that a company is deemed as being related to another company if that first company has a control over the other company or both the company and the other company are controlled by a common third party.

These articles elaborate further that a company is deemed as controlling the other company if it has a direct or indirect control over the commercial and business matters of the other company including in the following situations:

- The first company has a greater share of the capital or voting rights (than the other shareholders) in the other company.

Oman, The Sultanate of

- The shareholding of the first company in the other company entitles it to receive the largest portion of the income distribution when the other company distributes its total income.
- The shareholding of the first company in the other company entitles it to receive the largest portion of the distributed assets upon termination or dissolution of the other company.

Intercompany transactions

The Omani Tax Law and the Executive Regulations do not expressly define intercompany transactions. However, Article 125 of the Omani Tax Law implicitly refers to intercompany transactions as transactions entered into by related parties.

Transfer pricing methods

Neither the Omani Tax Law nor the Executive Regulations explicitly define specific transfer pricing methods, nor does Oman currently have separate transfer pricing guidelines.

Tax rates

The Omani Tax Law seeks to tax worldwide income of companies incorporated in Oman and the Omani source income of branches and other forms of permanent establishments. Applicable income tax rates are:

Taxable Profits in Omani Riyals (OMR)	Rate (%)
First OMR 30,000	0%
For taxable profits over OMR 30,000	12%

The tax rates applicable as per a special provision, to income derived from the sale of petroleum is 55%. However, the tax rates are applied on income as determined by the individual Exploration and Production Sharing Agreements entered into between the Government of Oman and the company engaged in the sale of petroleum. Under these agreements, the government pays the company's share of income tax from amounts withheld from the government's share of production. Therefore, the income tax is not actually borne by the company.

Non-deductible expenses

A number of expenses are non-deductible for Omani tax purposes. Some of the most relevant non-deductible expenses are discussed below:

- Sponsorship fees paid to Omani sponsors are restricted to 5% of net taxable income before sponsorship fees.
- As per Article 57 of the Executive Regulations, charges or expenses allocated from the head office to the permanent establishment in Oman (unless directly identifiable to the activities of the Omani permanent establishment) are limited to 3% of gross income in the relevant tax year (5% for banks and insurance companies, and 10% for hi-tech industrial activities).
- Agent commissions paid by foreign insurance companies which operate in Oman through an authorised agent are restricted to 25% of net premiums collected.
- Provisions in respect of bad debts, stock obsolescence, warranties, and similar types of contingencies are not deductible except at the time of write-off. However, provisions created by licensed banks/leasing companies for bad debts are allowable within the limits approved/required by the Central Bank of Oman.

- Losses arising on sale of investments listed on the Muscat Security Market are non-deductible.
- Any expense/costs which have been incurred to generate income exempt from tax are not allowed as a deduction.
- Amounts paid as tax consultancy or advisory fees, directors' fees, payments of bribes/kickbacks and other illegal payments, and civil fines and penalties are also considered non-deductible.

Payments to foreign affiliates

Payments to group entities/foreign affiliates normally receive in-depth scrutiny from the Secretary General. In order to be prepared for such scrutiny, taxpayers would be advised to maintain appropriate documentation in order to establish that these transactions were entered into on an arm's-length basis.

Withholding taxes (WHT)

Omani sourced income earned by foreign companies that do not have a permanent establishment in Oman (of the below categories) for tax purposes are subject to WHT at the rate of 10% of the gross income from such sources:

- Royalty.
- Consideration for research and development (R&D).
- Consideration for use of or right to use computer software.
- Management fees.

Such WHT is required to be withheld by the Omani company and paid to the Secretary General within 14 days of the end of the month in which tax is deducted or payments are due or made to the foreign company. There is no WHT payable on dividends and interest payments.

Branch income

Branches of foreign entities are subject to tax at the rate of 12% on income over 30,000 Omani rial (OMR). As specified by Articles (56) and (57) of the Executive Regulations, expenses incurred by the head office that can be identified as directly related to the branch's activity are deductible. The deduction for other head office expenses is limited to 3% of the branch's gross income for the year (5% for banks and insurance companies, and 10% for hi-tech industrial activities).

Thin capitalisation

The Executive Regulations specify a requirement for the debt equity ratio not to exceed 2:1 before a deduction can be claimed in respect of interest on loans from related parties. This provision does not apply to interest costs incurred by banks and insurance companies, permanent establishments of foreign companies and proprietary establishments.

In case of permanent establishments of foreign companies, the requirements for interest on related party loans to be deductible are:

- The head office should have obtained a loan from an unrelated third party for the benefit of its permanent establishment.
- The loan should be utilised by the permanent establishment to finance its activity.

Oman, The Sultanate of

In case of permanent establishments of banks, the loans should have been provided by the head office (or any person controlled by the head office) based on arrangements concluded by the head office and the permanent establishment on an arm's-length basis. Such loan should not be utilised by the permanent establishment to raise its capital required to be maintained under the Omani Banking Law.

In case of sole proprietary establishments, the loan provided by the proprietor should have been obtained from banks registered in Oman and such loan should be utilised to finance the activity of the establishment and not for the purpose of raising the capital.

Legal cases

No specific transfer pricing cases have been brought in Omani courts. However, summarised below are a few insights, based upon our experiences with the Secretary General:

- All inter-company payments are scrutinised in detail to ensure that the profits are not transferred to avoid payment of tax.
- In the absence of any detailed transfer pricing guidelines in Oman, it is difficult to anticipate which transfer pricing method would be an acceptable method from the perspective of the Omani tax authorities. Often the most widely accepted methods (such as the ones specified by the OECD Guidelines and widely accepted by several countries) may not be accepted by the Omani tax authorities.
- The reaction of the Omani tax authorities to the acceptability of any transfer pricing method can therefore said to be almost arbitrary and taxpayers can expect a fair amount of uncertainty around whether a particular method may be considered acceptable by all tax inspectors (i.e. a method that may be accepted by one tax inspector may not necessarily be the method of choice of another tax inspector).

Burden of proof

Given the absence of transfer pricing guidelines with specific transfer pricing provisions (including delineation of specified transfer pricing methods), there are no specific rules regarding burden of proof. However, taxpayers are expected to produce sufficient transfer pricing documentation (and other supporting documents, including intercompany agreements, schedules and invoices) to support their declared transactions on the tax return. But there is uncertainty around what constitutes acceptable transfer pricing documentation to the Omani tax authorities.

Tax audit procedures

Tax returns

The tax year is usually the calendar year. Taxpayers can choose to file their tax returns on the basis of a year-end other than 31 December, provided permission is granted in advance by the Omani tax authorities and the year-end is consistently adhered to by the taxpayer.

A provisional declaration of tax must be submitted in the prescribed form within three months from the end of the accounting/tax period to which it relates. The final annual return of income should be submitted in the prescribed format within six months from the end of the accounting/tax period to which it relates. Reasonable time extensions can be sought and are normally provided for filing the provisional and annual returns of income, but these do not defer payment of tax, which will be subject to additional tax at the rate of 1% per month from the due date to the actual date of payment.

In the case of companies having a paid-up capital in excess of OMR 20,000, the annual return of income should be accompanied by audited accounts (drawn up in accordance with IFRS) signed by an auditor registered in Oman.

Penalties and interest

The Omani Tax Law confers wide powers on the Secretary General for requesting information. Based on experience, notwithstanding the presentation of audited accounts, we are aware that the tax department requests very detailed information and supporting documentation relating to revenue and expenses. Failure to provide such information or the provision of incorrect information can result in an additional assessment by the Secretary General and/or various penalties on the company and/or the officer responsible for providing the information.

Delay or failure in submitting the provisional or annual returns may attract a penalty of not less than OMR 100 and not more than OMR 1,000. Failure to file the provisional or annual returns of income may result in an estimated profit assessment by the Secretary General. Failure to submit audited accounts as required under the Omani Tax Law is deemed to result in an incomplete annual return of income and may attract an estimated profit assessment.

Failure to pay taxes by the due date attracts interest at the rate of 1% per month from the date on which such tax was due to the date of payment. The difference between the amount paid and the amount assessed, subject to filing of an objection, should be paid within one month from the date of the assessment. The additional amount assessed attracts interest at the rate of 1% per month from the date on which such tax was due to the date of payment.

Under the Omani Tax Law, the Secretary General has the authority, with the approval of the Minister and the Tax Committee, to sequester and sell the assets of a taxable entity to recover the taxes due. If decisive proof is presented to the Secretary General that any person has paid tax for any year exceeding the tax due and payable for such tax year as finally settled, such person has the right to recover the tax. However, if any tax has become payable by such person in respect of another tax year, the excess amount will be adjusted against the future tax liability. Any request for recovery must be presented within five years from the end of the tax year to which it relates. Where the taxpayer fails to declare correct income in the tax return for any tax year, the Secretary General may impose a fine not exceeding 25% of the difference between the amount on the basis of the correct taxable income and the amount of tax as per the return submitted.

Assessments and appeals

The Secretary General has a period of up to five years from the end of the year in which a tax return is submitted to complete the assessment for that tax year. However where the company has not submitted any tax return, the tax authorities have a period of ten years to complete the assessments.

Objections to appeals

A taxpayer has a right to object to any assessment issued by the Secretary General. The objection document should be prepared in writing (in English and in Arabic) and filed with the office of the Secretary General within 45 days from the date of assessment. The Secretary General is required to give a judgment within five months, extendable up to another five months at the Secretary General's discretion, from the date of

Oman, The Sultanate of

receiving the objection. The tax demanded may be kept in abeyance on request. No additional tax is payable until the Secretary General issues the judgment.

Use and availability of comparable information

Given the absence of transfer pricing guidelines, Oman has no specific rules regarding comparable information.

Tax treaty network

Oman has entered into double-tax treaties with a number of countries which provide for reduced rates of WHT. There are also agreements which are still being finalised or awaiting the ratification process. These countries together include Algeria, Belarus, Belgium, Brunei, Canada, China, Croatia, Egypt, France, India, Iran, Italy, Korea, Lebanon, Mauritius, Moldova, Morocco, Netherlands, Pakistan, Russia, Seychelles, Singapore, South Africa, Sri Lanka, Sudan, Sweden, Switzerland, Syria, Thailand, Tunisia, Turkey, United Kingdom, Uzbekistan, Vietnam and Yemen.

57.

Peru

Introduction

In January 2001, the Peruvian income tax law (PITL) introduced transfer pricing rules governing transactions between related parties (domestic and international), as well as transactions with entities operating in tax havens¹. These rules are applicable for transactions with all kinds of goods and services.

The rules currently governing Peruvian transfer pricing are set forth in Articles 32 and 32(A) of the PITL as amended in 2003, and Chapter XIX of the regulations, published in December 2005 and effective as of January 2006 until December 2012. Also in 2012, in the context of a broader tax reform, some changes were introduced to these rules which will be effective from January 2013.

The modifications introduced in 2012 have made changes in the scope of application of the rules, the adjustments required, and to some other obligations under the law.

Penalties are established in the Peruvian Tax Code. Article 32 of the PITL establishes the arm's-length principle. In addition, the PITL sets forth the obligation for qualifying taxpayers, which includes annually filing an informative return describing transactions carried out with related parties or parties resident in low-tax jurisdictions (tax havens); preparing a transfer pricing study; and keeping supporting documentation.

Statutory rules

Arm's-length principle

The PITL establishes that all transfers of goods and services must be carried out at fair market value. According with the PITL, fair market value is the price that is normally obtained by the same entity when engaging in transactions with nonrelated parties under the same or similar conditions. If such comparable transactions (internal comparables) are not available, then the fair market value will be established by reference to prices agreed upon between two unrelated parties for the same or similar transactions.

Scope of application

According to the PITL as amended in 2003 and effective until December 2012, the transfer pricing rules must be applied when the transfer price used has led to a lower

1 Supreme Decree No. 045-2001-EF established a list of 43 countries that were considered tax havens by the Peruvian Ministry of Economy and Finance. The list is not restrictive, therefore other countries that are not specifically named could be considered. The Tax Authority published Inform No. 178-2009-SUNAT/2B0000, which establishes that when a company pays to a third party through a tax haven (the account is located in the tax haven), even when the third party is not located there, the situation falls within the scope of numeral 4 Article 32 of the PITL, which states that all inter-company transactions that are carried with, from, towards and through a tax haven must be analysed.

Peru

income tax payment than what would have been determined if market value were used². In any case, the rules must be applied in the following cases:

- One of the parties is a resident of a foreign jurisdiction.
- The company has performed transactions with parties resident in tax havens.
- The intervening parties are domestic, and one of them is either an exempt taxpayer (with the exception of the public sector); is subject to a beneficial tax treatment such as an exoneration from income tax; is subject to a special income tax regime (like that for entities in the jungle region); or has in force a contract that guarantees fiscal stability.
- The intervening parties are domestic entities, and at least one of the parties has had tax losses in one of the past six fiscal years.

The transfer pricing rules also must be applied to the value added tax (VAT) and the selective consumption (excise) taxes, except when the adjustment would determine an increase in refundable VAT. Transfer pricing rules are not applicable for customs valuation, where World Trade Organisation regulations apply.

These rules will change from January 2013, when the modifications introduced in 2012 will take effect. In these modifications the requirement of the lower income tax payment is eliminated along with the four cases mentioned. It is only required that a Peruvian taxpayer has entered in a transaction with a related party or a resident in a tax haven in order for the transfer pricing rules to be applicable. Also, the application to the VAT and excise taxes is repealed³.

Transfer pricing adjustments to the taxable base

In the rules effective until December 2012 an adjustment to the taxable base must be performed only to the domiciled taxpayer in Peru. This adjustment will be attributed to the fiscal year when the related party transaction has been performed. Also, it was possible to take in account all transactions performed with a specific related party, whether they have determined a higher or lower tax paid in order to determine in a sum up of all adjustments if a lower tax has been determined by the taxpayer⁴.

From 2013, these adjustments will be attributed to the fiscal year following the attribution rules stated by the law. This means that an adjustment could be divided between several years. In order to evaluate if a lower income tax has been calculated, it must be taken in account the independent effect of each transaction depending on if they were analysed individually or jointly. This means that only those transactions that determine a lower income tax must be taken in account and be adjusted.

Furthermore, if the transaction has been entered with a related party domiciled abroad, the adjustment is applicable to the Peruvian taxable income or the deduction of the non domiciled party. This implies that adjustments are applicable to withholding tax.

2 Regulation also clarifies that tax detrimental occurs, not only when the taxpayer avoids totally or partially the tax, but also when the taxpayer achieves the deferral of the tax from one period to another.

3 It should be noted that the changes regarding the VAT are applicable for 2012 too.

4 According to the report 207-2008 SUNAT, the Tax Authority (TA) concedes that it is possible to use in the calculation of adjustments those transactions that according to the transfer pricing analysis have determined a higher tax paid by the taxpayer in order to evaluate if a lower income tax has been calculated.

Related parties

Two or more individuals, companies, or entities are considered related if one of them participates directly or indirectly in the administration, control, or capital of the other; or if the same person or group of persons participate directly or indirectly in the administration, control or capital of various persons, companies or entities.

In addition, there shall be a relationship if the transaction is carried out using third-party intermediaries whose sole purpose is to hide a transaction between related parties.

The PITL regulations specify, amongst others, the following forms of 'economic relationship':

- A natural person or company owns more than 30% of the capital of another company directly or indirectly through a third person.
- More than 30% of the capital of two or more companies belongs to the same natural person or company, directly or through a third person.
- Companies that have one or more directors or managers in common with full decision-making power.
- When a person, company, or other entity domiciled in the country performs in the fiscal year previous to the one under analysis, 80% of its sales of goods or provision of services to a person or company for whom those sales in turn represent 30% of their purchases during the same period⁵.
- When a person or a company has or exercises 'dominant influence' over the management decisions of one or more companies or entities.
- When companies consolidate financial information.

Transfer pricing methods

Article 32A of the PITL states six transfer pricing methods. Regulations will establish the criteria to determine the most appropriate transfer pricing method for each case.

The following methods are acceptable:

- Comparable uncontrolled price method (CUP).
- Resale price method (RPM).
- Cost plus (CP) method.
- Profit split method (PSM).
- Residual profit split method (RPSM).
- Transactional net margin method (TNMM).

A provision has been added to the CUP method in the amendments of 2012. This provision is applicable when an import or export of commodities or goods with a known price in transparent markets is made to a related party (or an entity domiciled in a tax haven) and there is a participation of an international intermediary that is not the actual receiver of the goods being sold.

It should be noted that this method will not be applicable when:

- the taxpayer has entered in future contracts with the purpose of hedging the risk in the import or export of the goods

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⁵ This fact has to be verified in the average of a three-year period.

Peru

- it is documented that the international intermediary complies with the following:
 - Actual existence in the place of domicile (possessing a commercial establishment where its business is managed, complying with legal requirements for incorporation and registration, as well as for the filing of financial statements). The assets and risk incurred by the international intermediary must be related to the volume of the transactions entered into.

Its main activity should not be to obtain passive income or act as an intermediary in the sale of goods with the members of the group. The main activity will be understood as the one which represented the biggest amount of transactions during the precedent Fiscal Year.

In general terms, the application of the above-mentioned methods is governed by doctrine and by the Organisation for Economic Co-operation and Development (OECD) Guidelines, which now have explicit legislative recognition as source of interpretation in the body of the PITL (always prevailing the PITL). Regarding comparability, the PITL⁶ establishes two general guidelines:

1. Two transactions are comparable as long as none of the differences existing between the transactions compared or between the characteristics of the entities involved may materially affect the price or free market margin.
2. Two transactions may be comparable even if (1) above is not met (i.e. the conditions of the transactions compared are not similar or the same), as long as adjustments can be made (and are made) to offset the effects of such differences.

Informative return

Beginning fiscal year 2006, taxpayers are required to render a TP Informative Return Form if they have carried out transactions with related parties for a value of at least 200,000⁷ nuevos soles (PEN) (approximately 70,200 United States dollars [USD]). By value the law means the sum of the income accrued during the fiscal year and to the acquisition of goods and/or services made during the fiscal year without distinction or netting between positive and negative values, as long as these derive from transactions with related parties. The return has to be filed also by a taxpayer if it has performed a transaction with parties resident in tax havens without exception. The TP Informative Return Form must be filed every year on a date set each year by the TA through the issue of a resolution. From and on 2010, the date has been set in June.

Transfer pricing study

Early in 2001, transfer pricing regulations were passed under the PITL. The regulations established the obligation for taxpayers to keep documentation and information regarding the methods used to determine their transfer prices with related entities. The documentation must emphasise the criteria used to establish transfer prices and any other objective elements relevant to a transaction. A similar obligation was established for taxpayers in connection with their transactions with entities resident in tax havens.

In addition to the TP Informative Return, beginning fiscal year 2006 the taxpayer is obliged to have a transfer pricing study (*Estudio de Precios de Transferencia*) if it has

6 Notice that there is a factual sort of order of preference for method selection that establishes in the first place the comparison of prices, followed by the comparison of gross margins and finally the comparison of operating margins.

7 When calculating, all inter-company loans that accrued an interest rate of zero must not be taken into consideration. However, if all other inter-company transactions exceed the amount set by the TA, the inter-company loans must be informed and documented.

performed transactions with parties resident in tax havens⁸ or if it has transactions with foreign and local related parties for a value greater than PEN 1 million (approximately USD 350,900) and if the revenue accrued from the taxpayer exceeds PEN 6 million (approximately USD 2.110 million). However, in cases where a transfer pricing study is not required, the taxpayer must have information and documentation that prove that transactions with related parties were conducted at an arm's-length value.

Advance pricing agreements (APAs)

The PITL makes expressed reference to the possibility of entering into advance pricing agreements. The amendments made in 2012 have included the possibility of entering into APAs for transactions between domiciled parties or between the Peruvian TA and the TA of other countries.

Chapter XIX of the PITL regulations sets forth APA procedures and characteristics. According with the aforementioned regulations, the APA objectives are: to set price, amount of compensation, profit margin, and the transfer pricing methodology supporting the values the taxpayer will use in future operations with related parties or with entities operating in tax havens. The APAs cannot be modified or unilaterally terminated, except when any of the related parties involved in the APA has been condemned by court for tax or customs crimes or if the terms of the APAs are not met.

Under the procedure, the taxpayer proposes the transfer pricing method (TPM), the comparable transactions or enterprises, and the supporting data, including years analysed, adjustments made to the selected comparables, the exact price or range of prices, amount of compensation or profit margin; also the hypothesis used for the proposal.

After reviewing the proposal, the administration may approve it, approve an alternative version, or reject it. The administration will have a 12-month period to review the proposal. If after this period it has not issued a response, the proposal is automatically considered rejected.

The APAs will be applicable to the fiscal year during which it was approved and the three subsequent years.

Burden of proof

The burden of proof lies with the taxpayer. However, a challenge by the TA would require some supporting evidence to be accepted by the tax courts (TC). It is expected that regulations to the recently passed legislation will shift the burden of proof to the authorities if it has an APA and if proper transfer pricing documentation exists.

Tax audit procedures

If a company has been selected for audit, the TA grants several days' notice of the impending audit to the company, requesting that all information be ready for its review. During the audit the taxpayer may informally clarify issues, produce evidence to support facts and discuss tax issues with the auditors. After the audit, the TA may or may not issue an assessment. If it does, the taxpayer may file an appeal if it does not agree with the assessment. If transfer pricing documentation was requested during

⁸ The taxpayer must take into consideration that all expenses accrued with a tax haven that are not recognised in the cost of goods sold must be included in the taxable income. Even though it's contradictory, all expenses must be informed and analysed for transfer pricing matters.

Peru

the audit and was not provided, the documentation may not be presented during an appeal, unless the full amount of taxes assessed is either paid in advance or the debt is bonded. The attitude of the Peruvian TA generally is considered aggressive, although, so far, it is only beginning to focus on transfer pricing issues. No settlements are possible in the course of the audit or later. As of 2012, there have been audits specific to transfer pricing, but we are not familiar with the outcome of the procedures.

It must be taken into consideration that the TA has used information submitted to customs related to the prices of the goods in order to calculate differences in the taxable income.

Additional tax and penalties

Each transfer pricing violation is penalised, based on the Tributary Tax Unit, called *Unidad Impositiva Tributaria* (UIT). For 2011, one UIT is PEN 3,600 (approximately USD 1,270). The following constitute violations of the related transfer pricing obligation:

- Not keeping the documentation and information, reports, and analysis related to the operations that could create tax obligations during the period of time of the obligation will result in a penalty of 0.3% of the net income; it may not be less than 10% of a UIT or greater than 12 UITs.
- Not providing the TP informative return according with the deadline set by the law will result in a penalty of 0.6% of the net income; it may not be less than 10% of a UIT or greater than 25 UITs.
- Not exhibiting or presenting the documentation and information that supports the calculation of transfer prices according to law will result in a penalty of 0.6% of the net income; it may not be less than 10% of a UIT or greater than 25 UITs.
- Not counting with the documentation and information that supports the calculation of transfer prices according to law will result in a penalty of 0.5% of the net income. (When the penalty is calculated over the annual net income it may not be less than 10% of a UIT or greater than 25 UITs.).
- Any adjustments to transfer prices as a result of information omitted in tax returns will automatically trigger a penalty equivalent to 50% of the taxes imposed on the adjustment.

In case a company has several transactions with a related party, the TA must take into account all the transactions made between the companies and not limit its analysis to only transactions made beneath market value.⁹

Legal cases

The following are some important TC rulings regarding the prices for transactions:

- In the case of Lamitemp SA (a company specialising in the sale of glass), the TA considered there was an undervaluation of sales in two of the company's business lines due to the fact that the cost of sales for some months was above the sales value and because there were discounts of 40% granted to a single client. The TC decided that market value does not necessarily have to be above the cost, a situation that can derive from technological factors, higher financial costs in comparison with other companies, and access to market of raw materials, amongst

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9 According to Inform No. 208.2007-SUNAT/2B0000, published by the TA.

others. Thus, what should have been done is to prove that market value was above that considered by the company. Finally, in order to deny the discounts granted, the TC stated that the TA should have verified that these were not granted to other clients, that it was not a usual practice or that they did not correspond to the volume of items bought or payment conditions. Therefore, it cannot be argued that the discounts do not comply with current legislation.

- In a case against Aceros Arequipa SA (a company dedicated to the smelting and commercialisation of steel), the TC confirmed the adjustment made to discounts granted to clients for achieving certain volume goals. The TC stated that for such discounts to be valid, they must be offered to clients complying with certain criteria (general principle) and should be granted uniformly. However, the company did not grant the discounts to certain clients that did meet their criteria but did grant them to other clients that did not. Thus, the deduction of all discounts was denied.
- The Peruvian TA, based on a valuation report found during the audit process, pointed out that the company Hotel Macchu Picchu SA had undervalued the sales price agreed for the transfer of the right to use the hotel unit, which included assets and/or furniture. The company argued that the transfer value used corresponded to the valuation report with a minimum reduction of 1.1564%. The TC considered that the company should have used the value set forth in the valuation report with no adjustments.
- In a case against a company dedicated to the renting of helicopters, the TA challenged the comparables selected in the transfer pricing study. The company rendered transport services to its related party and to an independent party, so the TA considered that an internal comparable existed. The company's counterargument was that the services were not similar, due to the differences in the types and heights of the flights performed with the related and the third party. The TC is still evaluating the case.
- In the case against a company that distributes technology products, the TA disqualified the reclassifications of accounts made by the company in order to analyse the imports from related parties. The company maintained its position obtained a report from a third party accounting expert to support it. Additionally, the TA modified the sample of comparable companies, as they did not agree with the qualitative filters applied.
- In a case against a glass distributor, the TA questioned the TP method used for the analysis of imports of glass from related parties. They considered that the RPM should be applied. Nevertheless, the company argued that the appropriate method was the TNMM as a gross profit evaluation would require some adjustments to account for the differences in the classification of costs and expenses between the company and the comparable companies.

Resources available to the TA

There are special units being trained within the Peruvian TA in order to deal specifically with transfer pricing issues. At present, transfer pricing issues are being dealt with by the Peruvian tax inspectors mainly during the course of a general tax audit and at a smaller and more incipient level by the transfer pricing unit. Since the beginning of fiscal year 2010, the transfer pricing unit sent out several information requests to a substantial number of companies, these actions continue in 2011.

Use and availability of comparable information

Neither the law nor the regulations have established criteria as to which are the acceptable sources for comparable information. According to the Tax Code, the TA

Peru

could use third-party confidential information; however, the Peruvian Tax Court in its resolution N°02649-5-2006 indicated that in case a company has internal comparables the TA should consider them as a source of information.

If the TA uses third-party information, the taxpayer has limited access to this data through only two nominated representatives. Nevertheless, it is understood that the authorities should only use publicly available information; otherwise, constitutional rights to due procedure and defence could be violated. Due to the limited amount of local public information on comparable transactions, the use of foreign comparable transactions is acceptable; in this case, necessary adjustments should be made. Article 32 of the PITL explicitly establishes that in order to determine comparable transactions and, in the event that there is no locally available information, taxpayers are allowed to use foreign companies' information, provided that the necessary adjustments are made to reflect market differences. Said provision puts an end to the problem of having very little information available in countries where the financial market is underdeveloped, and, therefore, the access to public financial information of companies is very limited.

Furthermore, specific information on local industries can be obtained from a number of industry associations, such as the *Sociedad Nacional de Industrias* for the manufacturing industry, *Sociedad Nacional de Minería, Petróleo y Energía* for the energy, mining and oil industry, *Asociación de Exportadores* for the exports trade, the *Superintendencia Nacional de Bancos y Seguros* for the banking industry, *Asociación Nacional de Laboratorios Farmacéuticos* for the pharmaceutical industry, *Cámara Peruana de la Construcción* for the construction industry, and the *Confederación Nacional de Comerciantes* for the trade industry, amongst others. Membership of these organisations might be required to obtain information. A second possibility for obtaining local comparable information is through the *Superintendencia del Mercado de Valores*, the agency that supervises the stock exchange market and where publicly traded companies file their financial statements.

Also, it's important to mention that the amends made to the PITL in 2012 stipulate the prohibition of the use of comparables in which one of its unrelated parties is related to one of the entities in the intercompany transaction under review.

Risk transactions or industries

There are no transactions or industries excluded from the transfer pricing regulations as set out above.

OECD issues

Even though Peru is not a member of the OECD, the OECD Guidelines are used only to interpret transfer pricing regulations.

Joint investigations

There is no evidence of any joint investigations having taken place in Peru. However, the Peruvian TA may exchange information with other countries for transfer pricing purposes. For example, Peru has a treaty with the US, which provides for the exchange of information.

58.

Philippines

Introduction

The Philippines' statutory transfer pricing rule is patterned after what is now Section 482 of the US Tax Code. It was codified in 1939 and has remained unchanged since. Court decisions have also confirmed that Section 482 of the US transfer pricing regulations can be used as guidance when applying the Philippine transfer pricing rules. The Philippine Bureau of Internal Revenue (BIR) also relies heavily on the Organisation for Economic Co-operation and Development (OECD) Guidelines.

Since 2005, the BIR has begun challenging the transfer pricing arrangements of some taxpayers. These challenges arise mostly from ad hoc examinations during a regular tax audit. BIR auditors are gaining sophistication in this area; they have made significant transfer pricing tax assessments, although these could also be based on a misappreciation of issues. Because of this and the potential issuance of more comprehensive transfer pricing revenue regulations, companies are advised to pay close attention to transfer pricing arrangements when doing business in the Philippines.

Statutory rules

The statutory rule on transfer pricing is found in Section 50 of the National Internal Revenue Code (NIRC). The rule has remained essentially unchanged since 1939, when it was patterned after the transfer pricing rule in the US Revenue Act of 1934. Section 50 allows the BIR to allocate income and deductions between related parties as a means to prevent tax evasion or clearly reflect the amount of income earned by each party.

Other regulations

The only formal regulations for transfer pricing are found in Section 179 of Revenue Regulations No. 2, issued in 1940. These regulations were drawn directly from Article 45 of US Regulation 86, issued in 1935, and details the scope and purpose of the transfer pricing rule – to place a controlled taxpayer on tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.

Additional guidance is provided in Revenue Audit Memorandum Order (RAMO) No. 1-98 and Revenue Memorandum Order (RMO) No. 63-99. The former, issued in 1998, provides audit guidelines and procedures for examining interrelated groups of companies and endorses the use of the OECD Guidelines. The latter, issued in 1999, deals with intragroup loans and broadly follows US Section 482 regulations. Both documents are less authoritative than regulations, but they reinforce the general theme that Philippine transfer pricing rules should be applied in accordance with the arm's-length principle as it is applied internationally.

Philippines

The government plans to issue more detailed transfer pricing regulations, a final draft of which has been in existence since 2006. Due to changes in the BIR leadership, however, these new regulations have yet to get the final approval of the Secretary of Finance to become effective. In the meantime, the BIR has stated through Revenue Memorandum Circular (RMC) No. 26-08, issued in 2008, that it will follow the OECD Guidelines in resolving transfer pricing issues and concerns.

Legal cases

The broad doctrine followed in the Philippines is that when Philippine law is based on an equivalent provision in the US Tax Code, the decisions of American courts interpreting said US provision are entitled to significant weight in applying such Philippine tax laws.

In two Philippine cases relating to transfer pricing, the Court of Tax Appeals (CTA) has taken the doctrine further and allowed the Section 482 regulations to have persuasive effect.

In the Cyanamid case (1995, affirmed by the Court of Appeals [CA] in 1999), the CTA held that the BIR had acted in an arbitrary, unreasonable, and capricious manner when it made no apparent attempt to verify the comparability of pharmaceutical products being compared under a comparable uncontrolled price (CUP) method analysis.

In the Filinvest case (2002), the CTA upheld the imputation of interest by the BIR on an interest free loan. The CTA also required the BIR to allow correlative relief by way of an interest deduction, based on Section 1.482-(1)(g) of the US regulations. Upon appeal, however, the CA reversed this decision, citing that the imputation of interest rule does not apply to alleged indebtedness which is in fact a contribution of capital; the CA appreciated the loan/advances made in the case to be capital contributions. In 2011, the Supreme Court (SC) affirmed the decision of the CA. The SC ruled that the BIR's power to allocate gross income does not include the power to impute 'theoretical interest' because there must be actual or, at the very least, probable receipt or realisation by the taxpayer of the income that is being allocated. In this case, both the CA and the SC also recognised that under Philippine law, interest cannot be imposed unless expressly stipulated in writing.

The same issue on imputation of interest was presented in the Belle Corporation case (2005) where the CTA ruled in favour of the taxpayer, deciding that RMO 63-99 was inapplicable to the facts of the case.

Two other cases decided by the CTA in early 2005, Avon Products and ING Barings Securities, validated the notion that the initial burden to prove that the inter-company pricing complies with the arm's-length principle lies with the taxpayer. However, once proof is provided, the onus shifts, and the revenue authority is supposed to prove that its basis for questioning the taxpayer's policy has sufficient support. Accordingly, in these two cases, the courts ruled in favour of the taxpayers after the BIR failed to produce evidence to refute oral explanations by the taxpayers during the trial proceedings.

Anticipated developments

The BIR has drafted comprehensive Transfer Pricing Revenue Regulations (TPRR) that seeks to consolidate and expand the existing transfer pricing issuances. The provisions in the draft TPRR were heavily lifted from the US TP regulations and OECD Guidelines.

The draft TPRR includes a reiteration of the BIR Commissioner's authority to look at transfer pricing, as well as the bureau's adoption of the arm's-length standard in determining the true taxable income of a controlled taxpayer.

The draft regulations also provide for five methodologies in determining the arm's-length price. The five methods are all accepted internationally. In broad terms, these methods can be grouped into two categories: the traditional transaction method consisting of (1) the comparable uncontrolled price (CUP) method, (2) the resale price method, and (3) the cost plus method; and the transactional profit methods involving (4) the profit split method and (5) the transactional net margin method.

The application of each method depends on the transaction and the circumstances involved; the draft TPRR contains illustrations to show the interplay of the different methods. No hierarchy of methods is provided in the draft regulations, but they do indicate that the method requiring the fewest adjustments and providing the most reliable measure of the arm's-length result is the preferred method.

The regulations also provide more details on the general rules that apply to specific situations, such as loans or advances, performance of service for another, use and sale of tangible property, and transfer or use of intangible property. In all these cases, the concept of comparability, determination of the appropriate transfer pricing method, and the arm's-length principle apply.

The draft regulations provide guidelines for the preparation of documentation to support the transfer price adopted. The BIR requires fairly extensive documentation, including functional and economic analyses of the taxpayer's business and results, as well as benchmarking. Based on the draft TPRR, when the BIR requests transfer pricing documents, the taxpayer must submit them within 45 days of the request.

Although the TPRR still needs to be signed by the Secretary of Finance to become effective, the BIR has already started challenging taxpayers using the provisions of the TPRR. Assessments made to date run into hundreds of millions of pesos, and there is reason to believe that this BIR challenge will continue.

In 2009 and 2010, the BIR specifically mandated the audit and investigation of certain taxpayers, including companies that are interrelated or that form part of a conglomerate. Through the issuance of RMO No. 23-2009 and RMC No. 36-2010, special audit teams under the Large Taxpayers Services and Enforcement Division of the BIR were created and assigned to conduct a simultaneous, joint and coordinated audit and examination of the books of accounts of the identified taxpayers to ensure that these taxpayers are clearly reflecting income and expenses attributable to inter-company transactions.

There are indications that the BIR is conducting structured training for its personnel. In fact, following the release of the Revised OECD Guidelines last July 2011, OECD Transfer Pricing Advisors conducted a briefing for BIR officials on the revised

Philippines

Guidelines and recent international developments in transfer pricing. In view of these developments, taxpayers can expect the BIR to be more knowledgeable on, and to pay greater attention to, transfer pricing in the Philippines.

Burden of proof

As a general rule, taxpayers should be prepared to justify their transactions to the BIR. The NIRC affords the BIR commissioner fairly strong assessment and collection powers. However, the burden of proof shifts to the BIR once the taxpayer is able to demonstrate that its pricing complies with the arm's-length principle, as the 2005 cases of Avon Products and ING Barings Securities demonstrate.

Tax audit procedures

To date, transfer pricing has been raised as an issue only in the context of regular audits by the BIR. A framework does exist, however, for issue-oriented audits to be undertaken.

Based on the fact that the BIR is training its people and the likelihood that regulations will be issued, it seems reasonable to expect transfer pricing-specific audits to occur in the future.

The audit procedures

The tax examination process starts with the issuance of a Letter of Authority by the BIR. This authorises a specific revenue examiner to gather documents and financial information from the taxpayer, such as books of accounts and other accounting records, for the purpose of determining whether the taxpayer has deficiency tax liabilities.

Upon discovery of deficiency tax, the revenue examiner is required to prepare a report stating whether the taxpayer agrees with the findings. If the taxpayer does not agree with the examiner's findings, the BIR communicates the examiner's findings to the taxpayer in writing and offers the taxpayer the opportunity to respond in an informal conference.

If the taxpayer fails to respond within 15 days from receiving the notice from the BIR, or engages in the informal conference but is unable to dissuade the revenue examiner from the examination findings, the case is referred to the Assessment Division of the Revenue Regional Office (ADRRO) or to the commissioner or the duly authorised representative for appropriate review and issuance of a deficiency assessment, if warranted. If the ADRRO determines that sufficient basis exists to assess the taxpayer for deficiency tax, it issues a Preliminary Assessment Notice (PAN) which the taxpayer must contest within 15 days from receipt. If the taxpayer does not contest the PAN, a formal letter of demand and assessment notice is issued.

Appeals procedures

Within 30 days from receipt of a formal demand and assessment notice, a taxpayer must file an administrative protest with the BIR. The taxpayer then has 60 days from date of filing of the protest letter to submit all the required documents supporting the protest. Failure to meet these requirements renders the assessment final, executory, and demandable.

If the protest is denied by the BIR, the taxpayer has 30 days from receiving advice from the BIR to appeal the decision to the CTA. Alternatively, if the BIR fails to act on the taxpayer's protest within 180 days from submission of the documents supporting its protest, the taxpayer has the right to appeal to the CTA within 30 days from the end of that 180-day period to expedite resolution of the protest.

An adverse decision by a CTA division may be appealed to the CTA en banc, and from there, to the Supreme Court.

Additional tax and penalties

The Philippines does not have specific transfer pricing penalties, hence transfer pricing adjustments are governed under the general penalty rules. A 25% surtax is generally imposed on tax deficiencies. Interest is imposed on the deficiency tax (but not on the surtax) at 20% per annum. A compromise penalty of up to 50,000 Philippine pesos (PHP) is also imposed.

Resources available to the tax authorities

The BIR's computerisation programme is now producing positive results in terms of catching tax evaders. The efficiency of its system has, to date, generated a significant amount of tax collections, and there are indications that the BIR will leverage the system for its other revenue-generating efforts. However, whether it will be used as an aid to challenge taxpayers' transfer pricing policies and arrangements remains to be seen.

In addition, the BIR has issued RMO No. 05-12, prescribing updated guidelines in taxpayer profiling and benchmarking activities to help address collection problems, plug tax leakages and implement risk-to-revenue based audit and enforcement activities. Under this issuance, the agency shall adopt the Performance Benchmarking Method as a surgical measure to detect tax leakages and improve collections on value-added tax, income tax and other taxes. The benchmarking results could potentially be used by the BIR as basis to conduct transfer pricing-specific audits.

Risk transactions

The BIR has increased its challenges on the transfer pricing arrangements of multinationals, and the areas of concern are varied. For example, whereas previously the BIR would be content with brief explanations on payments for management services, they now require further proof on the validity of these charges, sometimes asking for additional documentation such as passport details of visiting foreign employees and basis of the charges.

The provision of outbound services is now also attracting the BIR's attention. Previously, a 5%–10% mark-up on cost could be safe harbour. However, it is difficult nowadays to say that even a 10% mark-up is defensible, especially if the services involve high-value-adding activities such as R&D, technical design, or knowledge processing outsourcing services. Benchmarking therefore is key. What apparently alerts the BIR is when they notice a sharp decline in profitability in certain companies' operations once they finish their tax holiday, which is generally available for these sunshine industries. Certainly, this is an area that the BIR will be looking into more closely in the future.

Philippines

Thin capitalisation

The Philippines does not have statutory rules dealing with thin capitalisation, although this does not prevent the tax authorities from attempting to recharacterise interest as dividends. The TPRR also contains provisions on thin capitalisation, indicating that an interest payment or accrued interest attributable to the excess debt shall be treated as dividends, hence shall be taxed accordingly and shall not be deductible.

The proposed rules in the TPRR provide for a threshold ratio of three-to-one (3:1), unless a different debt-to-equity ratio is prescribed by special laws or special provisions of existing law. This 3:1 ratio does not apply to banks, financing companies and non-bank financial intermediary performing quasi-banking functions.

Advance pricing agreements (APAs)

The TPRR recognises that an APA could be useful in avoiding or resolving transfer pricing disputes. APAs look to the future, in that the agreement involves setting an appropriate set of criteria (e.g. methods, comparables and adjustments, and critical assumptions) for the determination of the transfer pricing for the covered transactions over a fixed period of time. The result is a stable transfer pricing environment for the parties involved, so much so that a taxpayer can rest assured that its transfer pricing arrangements will not be challenged by the BIR as long as it complies with the parameters set.

APAs may also involve the agreement of more than one revenue authority and taxpayer. The draft regulations provide details on how APAs may be initiated, monitored and concluded.

Joint investigations

No public evidence suggests that the BIR has been or is prepared to be involved in joint investigations with the authorities of other jurisdictions, although a framework exists under existing BIR issuances.

OECD issues

The Philippines is not a member of the OECD. However, the BIR relies heavily on the OECD Guidelines and treaty models with regard to international tax issues. As earlier mentioned, in RMC 26-2008, the BIR stated that, as a matter of policy, it subscribes to the OECD Guidelines. Taxpayers, therefore, should feel confident that they will be in better standing if they follow the OECD Guidelines.

59.

Poland

Introduction

Poland has well-established transfer pricing regulations that apply to cross-border as well as domestic transactions. These regulations draw heavily on the Organisation for Economic Co-operation and Development (OECD) Guidelines (Poland has been a member of the OECD since 1996). The statutory thresholds for the documentation requirements (introduced in 2001) are relatively low, and the requirements apply to a wide range of transactions. Since 2007, legislation also requires taxpayers to document the allocation of profits to permanent establishments.

On 1 May 2004, Poland joined the European Union. Poland, therefore, accepts the EU Transfer Pricing Code of Conduct. Nonetheless, based on local regulations, the tax authorities accept only documentation that is written in Polish and covers all items required under local law.

In January 2006, Poland introduced APA legislation which, from 1 January 2007, also applies to the allocation of profits to permanent establishments.

Statutory rules, other guidelines

Methods for determination of the arm's-length price

From 1 January 1997, Article 11 of the Corporate Income Tax (CIT) Law and Article 25 of the Personal Income Tax (PIT) Law, have presented the methodology for determining arm's-length prices by use of:

- Comparable uncontrolled price (CUP).
- Resale price.
- Reasonable margin (cost plus).

Where these methods cannot be applied, transactional-profit methods may be used. However, the tax authorities prefer traditional transaction-based transfer pricing methods when estimating income from given transactions.

In October 1997, the Ministry of Finance issued a regulatory decree on the methods and procedures for determining taxable income by estimation of prices applied in transactions between taxpayers. The decree was replaced in October 2009 by two decrees on the methods and procedures for determining taxable income by estimation and the methods and procedures of eliminating double taxation in case of a transfer pricing adjustment (TP decrees). One decree concerns PIT law, while the other concerns CIT law. However, for all intents and purposes, both decrees contain the same rules and regulations.

Poland

The new decrees introduced more detailed regulations with regard to comparability and new provisions concerning the procedure of eliminating double taxation in case of transfer pricing adjustments. The decrees also present in more detail the application of the five pricing methods in a manner similar to that outlined in the OECD Guidelines. The decrees oblige the tax authorities to verify transfer prices using these methods.

Definition of related parties

Polish transfer pricing regulations apply to domestic and cross-border relationships. However, the definitions of these relationships differ.

A Polish and a foreign company are considered 'related' if one of the following three conditions is met:

- A Polish taxpayer participates directly or indirectly in the management or control of a company located abroad or holds a share in its capital.
- A foreign resident participates directly or indirectly in the management or control of a Polish taxpayer or holds a share in its capital.
- The same legal or natural person, at the same time, participates directly or indirectly in the management or control of a Polish and a foreign entity or holds shares in their capital.

Polish companies are considered 'related' when one of the following conditions is met:

- A domestic entity participates directly or indirectly in the management or control of another domestic entity or holds a share in its capital.
- The same legal or natural person participates, at the same time, directly or indirectly, in the management or control of two domestic entities or holds a share in their capital.
- Relationships of a family nature, resulting from employment contracts or common property, exist between (1) two domestic entities or (2) persons involved in their management, control or supervision.
- The same person combines managerial, supervisory or controlling duties in both entities.

Documentation requirements

From 1 January 2001, the CIT law imposes compulsory documentation requirements on taxpayers concluding transactions with related parties and for transactions resulting in payments to entities located in tax havens. Entities are obliged to prepare documentation comprising:

- A functional analysis.
- The determination of costs, including the form and terms of payment.
- The method and manner of calculating the profit and determination of the price applied.
- The business strategy adopted.
- Other factors if they influenced the transaction.
- In the case of contracts relating to intangible products and services, determination of the benefits.

The reporting thresholds are 20,000 euros (EUR) for transactions with entities located in tax havens and EUR 30,000 – EUR 100,000 (depending on the company's share capital and the nature of the transaction) for transactions with related parties.

From 1 January 2007, the same requirements apply to the allocation of profit to a permanent establishment.

A company is obliged to submit the required documentation within seven days of a tax inspector's request. Failure to submit the documentation is subject to a fine of up to 120 daily rates (the level of daily rate is set by the court in each case and may amount up to approx. EUR 5,000), while submission of false documentation is subject to a fine of up to 240 daily rates. Therefore, the maximum fine for submitting false documentation may be up to EUR 1.2 million. If the tax inspector makes an assessment of the taxable income/tax-deductible costs and there is no documentation in place for the transactions subject to the assessment, the difference between the profit established by the tax authority and that declared by the taxpayer will suffer a 50% CIT rate (in comparison with the 19% CIT rate applicable for 2011).

When filing its annual tax return, the company is required to state whether it was required to prepare transfer pricing documentation according to the requirements.

Reporting requirements

Information on agreements concluded with related entities (ORD-U form)

A taxpayer is obliged to submit information on agreements concluded with related entities. Taxpayers are required to report related party transactions concluded with one of the following:

- Non-residents where they exceed EUR 300,000 in a given year with the same entity.
- A non-resident owning a company, permanent establishment or representative office in Poland where the amount of receivables or payables resulting from a single transaction exceeds EUR 5,000.
- Both foreign and domestic related parties on the specific request of the tax authority.

The taxpayer is obliged to submit the information on a designated form (ORD-U). The information should be submitted to the tax office together with the annual tax return (i.e. by the end of the third month after the fiscal year-end). Failure to submit the notification or submitting false information is subject to similar fines as in the case of TP documentation, i.e. up to 120 daily rates or up to 240 daily rates respectively. The maximum fine may be approx. EUR 1.2 million.

Information on fees paid to specialist services providers (ORD-W1 form)

Polish entities must collect, draw up and submit information on fees paid for services provided by natural persons who are not Polish tax residents. The information should be presented on a special form (ORD-W1) by the end of the month following the month in which the non-resident started providing the services. This obligation arises only when:

- the fee is paid to a non-resident natural person by a foreign entity
- the foreign entity is related to the Polish entity, and
- the amounts paid have an impact on the tax obligation of the natural person performing the services (the taxpayer is obliged to submit the information under the same conditions as for the ORD-U report).

Poland

Tax havens

Taxpayers concluding transactions that result in payments to companies located in tax havens, regardless of whether they are related, are required to prepare suitable documentation. A decree of the Minister of Finance lists countries applying harmful tax competition (tax havens). From 1 January 2007, if the transactions concluded by Polish taxpayers with companies located in tax havens are not arm's length, the tax authorities may assess taxable income on the same grounds as income from intragroup transactions.

Legal cases

Each year the Polish fiscal control office conducts several hundred tax audits concerning related party transactions. Proceedings might also be initiated by tax offices independent from fiscal control offices. Furthermore, there are approx. 40-50 administrative court verdicts related to TP each year. The court verdicts are formally not binding source of legal regulations in Poland. Nevertheless, they are often used as interpretative guidelines. Some of these court verdicts settled, among others, the matter that the tax authorities should take into account during transfer pricing audits not only local regulations but the OECD Guidelines as well.

Burden of proof

Taxpayers are required to maintain specific documentation describing the conditions applied in related party transactions. However, the burden of proof that non-arm's-length prices or other conditions are applied falls on the tax authorities.

When examining transfer prices, the tax authorities must determine the arm's-length value of a transfer using the method(s) previously applied by the taxpayer, provided that:

- The taxpayer established the transfer price using a traditional transaction-based transfer pricing method.
- The taxpayer submits documentation supporting the choice of a particular method, based on which the price calculation is performed and transfer pricing documentation required by the CIT law.
- The objectiveness and reliability of the documentation submitted, based on which a transfer price was calculated, cannot be reasonably questioned.
- Another method would not have been self-evidently more appropriate.

Tax audit procedures

Transfer pricing is examined as part of a normal corporate tax audit.

Foreign-owned companies that have been loss-making for more than three years are likely to be targeted. The tax authorities can request any information deemed necessary for the investigation and have full search powers. Noncompliance with information requests can result in severe penalties.

A particular characteristic of the audit procedure is the short time frame that taxpayers have to respond to transfer pricing assessments:

- Upon completion of a tax audit, the tax inspector issues a written protocol setting out his/her preliminary findings.

- The taxpayer has 14 (calendar) days to respond to this protocol in writing, presenting his/her explanations and objections.
- Within 14 days, the tax inspector issues a document of formal information on the method of dealing with the taxpayer's response.
- Subsequently, before issuing the tax decision, the tax authorities inform the taxpayer about the intended decision. The taxpayer has seven days to review the data collected during the tax audit and to present his/her opinion.
- The taxpayer can expect a tax decision or formal closing of the proceeding if the audit finds the taxpayer's reconciliation to be correct.
- The taxpayer may appeal in writing to the higher authority (the tax chamber) within 14 days.
- The verdict of the tax chamber may be further appealed to the administrative court within 30 days.
- The taxpayer has the right to appeal against the court's verdict to the Supreme Administrative Court within 30 days.

Tax investigations may examine related party transactions which are not time barred. Transactions are subject to the statute of limitations after five years from the end of the year in which tax returns concerning those transactions were filed (i.e. effectively six years). Penalty interest may be charged on underpaid tax, and the standard rate is currently (as of 1 August 2012) 14.5% per annum. Penalty interest is not tax-deductible.

Special tax offices for large entities

Special tax offices exist for large entities (i.e. taxpayers that exceed an annual revenue threshold of EUR 5 million). Additionally, all entities with a foreign shareholding exceeding 5% of voting rights and Polish holding companies are recognised as large entities.

Comparable information

Where possible during a tax audit, the Polish tax authorities try to use internal comparables (sometimes without carrying out all necessary adjustments). They also use external comparables drawing on data gathered through controls of comparable taxpayers. Here, however, due to commercial and fiscal secrecy, the taxpayer may have difficulty obtaining access to such data.

The tax authorities have access to databases to establish comparable information. However, it is rarely evident that they use such comparables during tax audits.

The tax authorities take a relatively sceptical view of foreign comparable data. In practice, while preparing benchmarking studies, domestic comparables should be examined first. If there is not sufficient information concerning domestic comparables, the search could be extended to comparables within the CEE region. If there is still not sufficient comparable data, a Pan-European benchmarking study may be conducted.

For taxpayers undertaking comparable analysis, the source of Polish company financial results is the government journal, Monitor Polski B. However, gathering the most up-to-date source financial data may sometimes be difficult as fines for not submitting financial information are low and many companies do not present their results at all or disclose them late.

Poland

Competent authority proceedings and advance pricing agreements

Rulings

Amended regulations relating to interpretations of the tax law by the tax authorities and the Minister of Finance were introduced on 1 July 2007. Currently, two types of rulings are issued by Polish tax authorities:

- General rulings – Issued by the Minister of Finance where there are differences in the interpretation of tax regulations by the tax authorities and apply to all taxpayers.
- Individual rulings – Issued by tax chambers appointed by the Minister of Finance and apply only to the case of the requesting taxpayer.

The request for an individual ruling is filed on a special form, ORD-IN, and should include:

- The background to the case.
- The applicant's standpoint with respect to the interpretation of the tax law.
- A declaration that the case subject to interpretation is not subject to a tax proceeding, tax control or earlier tax decision. If this condition is not met, the ruling is not binding and the person applying may be fined under the Penal Fiscal Code.

An individual ruling may not be harmful for the taxpayer (i.e. if the taxpayer follows the ruling, no penalty interest or sanctions under the Fiscal Penal Code may be imposed). If the ruling is issued before the transaction starts, no tax other than that resulting from the interpretation may be imposed on the taxpayer with respect to the transaction. This does not apply if the ruling is issued after the transaction started.

An individual ruling may be amended by the Minister of Finance at any time. If the amendment is less favourable for the taxpayer, the taxpayer is entitled to apply the earlier ruling until the end of the current accounting period.

The tax authorities must issue individual rulings within three months (this may be extended in complicated cases). The fee for an individual ruling is PLN 40 (approximately EUR 10) per question in the request.

Individual rulings cannot be used to confirm the correctness of the transfer pricing method.

Advance pricing agreements (APAs)

From 1 January 2006, a taxpayer may conclude an APA with the Minister of Finance to confirm the appropriateness of the taxpayer's transfer pricing policy. The purpose of an APA is to agree in advance the arm's-length character of the terms of the transactions between related parties. From 1 January 2007, APAs also cover the attribution of profit to permanent establishments. As a result, the local tax authorities will not be able to question the arm's-length character of these transactions.

The tax law allows for the following types of APAs:

- Unilateral APA – For transactions between domestic entities or a domestic entity and a foreign entity.
- Bilateral/multilateral APA – Issued by the Minister of Finance after obtaining foreign tax authorities' consent.

The administrative fee for the APA is approximately 1% of the transaction value. However, depending on the type of APA, the fee may not be lower than approximately EUR 1,250 or higher than approximately EUR 50,000 (exchange rate EUR 1 = PLN 4). The APA decision will include:

- Determination of the entities covered by the agreement.
- Determination of the type, subject and the value of the transaction covered by the agreement, as well as the period concerned.
- Determination of the transfer pricing method, method of calculation of the transfer price and rules of application of this method, including all crucial assumptions.
- Period during which the decision remains in force.

Starting from 1 January 2007, an APA will be concluded for a maximum period of five years, with the possibility of extending the period by another five years.

Corresponding adjustments

Poland ratified the convention on the elimination of double taxation in connection with the adjustment of profit of associated enterprises of 23 July 1990. The convention came into force on 26 August 2006.

The TP decrees introduced regulations regarding the procedure for elimination of double taxation. They are applicable to a price adjustment in cross-border transactions between related parties or in cross-border settlements between a head office and its permanent establishment. The procedure is based on the Arbitration Convention and double tax treaties.

According to the TP decrees, local taxpayers are entitled to file an application to the Minister of Finance to initiate a mutual agreement procedure (MAP) in order to avoid double taxation. In principle, the application should be submitted within three years from receipt of a decision or protocol that leads or may lead to double taxation. If the Minister of Finance believes the application is justified but cannot be settled under domestic proceedings, the Minister should initiate a MAP.

Liaison with customs and other tax authorities

In 2002, the customs authorities (GUC) merged with the Ministry of Finance. As a result, the flow of information between the two tax authorities improved. The tax authorities are now working on the digitisation of the tax system. Once finished, the information gathered by various tax departments is likely to be made available to the tax police.

The tax authorities cooperate with the tax authorities of other countries in conducting multijurisdictional international investigations. Poland also applies the procedure of mutual communication.

The tax authorities are active in information exchange procedures.

Poland

Thin capitalisation

Thin capitalisation rules came into force on 1 January 1999. These rules generally apply to loans from a direct shareholder or a lending company which has the same shareholder as the tested entity. The debt-to-equity ratio is 3:1. For the purposes of these rules, equity is defined narrowly as paid-up share capital.

For thin capitalisation purposes, the word 'loan' includes bonds and deposits.

Management services

Fees paid by Polish companies for consulting, accounting, market research, marketing, management, data processing, recruitment, guarantees and warranties, and other similar services are subject to 20% withholding tax, unless a relevant double tax treaty states otherwise. Poland has entered into such agreements with approx. 80 countries around the world. However, to apply the treaty withholding tax rate, the taxpayer needs a valid certificate of fiscal residence.

60.

Portugal

Introduction

Although the arm's-length principle has been included in Portuguese tax law for many years, it generally was not enforced, due to a lack of clarity and supporting regulations. However, this changed in December 2000, when new Portuguese transfer pricing legislation was enacted.

Statutory rules

Law number 30-G/2000 of 29 December 2000, which entered into force on 1 January 2001, by amending Article 57 of the Portuguese Corporate Income Tax (CIT) code, introduced detailed transfer pricing rules. This article was subsequently changed into Article 58 by decree-law number 198/2001, dated 3 July 2001 (decree-law 198/2001) and changed again into Article 63 by decree-law number 159/2009, dated 13 July 2009 (decree-law 159/2009). The new transfer pricing documentation rules are applicable to tax years starting on or after 1 January 2002.

Article 63, number 13 of the CIT code states that a Ministerial Order from the Minister of Finance will regulate, amongst others, the application of the transfer pricing methods, the type, nature and contents of the documentation and the procedures applicable to (corresponding) adjustments. This Ministerial Order, number 1446-C/2001, dated 21 December 2001 (Ministerial Order 1446-C-2001), was published in the *'Diário da República'* on 14 January 2002.

Article 63 CIT Code

The key elements of the transfer pricing rules are as follows:

- The concept of 'special relations' between entities is broadly defined, including situations ranging from statutory to economic dependency, and also certain family relations.
- A set of defined methodologies for evaluating transfer prices and the comparability factors that should be taken into account when assessing their arm's-length nature.
- The 'best method' or 'most appropriate method' for every transaction or series of transactions should be considered.
- Extensive requirements regarding how taxpayers justify and document their transfer pricing arrangements.
- A shift in the burden of proof from the tax authorities to the taxpayer (self-assessment procedure) in the case of controlled transactions with non-resident associated enterprises.

Arm's-length principle

Any commercial transactions, including transactions or a series of transactions related to goods, rights, services or financial arrangements between a taxpayer and

Portugal

another entity with which it has special relations must be conducted as if they were independent entities carrying out comparable transactions.

The transfer pricing methodology adopted must ensure the best level of comparability between the tested transactions and the comparable data used to provide the benchmark. Factors affecting comparability include characteristics of the goods, rights or services, economic and financial environment, activities and functions performed, assets employed and risks borne.

The transfer pricing regulations also apply in cases of transactions between a non-resident entity and a permanent establishment (PE) in Portugal or between a PE of a non-resident entity with other PEs outside the Portuguese territory. The rules also apply to entities that are simultaneously exercising activities that are subject to CIT and activities that are exempt from CIT, such as entities based in the Madeira International Business Centre (MIBC).

Associated enterprises

Special relations between two entities exist in case one entity has or may have, directly or indirectly, a significant influence in the management of the other entity. The law stipulates that a special relationship exists in the case of:

- An entity and its shareholders, or its relatives, that have directly or indirectly a participation greater than or equal to 10% of the capital or the voting rights.
- Entities in which the same shareholders, or its relatives, have, directly or indirectly, an interest greater than or equal to 10% of the capital or the voting rights.
- An entity and the members, and their relatives, of its corporate bodies.
- Entities in which the majority of the members of its corporate bodies, or of any other administrative body, board of directors or supervision or control, are the same persons or being different persons are connected with each other by marriage, other (legal) forms of joint households or by direct parental relation.
- Entities connected by a contract of subordination or other with equivalent effect.
- Entities that are required to prepare consolidated financial statements.
- Entities where one of the following relationships exist:
 - The activities of one entity substantially depend on industrial or intellectual property rights or know-how owned and granted by the other entity.
 - The sourcing of raw materials or the access to sales channels of products, merchandise or services for one entity substantially depends on the other entity.
 - A substantial part of the activity of one entity can be performed only with the other or depends on decisions taken by the other entity.
 - The prices for goods or services rendered or acquired by one entity is, by provision set in juridical act, determined by the other entity.
 - Terms and conditions of commercial or juridical relations between the parties have the effect that one entity can influence the management decisions of the other entity in a way other than between two commercial parties acting at arm's length.
- An entity resident in Portugal or a non-resident with a PE in Portugal and an entity resident in a territory considered by Portuguese law as a territory with a clearly more favourable tax regime.

These territories are listed in the Ministerial Order 150/2004, dated 13 February 2004, which has been altered by Ministerial Order 292/2011, dated 8 November 2011.

Transfer pricing methods

The methods to be used are:

- The comparable uncontrolled price method.
- The resale price method.
- The cost plus method.
- The profit split method.
- The transactional net margin method.
- Other methods when the methods mentioned above cannot be applied or if these methods do not give a reliable measure of the terms that independent parties would apply.

Tax information and documentation

Every taxpayer shall indicate, in the annual declaration of accounting and fiscal information (IES/*Declaração Anual*), an integral part of the annual CIT filings, the existence of transactions with associated enterprises.

The requested information includes the associated enterprises, the amount of the controlled transactions with each of the associated enterprises and an indication as to whether supporting documentation for transfer prices was prepared at the time the transactions took place (and is still available).

Taxpayers with turnover of 3 million euros (EUR) or more also should comply with the documentation requirements below.

Corresponding adjustments

Where the transfer pricing provisions apply to controlled transactions between two parties that are both liable to Portuguese CIT, any adjustment to the taxable income of one should be reflected by a corresponding adjustment to the taxable income of the other. If a tax treaty is applicable, then the Portuguese tax authorities may also make corresponding adjustments through the competent authority procedure.

Other regulations

The Ministerial Order 1446-C/2001 deals in more detail with the following issues:

- General rules on the arm's-length principle.
- Scope of application of transfer pricing rules.
- Adjustments to taxable income and corresponding adjustments.
- Transfer pricing methods and the best or most appropriate method.
- Factors determining comparability.
- Cost contribution arrangements and intra-group services.
- Relevant information and supporting documentation.
- Special provisions.

In addition, article 23 of the Portuguese CIT Code considers that costs are deductible only if indispensable for generating profits or gains or for the maintenance of the company's activity. However, the recent Portuguese case law is showing a more business oriented approach of such concept, meaning that it should be sufficient to demonstrate that the costs are related to the company's normal course of activity.

Portugal

However, non-documented costs or costs not complying with certain formal requirements are not deductible for CIT purposes. Furthermore, such costs are subject to an autonomous tax rate of 50%, even in the case of tax losses.

Legal cases

There have been few court cases on transfer pricing matters. More recent case law shows the importance of a well-prepared factual and functional analysis to support arm's-length dealings with associated enterprises.

Burden of proof

Although under the recent transfer pricing rules, the taxpayer is required to have transfer pricing documentation available demonstrating compliance with the arm's-length principle, according to the *Lei Geral Tributária* (general tax law) the burden of proof lies with the entity that wishes to prove otherwise.

In fact, article 77 of *Lei Geral Tributária* foresees that the proof of non-compliance with the arm's-length principle lies with the tax authorities.

In the case of controlled transactions with non-resident associated enterprises, the taxpayer should include any necessary adjustments in its corporate income tax return in order to reflect arm's-length pricing (self-assessment).

Documentation

Tax documentation file

Based on the Ministerial Order 1446-C/2001, taxpayers are required to keep a transfer pricing documentation file, which is expected to include the following information:

- The terms and conditions agreed, accepted and observed in the open market in relation to the controlled transactions.
- The selection and application of the method or methods most appropriate for benchmarking transfer prices through the use of arm's-length comparables.

The transfer pricing documentation file should include the following information and documentation:

- A description of any special relations that exist with any entities with which commercial, financial or other transactions are carried out.
- A record of the corporate relationship by which the special relationship arose, including any documents that demonstrate a subordination or dependency relationship as mentioned above.
- A description of the activities carried out during the controlled transactions, a detailed list of amounts recorded by the taxpayer over the past three years and, where appropriate, the financial statements of the associated enterprises.
- A detailed description of the goods, rights or services involved in controlled transactions and of the terms and conditions agreed if such information is not disclosed in the respective agreements.
- A description of the activities performed, the assets used and the risks assumed, both by the taxpayer and the associated enterprises involved in the controlled transactions.
- Technical studies on essential areas of the business, namely investment, financing, research and development, marketing, restructuring and reorganisation of

activities, as well as forecasts and budgets connected with the global business and business by division or product.

- Guidelines regarding the transfer pricing policy of the company, containing instructions on the methods to be applied, procedures for gathering information (particularly on internal and external comparables), analysis of the comparability of transactions, cost accounting policies and profit margins obtained.
- Contracts and other legal instruments concluded with both associated enterprises and third parties, together with any other document that may govern or explain the terms, conditions and prices under those transactions.
- An explanation of the method or methods applied to determine arm's-length prices for each controlled transaction and the rationale for the selection.
- Information regarding comparable data used (The grounds for selection, research records and sensitivity and statistical analyses should all be documented).
- An overview of business strategies and policies, particularly regarding commercial and operational risks that might have a bearing on the determination of transfer prices or the allocation of profits or losses for the transactions.
- Any other information, data or documents considered relevant for determining an arm's-length price, the comparability of transactions or the adjustments made.

The taxpayer is expected to maintain the documentation for a period of ten years after the filing of the tax return and to deliver the documentation to the tax authorities upon request. The documentation should help to verify the arm's-length nature of the transfer prices without the need for the taxpayer to incur excessive compliance costs.

The tax authorities have four years to raise additional CIT assessments. If tax losses were offset against tax profits within the above-mentioned period, the tax authorities may also audit the accounts of the years in which the tax losses were incurred.

Taxpayers are expected to update the prior-year documentation for transactions where the relevant facts and circumstances have changed to the extent that there is a material impact in the determination of the arm's-length price.

The Ministerial Order 92-A/2011 dated 28 February 2011, revised the set of documentation that needs to be included in the tax file, clarifying that the transfer pricing report is part of the tax file. The precedent legislation, Ministerial Order 359/2000 of 20 June 2000, had been in force prior to the introduction of transfer pricing documentation requirements and therefore, did not include any reference to the transfer pricing documentation file.

Cost contribution arrangements (CCAs)

With respect to CCAs, the taxpayer must maintain the following documentation:

- Description of the participants and other associated enterprises involved in the activity covered by the agreement or that are expected to exploit or use the results of that activity.
- The nature and type of activities carried out within the scope of the agreement.
- The method by which each participant's proportionate share in the expected advantages or benefits are determined.
- The accounting procedures and methods applied to allocate costs, including the calculations made to determine each participant's contribution.

Portugal

- The assumptions that underlie forecasts of expected benefits, frequency of review and forecasts of any adjustments arising from changes in the agreement or in other facts.
- Expected duration of the agreement.
- Anticipated allocation of responsibilities and tasks under the agreement.
- Procedures for a participant entering or withdrawing from the agreement and conditions for the termination of the agreement.
- Penalty clauses.

Intragroup services

Regarding intragroup services agreements, the taxpayer must maintain the following documentation:

- A copy of the agreement.
- A description of the services covered by the agreement.
- A description of the recipient of the services.
- A description of the costs of the services and the criteria applied for their allocation.

Tax audit procedures

The audit procedure can be either internal or external. During an internal audit, the taxpayer is requested to send documentation to the tax authorities for analysis; in an external audit, investigations are carried out at the taxpayer's premises. In the last case, documentation also may be requested from the taxpayer in order to be analysed at the tax authorities' premises.

Furthermore, the audit procedure can be either global or partial. A global tax audit reviews the entire tax status of the taxpayer, while a partial tax audit will focus on only one or more (but not all) of the taxpayer's tax duties. An audit may address more than one taxable period. The tax audit procedure is continual and must be concluded within six months. However, under certain circumstances, this period may be extended.

The audit procedure begins with a notification sent by the tax authorities to the selected taxpayer. This notification sets out the nature and scope of the audit, as well as the rights and obligations of the taxpayer during the audit process.

Audits are completed when the tax auditor considers that all the necessary information has been obtained to draw up a proposed tax audit report. This proposal is sent to the taxpayer, who has the opportunity to oppose, in all or in part, against the conclusions of the proposal. After the objections have been heard, the tax auditor will issue a final audit report, which may give rise to an additional tax assessment.

Revised assessments and the appeals procedure

Following a tax audit, the taxpayer is allowed to challenge an additional tax assessment made by the tax authorities, either by means of an administrative claim submitted to the tax authorities, or via a judicial or arbitration appeal to the tax courts. An appeal against an additional tax assessment does not prevent the collection of additional tax. Therefore, the taxpayer should either pay the tax due or provide a guarantee for its payment.

There are no specific regulations in respect of appeals connected with additional assessments based on the transfer pricing arrangements adopted by the taxpayer.

Additional tax assessment and penalties

In general terms, additional assessments usually carry penalties and fines. The specific penalty in force for not having the transfer pricing documentation file organised ranges from EUR 1,000 to EUR 10,000 (negligence).

In case a taxpayer refuses to deliver the transfer pricing file, after declaring in the Annual Fiscal and Accounting Declaration (IES/*Declaração Anual*) that the transfer pricing file is organised, the applicable penalty that may range from EUR 750 to EUR 150,000.

Penalties for the nonpayment of taxes range between 30% and 100% of the amount of tax due, capped at EUR 45,000, in case of negligence. In case of *dolus*, penalties range between 200% and 400% of the amount of tax due capped at EUR 165,000. The taxpayers may request a reduction of the penalty (under certain circumstances) and may appeal against the penalties imposed by the tax authorities.

Late assessment interest (4% per year) is also charged. Neither penalties nor late assessment interest is deductible for tax purposes. In case of the late payment of an additional assessment made by the tax authorities, interest for late payment will be applied (the interest rate is determined annually, in December, using the monthly average of the *Euribor* at 12 months in the preceding 12 months, adding 5% – regarding 2012 the late assessment payment interest rate is 7.007% per year).

Resources available to the tax authorities

Practice

It is believed that the tax authorities have developed sufficient experience to deal with transfer pricing issues. Various transfer pricing audits have been performed, and recently the tax authorities have started to make transfer pricing adjustments to the taxable profit of taxpayers.

Use and availability of comparable information

Use

The taxpayer should select the transfer pricing method that assures the best grade of comparability between its transaction or series of transactions and the uncontrolled benchmarking data. Where possible, the comparable uncontrolled price (CUP) method should be used to establish an arm's-length price, making use of available comparable price information.

Availability

There are several commercial databases available that contain (financial) information about Portuguese companies.

The tax authorities have been using information available from their own sources (i.e. information that is not publicly available but obtained from CIT returns and governmental tax audits). Recently, the tax authorities acquired AMADEUS, a financial database, to assess the compliance of controlled transactions with the arm's-length principle.

In January 1999, the tax authorities published a list of ratios determined by dividing taxable income by turnover for the various sectors recognised for commercial register

Portugal

purposes. The ratios are based on taxpayer information for the years 1994, 1995 and 1996. Entities that in 1998 have a ratio that is inferior to the one determined for the relevant sector would, in principle, be subject to a tax inspection. We are not aware of such a study being repeated in later years. Furthermore, it is uncertain whether the tax authorities may use such data to support proposed adjustments to taxable income because the underlying data may be considered confidential (secret comparables).

Risk transactions or industries

Transfer pricing is becoming an area of increasing focus for Portuguese tax authorities. They are notifying more and more companies to deliver the transfer pricing documentation of the recent years. In our understanding, such companies are in different types of industries, and it does not follow that the tax authorities' transfer pricing audits are focusing on certain industries or specific types of transaction. Therefore, as a general rule, all controlled transactions should be duly supported and documented in accordance with the arm's-length principle.

More recently, tax authorities have started to question the economic analyses presented in the transfer pricing documentation, among others by questioning the chosen profit level indicators and the criteria used in the benchmark searches. Moreover, we have experienced that tax authorities are asking for detailed information and documentation underlying intragroup services, such as management fees, royalties, cost contribution arrangements, transactions with entities that are resident in low tax jurisdictions and group financing.

Limitation of double taxation and competent authority proceedings

In principle, transfer pricing adjustments should be implemented so as to avoid double taxation.

When the adjustment is between two resident associated enterprises, it is mandatory that the tax authorities perform the corresponding adjustment.

When the adjustment affects transactions between a Portuguese company and a non-resident, the mechanisms laid down in the relevant double taxation treaty should be applied. Where the non-resident is within the EU, the provisions of the Arbitration Convention relating to the elimination of double taxation (EC Directive 90/436) may also be applied.

Advance pricing agreements (APAs)

The Ministerial Order 1446-C/2001 stipulated that after relevant experience would have been gained regarding the application of the new transfer pricing rules, the Portuguese tax system would be in a position to adopt the OECD's recommendations in the area of APAs. The state budget for 2008 introduced APA rules by means of adding article 128-A to the CIT Code. This article was subsequently changed into Article 138 by decree-law number 159/2009.

Article 138, Number 9 of the CIT code stated that a Ministerial Order from the Minister of Finance would regulate the requirements and conditions for preparing and filing a request, as well as what procedures, information and documentation are to be applied in the APAs.

Detailed APA rules were introduced by the Ministerial Order 620-A/2008, which entered into force on 16 July 2008.

This Ministerial Order establishes specific regulations regarding the implementation (procedures and obligations) of the APA regime in Portugal, namely:

- The APA request or proposal should be sent to the Portuguese Tax Authorities (PTA) up to 180 days prior to the beginning of the first fiscal year covered by the agreement.
- The maximum duration of an APA (duration from APA application to final conclusion) is 300 days for unilateral APAs and 480 days for bilateral APAs.
- The conclusion of an advance agreement is subject to the payment of charges, which are determined under the terms and limits foreseen in Ministerial Order 923/99, dated 20 October 1999.
- The APA is valid for a maximum of three years with the possibility for renewal; and
- Rollbacks are not available.

Due to the fact that Portugal only recently enacted legislation concerning APAs, it is possible to obtain an APA only for the tax years starting on or after 1 January 2010.

Anticipated developments in law and practice

Recently, transfer pricing rules have been also extended to Value Added Tax (VAT) matters, in case one of the associated enterprises is not allowed to total VAT deduction. It is not expected that there will be further developments in the near future.

Liaison with customs authorities

Recently, the tax authorities and the customs authorities merged in a single authority and, therefore, it is expected that there will be increasing exchange of information between tax authorities and customs authorities.

OECD issues

Portugal is a member of the OECD. The new transfer pricing rules reflect the approach set out by the OECD Guidelines. Ministerial Order 1446-C/2001 indicates that in more complex cases, it may be advisable to consult the OECD Guidelines for further clarification.

Under a reservation made in Article 9 of the Model Tax Convention on Income and Capital, Portugal reserves the right not to insert paragraph two (regarding corresponding adjustments) in its tax treaties. The 'older' tax treaties, most of them with EU countries, do not contain a corresponding adjustment provision. However, the more recent treaties include a corresponding tax adjustment provision equivalent to the above-mentioned paragraph of the Model Tax Convention on Income and Capital.

Joint investigations

Portuguese law does not prevent Portuguese tax authorities from joining the equivalent body of another state to set up a joint investigation into a multinational company or group.

Portugal

Thin capitalisation

Portuguese taxation rules for thin capitalisation were introduced in January 1996. Where the indebtedness of a Portuguese taxpayer to a non-resident entity in Portugal or in an EU country with whom special relations exist is deemed excessive, the interest paid in relation to the part of the debt considered excessive will not be deductible for the purposes of assessing taxable income.

In determining whether special relations exist, reference is made to Article 63 of the CIT code regarding transfer pricing (i.e. special relations exist if the non-resident entity has or can have substantial influence, directly or indirectly, in the management decisions of the resident entity).

Excessive indebtedness occurs where the value of the debts in relation to each of the entities is more than twice the value of the corresponding shareholding in the taxpayer's equity. Any disallowed interest is not requalified as a dividend for withholding tax purposes. This means that withholding tax should be levied on the full amount of the interest, including the interest related to the part of the loan that exceeds the 2:1 debt-to-equity ratio.

To determine the qualifying debt, all forms of credit will be considered, whether in cash or in kind, including credit resulting from commercial transactions that are overdue for six months or more. In order to determine qualifying equity, paid in share capital includes all equity capital except for unrealised capital gains or losses, including those arising from revaluation not authorised by the tax legislation, and amounts resulting from the equity method of accounting.

In cases where the 2:1 ratio is exceeded, the taxpayer may be able to avoid adjustments under the thin capitalisation rules where it can be shown that the same level of indebtedness could have been obtained with similar conditions from an independent party. Such evidence must be kept in the annual tax file of the company for 10 years. This option is not applicable where the indebtedness is towards an entity resident in a territory considered by Portuguese law as a territory with a clearly more favourable tax regime.

61.

Qatar

Introduction

Two tax regimes

The State of Qatar is unusual in that it has two tax regimes, both of which include transfer pricing provisions. A brief summary of the provisions of the Qatar State Tax Law is provided at the end of this chapter, but the following comments in sections [00]01-[00]08 all relate to the Qatar Financial Centre (QFC) tax regime.

QFC tax law with specific transfer pricing provisions

The government of Qatar established an onshore financial centre, the QFC, in 2005, mainly aimed at regulated organisations operating in the financial services sector. However, the QFC law also permits certain other non-regulated activities to be carried out, such as accounting services, legal services, providing group treasury functions and acting as a holding company.

The new QFC tax law was published in the official Gazette in 2010. The law had originally been expected to come into force with effect from 1 May 2008, but a temporary tax holiday was in place until 31 December 2009. The QFC tax law applies retrospectively from 1 January 2010. Under the new tax regime all QFC-registered companies are subject to corporate income tax at a flat rate of 10% on their local-source profits. Additionally, the new law introduces new concepts including a self-assessment regime, an advance ruling scheme and transfer pricing legislation.

Statutory rules

Transfer pricing legislation

Transfer pricing in QFC tax law is covered under Part 8, Articles (47-59). Part 8 provides rules for the treatment for tax purposes of income affected by transactions between ‘associated persons’. Where transactions between associated persons are not on an arm’s-length basis, and this results in a reduction in the amount of the chargeable profits of one of those associated persons, the QFC tax authority has the power to compute the taxable profits of an entity as if the arm’s-length basis had been used for the transactions. An appeal can be lodged with the Regulatory Tribunal against such decisions.

Associated persons

As per the QFC tax law, ‘persons’ are ‘associated’ with each other if:

- one controls the other, either directly or indirectly, or
- both are controlled by the same person(s).

Control in relation to a company means that a person is able to ensure that the affairs of the first company are conducted in accordance with their wishes. This control

Qatar

may be exercised through the holding of shares or the possession of voting rights in the company, or by virtue of any powers conferred by the articles of association of the company.

Transfer pricing methods

The QFC tax law does not refer to any methods. However, it is practically understood that the following methods mentioned in the OECD Guidelines are acceptable for Qatar transfer pricing application:

Traditional transaction methods:

- Comparable uncontrolled price (CUP) method.
- Resale price (RP) method.
- Cost plus (CP) method.

Transactional profit methods:

- Profit split (PS) method.
- Transactional net margin method (TNMM).

Other regulations

The QFC tax return form includes a disclosure requirement for any adjustment with respect to transfer pricing. Specifically, it requires the authorised signatory of the return to confirm that:

- “no adjustment is required to local-source taxable profits or tax loss under Part 8 of the Tax Regulations (transfer pricing)” or, if an adjustment is required, to confirm that:
- “attached computations fully reflect adjustments required.”

Legal cases

The QFC tax law is relatively new and, as far as we are aware, there have so far been no specific transfer pricing cases in the QFC courts.

Burden of proof

The QFC tax law places the burden of proof on the taxpayer to produce sufficient transfer pricing documentation (and other supporting documents, including potentially intercompany agreements, schedules, and invoices) to support its declaration on the tax return.

Tax audit procedures

Since the QFC tax law is relatively new, there has been limited practical experience of transfer pricing audits. However, the QFC tax department has inquired into transactions between associated persons and has requested documents to support tax return declarations.

Penalties

Financial sanctions relating to returns, which are provided under the general tax provisions in Article (107), can be up to 100% of the tax understated. The specific penalty provisions state that:

“A QFC Entity which:

- (a) fraudulently or negligently files a return which is incorrect, or
- (b) discovers that a return filed by it, neither fraudulently or negligently, is incorrect and does not remedy the error without unreasonable delay, is liable to a tax-related financial sanction of an amount not exceeding the tax understated”.

Tax treaty network

According to the legislation, double-tax relief is available under any double-tax agreement concluded between Qatar and another country. In the absence of a tax treaty, double-tax relief may be claimed by way of credit or on election by expense relief.

Advance pricing agreements (APAs)

As part of the QFC’s determination to give certainty to companies regarding their taxable positions, an advance ruling scheme has been incorporated into the new regime. It has been confirmed with the QFC authorities that this can be used for advance pricing agreements and advance rulings have already been given with respect to the cost-plus method.

Anticipated developments

The QFC Tax Department recently commissioned the production of transfer pricing guidelines. These are expected to be issued in late 2012. The QFC is also expected to address more details on transfer pricing in its practice notes which are released from time to time.

Qatar State Tax Law

The Qatar State Tax Law (Law No. 21 of 2009) does not contain a specific provision on transfer pricing; however, it includes a general anti-avoidance provision. Under this provision, if it is deemed that the taxpayer has entered into arrangements or has carried out operations or transactions one of the main purposes of which is to avoid the payment of taxes due, the Tax Administration can take all or some of the following actions:

- Apply the arm’s-length value to the transaction, resulting in a different value than established by the taxpayer.
- Re-characterise the transaction if the nature of the transaction does not reflect its reality.
- Adjust the amount of the tax due by the taxpayer or any other person involved in the arrangements, operations or transactions.

Transfer pricing methods

The finalised executive regulations for the tax law were published on 9 June 2011. They state that the market price in the case of arm’s-length transactions should be determined in accordance with the Unrelated Comparable Price method. This method is essentially the same as the Comparable Uncontrolled Price (CUP) method as defined in the OECD’s guidelines on transfer pricing. Where the taxpayer wishes to use an alternative method they are required to submit an application ‘to apply any other pricing method approved by the OECD’.

Qatar

Related parties

The executive regulations include a definition of related parties which appears to be very broad:

- Natural persons are related where one party is a spouse, in-law or next of kin of the other party up to the fourth degree.
- A natural person and a legal person are related if the natural person owns individually or with another person or related persons, directly or indirectly, 50% or more of the capital, voting rights or income rights in the legal person.
- Legal persons are related where one of them owns individually or with another person or related persons, directly or indirectly, 50% or more of the capital, voting rights or income rights in the other legal person. Legal persons are also related where another person owns, directly or indirectly, 50% or more of the capital, voting rights or income rights in both parties.

62.

Romania

Introduction

The Romanian transfer pricing legislation follows the Organisation for Economic Co-Operation and Development (OECD) Guidelines and requires that transactions between related parties be carried out at market value. In case transfer prices are not set at arm's length, the Romanian tax authorities have the right to adjust the taxpayers' revenue and expenses so as to reflect the market value. Profit adjustments on transactions between related parties can be performed within the domestic statute of limitation period (i.e. six years).

The trend in transfer pricing developments in Romania reveals a growing interest of the Romanian tax authorities towards transfer pricing, which is one of the main areas of tax investigation. Under these circumstances, multinational companies are advised to pay close attention to the arm's length of their related party transactions and their documentation so as to be prepared in case of any transfer pricing disputes with the tax authorities.

Statutory rules

The arm's-length principle was first introduced in domestic tax law in 1994. An important milestone in the development of the transfer pricing legislative framework occurred in 2004, upon the introduction of the fiscal code, which set out in a systematic manner the definition of related parties, the statement of the arm's-length principle and the methods for setting transfer prices at arm's length.

The fiscal code norms detail the scope and the application of transfer pricing rules. Although Romania is not a member of the OECD, these norms expressly stipulate that in the application of transfer pricing rules, the Romanian tax authorities also will consider the OECD Guidelines.

The arm's-length principle

The arm's-length principle is applicable to all related party transactions, including those between a foreign legal entity and its Romanian permanent establishment. Beginning with 2010, related party transactions carried out between two Romanian legal entities also fall within the scope of transfer pricing investigations, whereas previously only transactions with non-resident related parties were scrutinised by the tax authorities.

Definition of related parties

Two legal entities are related parties provided that:

Romania

- one entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the other entity or it effectively controls the other entity, and
- one entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the two entities.

An individual is a related party with a legal entity provided that he/she holds directly or indirectly, including the shareholding of related entities, a minimum of 25% of the number/value of shares or voting rights in the legal entity or it effectively controls the legal entity (unfortunately the legislation is silent on the meaning of 'effective control'). Two individuals are related parties provided that they are spouses or relatives up to the third degree.

Transfer pricing methods

Local legislation provides that taxpayers may use traditional transfer pricing methods (comparable uncontrolled price, cost plus and resale price), as well as any other method that is in line with the OECD Guidelines (transactional net margin and profit split). If the comparable uncontrolled price or a traditional transfer pricing method is not used, as it is the case, the taxpayer should set out in the documentation the reasons for not doing so.

Taxpayers should consider the following main criteria when selecting the most adequate transfer pricing method:

- Activities carried out by the related parties.
- Availability of data and justifying documents.
- Accuracy of adjustments to meet comparability criteria.
- Circumstances of the specific case (e.g. characteristics of the tangible goods transferred, stage within the supply chain, payment conditions, guarantees, discounts).

For specific types of transactions, guidance is provided on the application of transfer pricing methods and the comparability factors that should be considered by the taxpayer.

- Provision of services – the arm's-length transfer price should be set using the comparable uncontrolled price method, by considering the usual fees for each type of activity or the standard rates in certain fields. In the absence of comparable transactions, the cost plus method should be used.
- Inter-company loans – the arm's-length transfer price is represented by the interest that would have been agreed upon between third parties in comparable circumstances, including the commission for handling the loan. Comparability factors that should be considered in assessing the arm's-length interest rate include: amount and duration of the loan, nature and purpose of the loan, currency and foreign exchange risk, existence of guarantees, costs of hedging the foreign exchange risk, etc.

Documentation requirements

In line with the fiscal procedure code, taxpayers engaged in related party transactions are required to prepare a transfer pricing documentation file that needs to be presented upon request of the tax authorities during a tax audit. The deadline is to be set at

maximum three months from the date of receiving the formal written request, with the possibility of a single extension with a period equal to the term initially established.

In February 2008, detailed regulations regarding the content of the local transfer pricing documentation file were published. The content of this file is in line with the Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union (EU TPD).

There is currently no minimum threshold for documenting controlled transactions or any simplified documentation rules and, therefore, irrespective of materiality, Romanian tax authorities can scrutinise the arm's-length nature of any controlled transaction.

Advance pricing agreements

In Romania, taxpayers engaged in related party transactions have the possibility to apply for advance pricing agreements (APAs). Details regarding the application procedure and the documentation that needs to be prepared by a taxpayer intending to request an APA are provided in a government decision issued in June 2007.

The APA is defined as an administrative act issued by the National Agency for Tax Administration in the view of addressing a taxpayer's request in relation to establishing the conditions and methodology to set transfer prices in related party transactions for a fixed period of time.

The procedure is initiated by the taxpayer through submission of a request for an APA that can be preceded, if desired by the taxpayer, by a pre-filing meeting. The documentation that needs to be provided upon request for an APA is similar to the transfer pricing documentation file and needs to suggest upfront the content of the APA.

The APA can be issued for a period of up to five years and is generally valid starting from the fiscal year subsequent to the filing of the request. By exception, its validity may be longer in case of long-term agreements. The APA is opposable and binding on the tax authorities as long as its terms and conditions are observed. In this view, taxpayers need to submit an annual report on these terms and conditions by the deadline for submitting the statutory financial statements.

If the taxpayer does not agree with the APA, a notification may be sent to the issuing tax authority within 15 days from the communication date, and the APA no longer produces legal effects.

The deadline for issuing APAs is 12 months for unilateral and 18 months for bilateral or multilateral APAs. In case of large taxpayers and for transactions with an annual value exceeding 4 million euros (EUR), the fee for issuing an APA is EUR 20,000, and the fee for amending it is EUR 15,000. For the rest of the taxpayers, the fee for issuing an APA is EUR 10,000, and the fee for amending it is EUR 6,000.

Taxpayers are classified as large taxpayers, provided that their annual turnover exceeds EUR 16.5 million; if they are banks, insurance companies or other financial institutions; or if they voluntarily make a formal commitment upon their set-up to perform investments of at least EUR 400 million.

Romania

Risk transactions or industries and legal cases

Having regard to the legislative changes and developments in the transfer pricing field, the transfer pricing audit activity has significantly increased, and requests for presenting the transfer pricing documentation file have started to become common practice.

In recent cases, the Romanian tax authorities adjusted the taxable result of taxpayers in accordance with the applicable regulations. The adjustments are carried out so that the profitability of the taxpayer reaches the median value of the arm's-length interval derived through a local benchmarking study. Most challenges and disputes generally arise in relation to the economic analysis.

Taxpayers should address with careful consideration the documentation of their related party transactions. Having appropriate transfer pricing documentation in place is, in all circumstances, a safeguard against noncompliance penalties and adverse tax consequences, which can result from transfer pricing adjustments.

Burden of proof and tax audit procedures

In Romania, the burden of proof lies with the taxpayer who should prepare transfer pricing documentation in order to defend the arm's-length nature of its transfer prices. In the case of litigation, however the burden of proof may shift to the tax authorities in order to demonstrate that the transfer prices set by the taxpayer are not at arm's length.

The Romanian tax authorities should first assess the arm's-length character of the controlled transaction by using the method applied by the taxpayer. However, in case the tax audit reveals that the arm's-length principle is not observed, the Romanian tax authorities may apply the most appropriate method from the ones listed above.

Comparable information

The detailed regulations regarding the content of the local transfer pricing documentation file include specific provisions on the procedure to conduct benchmarking studies. These should include local comparables. European or international benchmarking studies are accepted, provided that there are no local comparables or if the set of local comparables is too limited.

Another particularity of the way to carry out the benchmarking study is that the comparability range is narrowed to the interquartile interval. If the taxpayer's transfer prices fall outside the arm's-length range, the adjustment shall be carried out to the median.

In Romania, information on the performance of companies is available only in the form of published annual financial statements. These statements contain information that can enable computation of various profit level indicators. However, in some cases, segregation of transactions and identification of the cost base may prove to be difficult due to the particularities of the Romanian accounting system.

Additional taxes and penalties

Failure to present the transfer pricing documentation file may result in fines ranging from 12,000 Romanian leu (RON) to RON 14,000 (i.e. approx EUR 2,800 to EUR 3,300 at the current foreign exchange rate) and estimation of transfer prices by the

tax authorities based on generally available information on similar transactions, as the arithmetic mean of prices on three similar transactions.

The additional taxable profits resulting from this estimation or any transfer pricing adjustments are subject to the general 16% profit tax rate and related late payment interest and penalties. Under Romanian legislation, late payment interest and penalties are tax non-deductible.

Inter-company loans

Under the Romanian Fiscal Code, interest expenses incurred in relation to inter-company loans having a maturity that exceeds one year are subject to the following two limitations:

Safe harbour rules

Interest expenses on these inter-company loans are deductible within the limit of:

- In the case of loans denominated in hard currency (any other currency than the local currency), a ceiling established annually through government decision (i.e. 6%).
- In case of loans denominated in local currency, the reference interest rate of the National Bank of Romania.

The particularity of these ‘safe harbour’ rules is that taxpayers are not exonerated from their documentation obligations.

Interest expenses exceeding these limits are non-deductible and cannot be carried forward to subsequent years. This limitation is applied separately to each inter-company loan before considering the thin capitalisation rules detailed below.

Thin capitalisation rules

Interest expenses on inter-company loans are deductible, provided that the debt to equity ratio is lower than or equal to three. In case the debt to equity ratio is negative or higher than three, interest expenses are non-deductible in the current year and can be carried forward to subsequent years.

The debt to equity ratio is determined as a ratio between the company’s related party liabilities with a maturity exceeding one year (including liabilities whose maturity was extended so that it exceeds one year) and the owner’s equity, by considering the average of the book values recorded at the beginning and at the end of the year.

In particular, expenses with foreign exchange differences also need to be considered. Therefore, in case expenses with foreign exchange differences exceed revenue from foreign exchange differences, the difference is treated as interest expense and is subject to the limitation mentioned above. The expenses with foreign exchange differences subject to this limitation are those related to the liabilities considered for determining the debt to equity ratio.

This limitation is not applicable to banks, Romanian legal entities or branches of foreign banks, leasing companies for their leasing operations, real estate mortgage companies, credit institutions and non-banking financial institutions.

Romania

Other considerations

In case of related party financing, the following should also be analysed:

- Whether the loan granted serves the business interest of the beneficiary and has been used for that purpose.
- Whether there has been a profit distribution scheme.

Requalification of an inter-company loan into a profit distribution scheme occurs if, at the moment of granting the loan, a reimbursement is not expected and the agreement includes unfavourable conditions for the borrower. Under these circumstances, the loan can be reclassified as share capital; the deductibility of interest expenses and any foreign exchange differences can be challenged, and they can be assimilated to dividend payments.

Liaison with customs authorities

The tax and customs authorities in Romania do not usually cooperate when it comes to transfer pricing issues. The majority of customs value investigations to date have been related to the adjustment of the customs value according to Article 8 of the WTO Customs Valuation Agreement. Issues including the adjustment of customs value for royalties, licence fees, assists (e.g. packaging design, tools), and the inclusion of transport expenses were among the favourites of the customs inspectors.

However, we expect that transfer pricing adjustments, although not automatically notified to the customs authorities, will lead to further investigations and adjustments in customs as a result of the exchange of information between tax and customs authorities or as a result of their reflection in the business transactions.

63.

Russian Federation

Introduction

Russian transfer pricing provisions have been in force since 1 January 1999. Under the headings Principles of Determining the Price of Goods, Work or Services for Purposes of Taxation (Article 40 of the tax code) and Interdependent Parties (Article 20 of the tax code), the rules provided a basis for the tax authorities in certain circumstances to challenge transfer pricing arrangements. The provisions also set out the basic rules for determining market prices against which the prices used by taxpayers were compared. The general rules for determining prices for tax purposes were expanded by the Profits Tax chapter of Part II of the tax code, which came into force as of 1 January 2002 and contained some elements of transfer pricing to deal specifically with individual situations.

In July 2011, the law on the new Russian transfer pricing rules (the new law) was approved by the Russian Parliament and signed by the President. The new Russian transfer pricing rules became effective from 1 January 2012. The new law aims to make Russian transfer pricing rules work in practice and bring them closer to the Organisation for Economic Co-operation and Development (OECD) Guidelines. The new Russian TP provisions give the tax authorities more information about the transfer prices applied and the methods used in intragroup transactions (by introducing transfer pricing reporting and documentation requirements).

The following briefly summarises the new transfer pricing rules which apply from 2012.

Controlled transactions

The new rules cover the following types of controlled transactions:

- Domestic transactions between related parties (*see below*) if they meet one of the following criteria:
 - The amount of transactions exceeds 1 billion Russian rubles (RUB) (approx. 35 million United States dollars [USD]) per calendar year. According to transitional provisions of the new law, in 2012 this threshold will be RUB 3 billion (approx. USD 105 million); in 2013 – RUB 2 billion (approx. USD 70 million).

Transactions concluded between Russian companies registered in the same administrative region that do not have any subdivisions in other administrative regions within Russia or abroad are exempt from transfer pricing control (provided none of these companies has tax losses). In addition, transactions concluded between members of the same consolidated group of taxpayers will also be exempt from transfer pricing control.

Russian Federation

- Certain types of transactions which meet at least one of the following conditions and whose aggregate income exceeds RUB 60 million per calendar year (approx. USD 2 million):
 - If one party to a transaction is subject to mineral extraction tax and the goods are subject to the above tax at a percentage rate based on sales price.
 - One party to a transaction is exempt from profits tax or applies 0% tax rate, while the other party is a profits taxpayer in Russia and does not apply 0% tax rate.
 - One party to a transaction is resident in a special economic zone, while the other is not resident in that special economic zone; these provisions are effective from 1 January 2014.
- Transactions where one party applies the unified agricultural tax or a unified imputed income tax (regarding certain types of activities), while the other party pays profits tax under the general rules. Such transactions are subject to control starting from 1 January 2014 if the aggregate income (prices) exceeds RUB 100 million per calendar year (approx. USD 3.5 million).
- Cross-border transactions between related parties; under a general rule, no threshold is established for such transactions.
- Cross-border transactions with certain types of commodities: (1) oil and oil products, (2) ferrous and nonferrous metals, (3) fertilisers and (4) precious metals and stones. The list of commodities is to be established by the Russian Ministry of Industry and Trade. A financial threshold of RUB 60 million per calendar year is established for such transactions.
- Transactions with parties incorporated (domiciled, tax-resident) in a state or territory included in the Finance Ministry's list of offshore zones that grant beneficial tax regimes and do not share information during financial audits (a financial threshold of RUB 60 million per calendar year applies). The list of such territories is already approved by the Russian Ministry of Finance for the purposes of applying a participation exemption on dividends. The list includes such jurisdictions as the British Virgin Islands, Cyprus (to be excluded from the list from 2013), Hong Kong, Gibraltar, Liechtenstein and certain other territories.

Under transitional provisions of the new law, in 2012 cross-border controlled transactions will be subject to transfer pricing audit by the Federal Tax Service provided the amount of controlled transactions exceeds RUB 100 million; in 2013 – and RUB 80 million. Please note that the Russian tax authorities confirmed that for the purposes of financial threshold calculation, taxpayers should add up the value of all transactions with a particular counterparty during one calendar year.

According to the new law, if prices are regulated by the Russian authorities or established in accordance with Russian anti-monopoly law, the Russian tax authorities will accept such prices for tax purposes.

To conclude, the new Russian transfer pricing rules are, to a certain extent, aligned with those of the OECD, whose pricing controls focus solely on transactions between related parties. Nevertheless, by including cross-border transactions involving certain types of commodities and transactions with residents of low-tax jurisdictions in the list of controlled transactions, the tax authorities have in effect incorporated certain elements of anti-avoidance rules in the new Russian transfer pricing rules.

Interdependent parties

Under the new law, the following parties are recognised as being related under the tax code:

- Entities where one party (the party and its related parties) has more than a 25% direct or indirect participation in these entities.
- Entities where (i) more than 50% of the directors of these companies are the same individuals or (ii) not less than 50% of the directors are appointed/ chosen by the same individual.
- Entities, where the same individual/entity acts as the sole executive body; and on the basis of some other criteria.

Courts also have the right to recognise parties related for reasons other than those stipulated in the tax law if the relationship between the parties may have an impact on the conditions and outcome of a transaction performed by these parties or the results of their economic activity.

The economic interdependence of the parties to a transaction, arising, for instance, due to one party's dominant market position, is not to be used as grounds for declaring that the parties are related.

Basis for transfer pricing adjustment

The Russian tax authorities are allowed to make transfer pricing adjustments in relation to: (i) corporate profits tax, (ii) individual income tax (for individual entrepreneurs only), (iii) mineral extraction tax (if goods are subject to the above tax at a percentage rate), and (iv) VAT (if the counterparty is exempt from Russian VAT or is not a VAT taxpayer in Russia).

The new law introduced the concept of a market price (profitability) range (i.e. effectively the concept of inter-quartile range of prices or profit level indicators). The tax authorities will be able to adjust prices for tax purposes if the price applied in a controlled transaction or its profitability is not within the determined market range of prices (profitability).

Please note that the formula of the market range is slightly different from the interquartile range formula traditionally applied by OECD member countries to determine market prices. Moreover, when determining the market profitability range on the basis of the financial data of comparable independent companies, the new law establishes a number of criteria to be followed for selecting such comparable companies.

The new law have introduced a correlative adjustment mechanism for Russian companies in order to avoid double taxation with respect to domestic transactions. Provided that the tax authorities adjust the tax base of a Russian taxpayer and the latter pays the tax, the other party to the controlled transaction – a Russian company will be entitled to claim a corresponding adjustment to its tax base. The wording contained in the new law refers to correlative adjustments relating to Russian domestic transactions only. Furthermore, the correlative adjustments are possible if they result from a tax authorities' audit, rather than self adjustment by one of the counter parties.

Russian Federation

Some Russian tax treaties provide for correlative adjustment provisions in respect of cross-border transactions. However, in practice we have not come across such occasions where the Russian tax authorities have applied transfer pricing treaty protection for transfer pricing cases.

Transfer pricing methods

The transfer pricing methods are as follows:

- Comparable uncontrolled price (CUP).
- Resale price.
- Cost plus.
- Transactional net margin (comparable profits method).
- Profit split.

The law contains the best-method rule, coupled with a certain hierarchy in the methods' application. The CUP method remains the primary transfer pricing method to be used over all other methods (except for a case when a company purchases goods from a related party and resells them to independent parties; in this case, the resale minus method is given the priority). If the CUP and Resale Minus are not applicable, the taxpayer is free to choose between the remaining methods, although the profit split method should be used as 'the method of the last resort'. The choice of a particular transfer pricing method should be supported with due consideration of the functions performed, the commercial (economic) risks assumed and the assets employed in a controlled transaction. It is also possible to establish the transaction price/value by use of an independent appraisal, in the case of one-off transactions when none of the above TP methods can be applied.

The new rules contain quite brief provisions on application of the transfer pricing methods. It is expected that the new rules would be supplemented by clarifications detailing how the methods should be applied. Please note that the tax code does contain guidance in relation which comparability factors are important for a particular transfer pricing method. As a result, disputes with the Russian tax authorities may arise in relation to the choice of a transfer pricing method. The new law allows taxpayers to make self-maintained adjustments of tax amounts at the end of the calendar year if the prices used in a transaction between related parties are not at arm's length. However, such adjustments can be made only if tax liabilities were understated. Self-determined adjustments to decrease the taxable base are not allowed.

Safe harbours

The new law extends the list of comparability factors to be considered during the transfer pricing analysis; in particular, the company's functional and risk profile and business strategy will be introduced as comparability factors. However, there are no special safe harbours in the new law (the old law which was effective before 1 January 2012 allowed 20% deviations from the market price).

Securities and derivatives

The Profits Tax chapter of Part II of the tax code came into force on 1 January 2002 and introduced special transfer pricing rules for securities and derivatives. At the end of 2009, the Russian Parliament passed Federal Law No. 281-FZ of 25 November 2009, which introduced a number of important changes to the tax treatment of securities and derivatives. The rules establish the conditions that should be met so that the actual

price of a transaction is deemed to be the market price and therefore may be used as a basis for the calculation of taxes by the tax authorities.

Other regulations

On 12 January 2012 the Russian tax authorities issued special regulations on Advance Pricing Agreements; on 27 July 2012 – regulations on preparation of notifications on controlled transactions; and on 30 August 2012 – regulations on preparation of transfer pricing documentation.

There are a number of clarifications on the application of the new transfer pricing rules issued by the Russian Ministry of Finance/Federal Tax Service (e.g. about how to calculate the financial threshold).

Legal cases

Although case law does not exist in Russia, the vagueness of tax laws and the inconsistency that exists between the laws and their broad interpretation by the tax authorities means that the courts play a vital role in developing tax law interpretations in Russia. That is, in particular cases the law is construed by the decisions of various courts. However, for the reasons discussed, these decisions often serve only as a general guide in disputes between the tax authorities and taxpayers, where situations are similar.

An analysis of current Russian arbitration court practice in relation to transfer pricing cases shows that hot topics *inter alia* include challenging:

- deduction of intercompany management charges
- export sales at prices lower than prices for the domestic market
- trademark/franchise fee royalty deduction
- the use of European comparables from the foreign database to support profit attribution to a permanent establishment
- the sale of goods through intermediary companies (rather than directly to customers), and
- understatement of lease payments between related parties.

Burden of proof

In the new law, the burden of proof that the prices of controlled transactions do not correspond to market prices formally rests with the Russian tax authorities. However, during a tax audit the tax authorities are well equipped, since formal reporting and transfer pricing documentations requirements are introduced (*please see below*).

Reporting requirements

The new law have introduced reporting requirements for taxpayers, who will be required to submit certain information on controlled transactions no later than 20 May of the calendar year following the year when a controlled transaction was performed.

Such reporting requirements apply, provided the amount of controlled transactions concluded with the same entity exceed the threshold of RUB 100 million (approx. USD 3.3 million) in 2012 calendar year. It is intended that the above threshold will gradually decrease to RUB 80 million (approx. USD 2.6 million) in 2013 and to nil in 2014. By decreasing the threshold, the authorities anticipate covering a wider range of transactions in terms of reporting requirements.

Russian Federation

The notification form includes the following sections:

- Information about the transaction, including the amount of income derived and expenses incurred (disclosure of the pricing method and information sources used is optional).
- Information about the subject of the transaction, including the relevant contract number, the amount and the price, as well as the delivery terms.
- Information about the company / individual that is a party to the transaction.

In our view, the scope of information to be disclosed in the notification form exceeds the requirements of Russian tax code. The fiscal authorities treat transaction as each separate operation, e.g. each delivery of goods, rather than each contract. Thus, filling out a notification could prove to involve significant administrative costs.

Documentation requirements

The new law has formally introduced transfer pricing documentation requirements and provides that the tax authorities may request transfer pricing documentation during a tax audit, but not earlier than by 1 June of the calendar year following the year in which a controlled transaction was performed (e.g. transfer pricing documentation for 2012 would be required not earlier than 1 June 2013). Taxpayers will be required to present transfer pricing documentation within 30 working days of receiving a tax authority's request. Documentation can be prepared in a free format (provided there is no legislative requirement for a specific format) and contain the following information:

- Description, nature and terms of the controlled transaction.
- Functional analysis: Assets employed, functions performed, risks assumed by each party to the controlled transaction (although it is listed as an optional component, it is strongly recommended to include functional analysis in order to support the choice of the transfer pricing method).
- Transfer pricing method(s) used.
- Description of comparables: Sources of information and other data used and calculating the range of the arm's-length prices/profitability.
- Financial analysis: Calculations showing how the method has resulted in arm's-length terms, calculation of income (profit) to be received, and the economic benefit obtained in the controlled transaction (for transactions with IP rights).

For the purpose of applying transfer pricing documentation requirements, the threshold on income and expenses from controlled transactions is the same as for reporting requirements.

In cases where taxpayers have complied with the above procedure in a timely manner, the tax authorities will release taxpayers from penalty in the event of a tax adjustment. In these circumstances, taxpayers will have to pay tax calculated in addition to what they have already paid, plus late payment interest.

Russia's Federal Tax Service (FTS) has published Letter No. OA-4-13/14433 of 30 August 2012 (the Letter) 'On Preparing and Filing Documents for Tax Control Purposes'. The Letter explains the rules governing the preparation of transfer pricing documentation, specifically which transactions require documentation, the level of detail, the filing deadline, the archiving period, and other related information. The Letter contains two appendices. The first appendix recommends the content of the

documentation, while the second recommends the stages to be followed in preparing the relevant documents.

The Letter also says that a taxpayer's document filings will be used for conducting a pre-audit review and selecting an entity to undergo tax control measures. This could imply that the tax authorities are planning to request transfer pricing documentation before commencing a transfer pricing -related tax audit (although such approach is not in line with tax code provisions).

According to the Letter, economic analysis findings, i.e. a benchmarking study, should be revised annually not only for updating prior information about comparable companies, but also so as to include information about new comparable organisations in the marketplace, which may have emerged during the year, have a comparable profile and were not included in earlier samples.

Tax audit procedures

The new law introduced special transfer pricing audits which will be performed by the Transfer Pricing Unit of the Federal Tax Service.

The new TP audit-related rules will be enforced according to the following timetable:

- For transactions completed in FY12 can be initiated only until 31 December 2013.
- For transactions completed in FY13 can be initiated only until 31 December 2015.
- The standard three-year period available for audit will apply only from 1 January 2014.

During transfer pricing audits, the tax authorities will have the right to request information from both parties of a controlled transaction. A transfer pricing audit should last no longer than six months, but in exceptional cases, it can be extended up to 12 months. Further extensions are also possible, e.g. extensions may be necessary if information from foreign tax authorities is requested or there is a need to involve an expert.

Additional tax and penalties

The tax authorities may charge additional tax and late payment interest on underpaid tax. Interest should be charged in accordance with the general rules at a rate of 1/300 of the Central Bank of Russia refinancing rate (e.g. on 1 October 2012 this rate was set as 8.25% per year).

The new law has introduced penalties of up to 40% of the transfer pricing adjustment for underpayment of tax liability as a result of applying prices which do not comply with the arm's-length principle in the event of the non-submission or submission of incomplete, untimely or inaccurate transfer pricing documentation. The new law also provides for a transition period during the first years after the law takes effect. In particular, the law exempts any transactions that occur in 2012-2013 from transfer pricing penalties. A penalty of 20% will apply to the 2014-2016 tax periods.

The untimely submission of a transfer pricing reporting form, or its inaccurate completion, may result in a penalty of RUB 5,000 (approximately USD 167).

Russian Federation

Resources available to the tax authorities

In 2011, the tax authorities established a dedicated unit for handling transfer pricing issues under the new law. The tax inspectors of this unit are also responsible for concluding advance pricing agreements (APAs). In 2012 the tax authorities also established a special tax inspectorate which deals with transfer pricing issues, including economic analysis and other analytical work.

Use and availability of comparable information

The new transfer pricing rules have introduced an open list of information sources that can be used to establish the market price range. These sources include international exchange quotations, statistical data of Russian customs authorities and pricing information available from authorised state government bodies or publicly available information systems. Information from financial statements of foreign companies can be applied to determine an arm's-length profitability range for a Russian company only if the respective ranges cannot be calculated based on the Russian comparable data. To analyse Russian company's profitability, Russian GAAP data should be used.

Limitation of double taxation and competent authority proceedings

Russia is a party to around 80 double tax agreements, most of which have been concluded on the basis of the OECD model (although often with significant deviations) and therefore contain the 'Associated Enterprises' (or 'Adjustment of Profits') article. This article provides for correlative adjustments in the majority of the agreements (although primarily those concluded recently). In the older treaties, this article provided for a one-way adjustment that increases the profit of a treaty resident due to the use of nonmarket prices.

Very little information is available on the practice and procedure for invoking competent authority assistance (as no such information is published). However, the opportunity might exist, as according to informal interviews with Russian Ministry of Finance representatives, there are some cases when the mutual agreement procedure has been initiated (e.g. cases related to withholding tax application).

Advance pricing agreements (APAs)

Under the new law, only a selected group of taxpayers (the 'largest' taxpayers) are given an opportunity to conclude an APA. An APA represents an agreement between a taxpayer and the federal executive body responsible for control and supervision in the area of taxation. The term of the APA would not exceed three years, with the right being given to the taxpayer to apply for an extension of up to two years, provided that all of the APA's terms and conditions are being complied with by the taxpayer. The APA application fee is about USD 50,000. On 20 November 2012, the first APA was concluded between Federal tax authorities and a Russian oil company; the APA covers domestic transactions with oil.

Liaison with customs authorities

As noted above, the Russian tax authorities may cooperate with the customs authorities in determining comparables. The customs authorities possess certain databases for comparable prices and have certain techniques for evaluating the customs value of goods which may be used by the tax authorities when challenging prices in a controlled transaction. Moreover, the tax authorities will work in close cooperation with the

customs authorities on auditing prices in foreign trade transactions. However, it is to some extent unclear whether information provided by the customs authorities would satisfy comparability requirements for tax purposes.

Note that taxes payable on the import of goods to Russia (import VAT and customs duties) are calculated on the basis of the customs value determined by applying special rules contained in customs legislation as opposed to the general transfer pricing rules contained in the tax code. The customs pricing rules provide for six methods of determining customs values and contain a much wider definition of interdependent parties than that which is given in the tax code.

OECD issues

Russia is not a member of the OECD but is influenced by OECD Guidelines and models. In December 2007, the Ministry of Finance initiated discussions with OECD officials regarding the possibility of Russia becoming an OECD member country. Currently Russia has an observer status in some OECD committees.

Thin capitalisation

The Profits Tax chapter of Part II of the tax code, which entered into force on 1 January 2002, introduced thin capitalisation rules on debts between interdependent parties. These rules apply when the loans due to a foreign entity by a Russian entity that is more than 20% owned by this foreign entity or its affiliated parties exceeds by more than three times (or 12.5 times in the case of banks/credit institutions or enterprises engaged in leasing) the own capital of the Russian entity. These rules also apply to loans received from third parties if such loans are guaranteed by the above foreign company or its Russian affiliates. Such loans are determined in the tax legislation as controlled debts.

If the above conditions are met, the maximum deductible interest would be determined by the ratio of the interest accrued on the 'controlled debt' to a capitalisation coefficient (a ratio of the controlled debt multiplied by a percentage of the direct or indirect shareholding to the Russian entity's own capital multiplied by three [or 12.5 in the case of banks/credit institutions or enterprises engaged in leasing]). Interest in excess of the maximum interest is treated as dividends that are non-deductible for profits tax purposes and are subject to withholding tax.

In addition to restrictions imposed by thin capitalisation rules (if any), the general requirements on the deductibility of interest should be observed. Generally, interest incurred by an entity should be deductible for Russian profits tax purposes, provided such interest expenses meet the general deductibility criteria (i.e. they are economically justified, documentarily supported and relate to the taxpayers profit-generating activity).

At the same time, Russian tax legislation establishes certain limitations in respect of the level of interest deductible for tax purposes.

- For interest expense to be deductible, the interest rate should not deviate by more than 20% either way from the average interest rate on comparable loans obtained in the same calendar quarter (whereby comparable loans mean loans in the same currency for a comparable amount and against similar collateral), or at the taxpayer's choice.

Russian Federation

- A fixed deduction threshold set in the Tax Code (these thresholds are annually revised). For loans granted during 2012, the threshold is as follows: the Bank of Russia's refinancing rate (e.g. 8.25% on 1 October 2012) multiplied by 1.8 for RUB loans and multiplied by 0.8 for foreign currency loans.

The Russian tax authorities have expressed their position that the new transfer pricing rules apply to loans and guarantees. Therefore, both transfer pricing rules and interest deduction limits should be considered for determining deductible interest expense.

64.

Saudi Arabia, Kingdom of

Introduction

Although the Kingdom of Saudi Arabia (KSA) tax law does not have detailed transfer pricing regulations, it does explicitly state that transactions between related parties should be conducted based upon the arm's-length principle. This provision in the law allows the Department of Zakat and Income Tax (DZIT) to re-allocate revenues and expenses in transactions between related parties so as to reflect the returns that would have resulted if the parties were independent or unrelated. Taxpayers are also required to maintain documentation (in Arabic) to support the 'precise determination of tax payable by it'. Finally, the DZIT may use its discretion to examine a taxpayer's records and to request underlying documentation. As such, the DZIT can scrutinise related-party transactions, re-allocate/adjust revenues and expenses, disregard transactions, and/or reclassify a transaction whose form does not reflect its substance.

Statutory rules

Transfer pricing legislation

The KSA tax law contains no detailed transfer pricing rules or guidelines. However, transactions between related parties and the arm's-length principle are explicitly addressed in the law. More specifically, Article 63(c) provides that the DZIT may re-allocate revenues and expenses in transactions between related parties to reflect the returns that would have resulted if the parties were independent or unrelated. Furthermore, Article 64 defines related parties and Article 58 requires taxpayers to maintain documentation (in Arabic) to support the 'precise determination of tax payable by it'. Moreover, Article 61 provides the DZIT with the authority to examine a taxpayer's records. Taken together, these articles provide DZIT with the authority to request underlying documentation and to make income adjustments based on the arm's length principle whereby the DZIT's arm's-length test may differ significantly from Organisation for Economic Co-operation and Development (OECD) standards. Payments for goods or services delivered to the taxpayer by related parties to the extent that it is in excess of an arm's length value is considered non-deductible from a KSA perspective.

Related parties

As per Article 64: Related Persons and Persons under Common Control of the KSA tax law, companies and organisations are considered to be under common control if they are 50% or more controlled by the same related person(s). Control is defined as ownership of rights to income or capital, voting rights or value, or other beneficial interest either directly or indirectly through one or more subsidiaries of any type of companies.

Saudi Arabia, Kingdom of

Transfer pricing methods

The KSA tax law does not explicitly define specific transfer pricing methods, nor does KSA currently have transfer pricing guidelines.

Other regulations

Tax rates

The corporate tax rate in KSA is 20% of the net adjusted profits. Zakat, an Islamic assessment, is charged on the company's Zakat base at 2.5%. The Zakat base represents the net worth of the entity as calculated for Zakat purposes, including net adjusted profits. Only non-Gulf-Cooperation-Council (GCC) investors are liable for paying corporate tax in KSA. In most cases, KSA citizen investors (and citizens of the GCC countries) are liable for Zakat. Where a company is owned by KSA and non-KSA interests, the portion of taxable income attributable to the non-KSA interest is subject to corporate tax, and the KSA share goes into the basis on which Zakat is assessed.

For tax purposes, a recent change was effected in October 2010 with the intention of mitigating double taxation on foreign investor income realised from investments in other resident companies. According to this change in law, such income is to be excluded for tax purposes, subject to the following conditions:

- Such income is subject to tax in KSA.
- The percentage of ownership in the company invested in is not less than 10%.
- The period of ownership of shares is not less than one year.

With respect to the income realised by a resident capital company from its investments and operations outside KSA, it will be subject to tax in KSA (unless an effective double-tax treaty between KSA and the country invested in stipulates different provisions). However, for Zakat purposes, the concept of consolidation is acceptable and relief could be obtained for subsidiaries wholly owned by KSA companies that are subject to Zakat.

Moreover, an entity operating in KSA that has undertaken more than one project under the same commercial registration is required to consolidate the results of such projects into the financial statements of that entity and subject them to taxation as a single operation.

Non-deductible expenses

A number of expenses are non-deductible for tax and Zakat purposes. Some of the most relevant non-deductible expenses should be:

- net interest expenses exceeding 50% of the taxpayer's earnings before interest and tax (EBIT)
- provisions (such as bad-debt provisions and end-of-service benefits)
- contributions to pension funds, saving funds or social insurance outside KSA, and
- entertainment expenses.

Withholding taxes

Payments made from a KSA resident or permanent establishment (PE) to a non-resident for services performed are subject to withholding taxes. The withholding tax rates can range from 5% to 20% based on the type of service and whether the beneficiary is a related party. Moreover, withholding tax should be paid within the

first ten days of the month following the month during which the payment was made. The domestic rate for withholding tax is 5% on dividends, 15% on royalties and 5% on interest.

Branch income

Taxable income from a branch of a non-KSA-based corporation is taxed at 20%. Certain charges levied on a KSA branch by the head office are non-deductible for KSA purposes. Such non-deductible items may include:

- Royalties or commissions.
- Loan charges (interest expense) or any other financial fees.
- Indirect administrative and general expenses allocated on an estimated basis.

Thin capitalisation

No special legislation governs thin capitalisation for tax purposes. A KSA company may deduct interest payments to affiliates, provided that the amount of debt and rate of interest are at arm's length and that the interest deductibility formula is met. A KSA company may be financed with minimum capital, and there is no limit to the amount of debt that may be used.

Based on Saudi interest capping rules the taxpayer's net interest expense in excess of 50% of taxable earnings before interest and tax (taxable EBIT) should be added back to the tax base. However, this rule applies to interest expense irrespective of the recipient's qualification as related or unrelated party.

Legal cases

No specific transfer pricing cases have been brought in KSA courts. However, summarised below are a few insights, based upon experiences with the DZIT:

- Offshore supplies from related parties may require a certificate from the supplier's auditor that the purchase price for the goods equals international market prices, although it should be possible to reconcile book values of offshore supplies with the corresponding customs documentation.
- Head office (management) charges must be certified by the head office auditors as being direct expenses only, not including a profit margin, or they are likely to be partly or completely treated as non-deductible.
- Payments to related parties in excess of market values might be treated as constructive dividends and thus may attract 5% withholding tax if the recipient's parent company is not resident in KSA.
- The DZIT is entitled to rewards if it identifies additional tax liabilities. Hence, high-value major transactions might experience increased scrutiny during tax audits.

Burden of proof

Given the absence of transfer pricing guidelines with specific transfer pricing provisions (including delineation of specified transfer pricing methods), there are no specific rules regarding burden of proof. However, taxpayers are expected to produce sufficient transfer pricing documentation (and other supporting documents, including intercompany agreements, schedules and invoices) to support its declared transactions on the tax return.

Saudi Arabia, Kingdom of

Tax audit procedures

Saudi tax authorities are allowed to conduct tax audits at any time during the office hours of taxpayers. The authorities are not required to give the taxpayer prior notice of their visits. In practice, though, the audit team often notifies the advisors of taxpayers with particularly big operations and agrees the date, time and location for the kick-off meeting.

In case the taxpayer under review cannot provide sufficient documents to support its filing position, the DZIT is entitled to estimate the appropriate tax base and/or impose penalties. The law stipulates minimum estimates which vary depending on the industry of the taxpayer. Although the law encourages tax inspectors to use all available information and to apply realistic estimates many Saudi tax inspectors have a tendency to apply quite generous 'risk premium'.

According to Saudi law tax auditors are entitled to bonus payments in case they manage to increase tax revenues for the public treasury.

Returns

Tax filings are based on each taxpayer's fiscal year. Returns are due to be filed with the DZIT and tax due must be paid within 120 days after the taxpayer's year end. The system is one of self-assessment. Advance tax payments are required to be made for a current tax year under the following conditions:

- The taxpayer has earned income during the year.
- An advance payment of 25% of the amount resulting from the taxpayer's tax liability based on the previous year return minus the withheld tax.
- The computed payment is at least SAR 500,000.
- Three equal advance payments of tax on the last day of the sixth, ninth and twelfth months of the tax year.
- Late payment of an advance payment is subject to a delay penalty of 1% of the amount due for every 30 days of delay.

Appeals

Appeals against assessments issued by the DZIT are heard by the Preliminary Appeal Committee. Appeals against a decision by the Preliminary Appeal Committee are heard by the High Appeal Committee. A 60-day time limit applies for making appeals against tax assessments for financial years after 2004, as noted in the following table:

Appeal committee	Law
Appeal statutory date	Within 60 days from the date the final assessment is received
Committee ruling	Final unless appealed to the High Appeal Committee
Formation of the committee	Resolution from the Ministry of Finance

A time bar of five years generally applies to tax reassessments/audits by the DZIT unless the DZIT views the taxpayer's approach as tax evasion, in which case a ten-year time bar would apply.

Applicable tax penalties

Item	Law
Non-registration	From SAR 1,000 to SAR 10,000
Failure to file the tax return	From 5% to 25% of the unpaid tax
Delay payment	1% of the unpaid tax for each 30 days of delay
Evasion	25% of the unpaid tax

Use and availability of comparable information

Given the absence of transfer pricing guidelines, KSA has no specific rules regarding comparable information.

Tax treaty network

KSA has signed double-tax treaties with more than 30 countries, most of which are in force in 2010 and 2011, while the others are still being finalised or awaiting the ratification process. In addition, and to encourage foreign capital investments, there are plans for negotiations of double-tax treaties with several additional countries.

More specifically, KSA has entered into tax treaties with several countries, including Austria, China, France, India, Italy, Malaysia, Pakistan, South Africa, South Korea, Turkey and the United Kingdom. A number of other treaties are not yet in force (i.e. Poland, Singapore and Vietnam), and negotiations with a number of other countries are in progress. With that said, double-tax treaties have not often been effectively tested in KSA. However, they generally follow the OECD model treaty and may provide certain relief, including withholding tax on service fees, dividends, royalties and interest.

65.

Singapore

Introduction

Although Singapore's income tax rates are traditionally lower than the income tax rates of the majority of Singapore's primary trading partners, the Inland Revenue Authority of Singapore (IRAS) is increasing its focus on transfer pricing issues.

Statutory rules

The Singapore Income Tax Act (SITA) contains provisions that may be used in a transfer pricing context to effectively allow IRAS to challenge and revise intercompany transactions. Further, the IRAS issued transfer pricing guidelines on 23 February 2006 to provide greater clarity on transfer pricing matters and procedures in Singapore.

Anti-avoidance

Section 33 of the SITA contains general anti-avoidance rules that allow IRAS to disregard or revise any arrangement in order to counteract a tax advantage obtained under an existing arrangement. The rules are applicable to any scheme, agreement or transaction as a whole, as well as the component steps by which the arrangement was carried into effect. The anti-avoidance rules do not apply if the arrangement is conducted for bona fide commercial reasons and the reduction or avoidance of tax is not one of its main purposes.

Related party transactions

Section 34D has been enacted recently in the SITA to legislatively endorse the arm's-length principle.

Section 53(2A) of the SITA applies where a resident and a non-resident are closely connected and conduct business in such a way that produces profits to the resident that are less than the ordinary profits that might be expected to arise in such transactions. In such a case, IRAS may assess and charge the non-resident tax in the name of the resident, as if the resident were an agent of the non-resident. Where the 'true' amount of the profit is not readily ascertainable, IRAS has the power to assess tax on a 'fair and reasonable' percentage of the turnover of the business done between the resident and the non-resident.

Tax authorities' powers

As a final measure, IRAS has the power to simply refuse to accept a tax return as filed and assess tax based on taxable income determined according to the best of its judgment.

Singapore transfer pricing guidelines

Background

The Singapore transfer pricing guidelines (the guidelines) were issued by the IRAS in February 2006. These guidelines provide guidance to Singapore taxpayers on application of the arm's-length principle and on documentation matters.

The said guidelines also provide the procedures for applying for the mutual agreement procedure (MAP) and advance pricing arrangement (APA) facilities, which are used to avoid or eliminate double taxation.

Scope

The guidance on application of the arm's-length principle is applicable to all related party transactions of goods, services and intangible properties. The guidance on MAPs and APAs are applicable only to related party transactions involving at least one party resident in Singapore or a jurisdiction with which Singapore has a comprehensive Double Taxation Avoidance Agreement. Further, the guidelines are applicable where at least one related party is subject to tax in Singapore.

Definition of related party

The guidelines define a related party for Singapore transfer pricing purposes as:

“The related party, in relation to any entity, means any other entity who directly or indirectly controls that entity or is controlled, directly or indirectly, by that entity, or where both entities, directly or indirectly, are under the common control of a common entity.”

The arm's-length principle

The arm's-length principle described in the guidelines and legislated in the SITA is in line with the arm's-length principle in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and Capital and in the OECD Transfer Pricing Guidelines (i.e. the arm's-length principle requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent entity).

The guidelines, however, recognise that establishing and demonstrating compliance with the arm's-length principle requires exercise of judgment and recommends that taxpayers adopt a pragmatic approach to ascertaining arm's-length pricing for related party transactions.

The guidelines seek to provide guidance and recommendations on the application of the arm's-length principle with the following three-step approach:

Step 1 – Conduct a comparability analysis.

A comparability analysis is conducted to analyse whether the uncontrolled price/margins being compared to the controlled price/margins have all economically relevant characteristics similar, such that one of the following conditions exists:

- None of the differences of the situations being compared can materially affect the prices or margins being compared.

Singapore

- Reasonably accurate adjustments can be made to eliminate the effect of any such differences.

The guidelines also suggest that a comparability analysis should examine the comparability of the transactions in the following three aspects:

- Characteristics of goods, services and intangible properties.
- Analysis of functions, assets and risks.
- Commercial and economic circumstances.

The ultimate aim of the comparability analysis is a comprehensive assessment and identification of the areas and extent of significant similarities and differences (such as product characteristics or functions performed) between the transactions/entities in question and those to be benchmarked against.

Step 2 – Identify the appropriate transfer pricing method and tested party.

The guidelines indicate that, in theory, the traditional transaction methods provide for a more direct comparison with independent party transactions and hence would be superior to the transactional profit methods. However, the guidelines do recognise that, in practice, the reliability of the results produced by any method would be crucially affected by the availability and quality of data, as well as the accuracy with which adjustments can be made to achieve comparability. Hence, the guidelines do not have a specific preference for any one method. The guidelines recommend the adoption of the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments.

The guidelines allow the Singapore taxpayer to select any one of the following methods for its transfer pricing purposes:

- Comparable uncontrolled price (CUP) method.
- Resale price method.
- Cost plus method.
- Profit split method.
- Transactional net margin method.

The guidelines also allow the taxpayer to use a modified version of one of these methods to comply with the arm's-length principle, as long as the taxpayer maintains and is prepared to provide sufficient documentation to demonstrate that its transfer prices are established in accordance with the arm's-length principle.

Step 3 – Determine the arm's-length results.

Once the appropriate transfer pricing method has been identified, the method is applied on the data of independent party transactions to arrive at the arm's-length result.

Documentation

The guidelines provide guidance on the type of documentation that taxpayers should keep in order to demonstrate that reasonable efforts have been taken to comply with the arm's-length principle.

The guidelines indicate that the following information (not exhaustive) would be useful in substantiating that the taxpayer's transfer pricing analyses are in accordance with the arm's-length principle and that the taxpayer has made reasonable efforts to determine arm's-length transfer prices, margins or allocations:

- General information on the group.
- Information on each related party in Singapore (Singapore entity).
- Details of transactions between Singapore entity and all related parties.
- Transfer pricing analysis.

However, the guidelines recognise that keeping robust documentation may result in compliance and administrative costs for taxpayers. In this respect, the guidelines indicate the following principles with regard to documentation:

- Taxpayers are only required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm's-length principle.
- Singapore currently does not impose a penalty specifically for the lack or insufficiency of documentation. However, if the taxpayer violates the recordkeeping requirements under Sections 65, 65A and 65B of the SITA, the IRAS would not in any way be precluded from enforcing these relevant provisions.
- The IRAS does not require documentation to be submitted when the tax returns are filed. Taxpayers should keep the documentation and submit it to IRAS only when requested to do so.

Guidelines in connection with MAP

The guidelines also provide the IRAS' position on the MAP process as well as provide guidance on the manner in which taxpayers may apply for the MAP with respect to transfer pricing adjustments.

The MAP aims to provide an amicable way by which competent authorities may eliminate double taxation. Although IRAS would endeavour to eliminate or reduce the double taxation that the taxpayer may encounter, it is possible only if there is concurrence by all competent authorities involved in the process and full cooperation by the taxpayer.

The guidelines indicate that the IRAS generally accepts a taxpayer's request for MAP if:

- the taxpayer has complied with the time limit specified in the applicable double tax agreement (DTA) for presenting the MAP request
- double taxation is almost certain and not just a possibility, and
- the taxpayer is willing and able to render full cooperation.

Further, the guidelines also provide the procedural aspects involved in making a MAP request to IRAS. The procedure involves:

Step 1 – Submit notification of intention to make MAP request

The notification to IRAS should be made in writing and should describe briefly the circumstances and provide basic information concerning the cause of double taxation.

Singapore

Step 2 – Hold preliminary meetings

In the preliminary meetings, the IRAS evaluates the taxpayer's situation and grounds for making the request as well as the quality and adequacy of the taxpayer's documentation.

Step 3 – Submit formal request

Unless the IRAS or other competent relevant authorities object to the taxpayer's MAP request, the taxpayer should formally submit a MAP request to the IRAS.

Step 4 – Review and resolve double taxation

IRAS commences the process of MAP and tries to resolve the double taxation issue with the other relevant competent authorities.

Step 5 – Hold post-agreement meeting and implement agreement

Upon reaching agreement with the other competent authority, the IRAS meets with the taxpayer to discuss the details of the agreement and to implement the agreement.

Guidelines in connection with APA

An APA determines, in advance, an appropriate set of criteria to ascertain the transfer prices of specified related party transactions over a specified period of time. The treaty provisions and the domestic tax provisions enable Singapore competent authorities to accede to requests from taxpayers for APAs and enter into such agreements. Singapore allows for unilateral as well as bilateral APAs.

IRAS has issued additional guidance for taxpayers seeking to enter into unilateral, bilateral or multilateral APAs. This supplementary administrative guidance on APAs sets out various important time lines to observe during preliminary meetings, the formal APA submission and review, and when (and the period for which) roll-back may apply to bilateral or multilateral APAs. The guidance also spells out the circumstances under which the IRAS will discontinue an APA discussion. Broadly, the process involves:

Step 1 – Hold preliminary meetings

Generally, at preliminary meetings, the taxpayer is expected to present the salient information such as the company's business model and industry information, transactions to be covered, the period of APA, etc. The first preliminary meeting with the IRAS should take place at least three months before the date the taxpayer intends to submit an APA application to the IRAS and/or another competent authority. The IRAS discourages anonymous requests to discuss potential APAs. If the IRAS is willing to accept the APA, it advises the taxpayer on the appropriate follow-up action.

Step 2 – Submit formal APA

Unless the IRAS or relevant foreign competent authorities disagree, the taxpayer should formally submit an APA request at least six months before the first day of the proposed APA covered period.

Step 3 – Review and negotiate APA

Within one month of receipt of the formal application, the IRAS informs the taxpayer of whether the APA application has been accepted or rejected. The taxpayer should note that the IRAS reserves the right to propose alternative methodologies or to request a restriction or expansion of the scope of the proposed APA subsequent to the formal submission of the APA application. If the IRAS accepts the APA application, it

begins the process of seeking an APA with relevant foreign competent authorities (in case it is a bilateral or multilateral APA).

Step 4 – Hold post-agreement meeting and implement APA

Upon reaching agreement, the IRAS meets with the taxpayer to discuss the details of the agreement and to implement the agreement.

Other regulations

The IRAS releases interpretation and practice notes as well as administrative statements to provide guidance to taxpayers on a variety of issues. These publications do not have the force of law and are not binding. However, they do provide the IRAS' view on the law and its administrative practices in its application of the law.

Legal cases

To date, no specific cases relating to transfer pricing issues have been brought before a Singapore court. However, case law from other common law jurisdictions may be applicable on a case-by-case basis.

Burden of proof

It is common for the IRAS to query the basis of inter-company charges or transactions by requesting that a taxpayer provide evidence that such transactions are at arm's length. The burden of proof lies with the taxpayer.

Tax audit procedures

Pursuant to the transfer pricing consultation circular issued by IRAS in July 2008, a questionnaire requesting information on related party transactions is sent to selected taxpayers. The objective of the transfer pricing consultation is to assess the level of compliance with the Singapore transfer pricing guidelines by reviewing the taxpayer's transfer pricing documentation. This questionnaire is, in effect, a declaration that the taxpayer must sign. Based on the response to the questionnaire, taxpayers may be selected for an in-depth field visit and further examination by the IRAS if their transfer pricing practices are found to be inappropriate.

Additionally, to determine the accuracy of a tax return, the IRAS may require any taxpayer to provide their books, documents, accounts, returns and any other information that would allow the IRAS to obtain full information in respect of the taxpayer's income. Business records are required to be maintained for at least five years.

Revised assessments and the appeals procedure

If the IRAS does not agree with a taxpayer's tax return, it may, within six years after the year of assessment (for year of assessment 2007 and earlier) and four years after the year of assessment (for year of assessment 2008 and thereafter), issue a notice of assessment based on its 'best judgment'. A taxpayer that disagrees with a notice of assessment must object in writing within 30 days from the date of the notice. As the taxpayer is required to provide detailed grounds for objection, documentation to support its inter-company pricing should be available at this time. The IRAS considers the grounds for the objection, including any documentation received, and may issue an amended assessment. If the IRAS and the taxpayer are unable to reach an agreement, a 'Notice of Refusal to Amend' is issued.

Singapore

Taxpayers have the right to appeal to the Board of Review if they are dissatisfied with the IRAS' decision. Based on the decision of the Board of Review, the taxpayer or the IRAS may choose to appeal to the High Court. Subsequently, application may be made to the Court of Appeal if either party is dissatisfied with the High Court's decision. However, the Court of Appeal does not hear appeals on a question of fact.

Additional tax and penalties

The legislation and the transfer pricing guidelines do not provide penalties specifically directed at transfer pricing 'offences'. However, the general provisions relating to offences and penalties are applicable where the IRAS has a dispute with a taxpayer in relation to its inter-company transactions.

A taxpayer that omits or understates any income may be subject to a penalty equal to the amount of tax that has been or would have been undercharged. Where a taxpayer is found to be negligent in omitting or understating income, the penalty is double the amount of tax that has been undercharged plus a fine not to exceed 5,000 Singapore dollars (SGD), or imprisonment for a term not to exceed three years, or both. A taxpayer who is found to have wilfully understated their income with intent to evade tax is subject to more severe penalties.

Further, IRAS can invoke penalty provisions under Sections 65, 65A and 65B of the SITA for violation of record- or information-keeping requirements; can impose a fine not to exceed SGD 1,000; and, in default of payment of fine, can impose imprisonment for a term not to exceed six months.

Penalties and interest charges on the underpayment of tax are not deductible for tax purposes.

Resources available to the tax authorities

The IRAS has obtained training on transfer pricing from other tax authorities and shares information on a regular basis with other Association of South East Asian Nations (ASEAN) tax jurisdictions in relation to the taxpayers.

Use and availability of comparable information

Although Singapore does not mandate contemporaneous documentation requirements, it requires taxpayers under review to verify and confirm the arm's-length nature of its related party transactions through sufficiently detailed and comprehensive documentation. The documentation should include an analysis of the functions and risks undertaken by the Singaporean taxpayer and the methodology upon which it derived the transfer price, including benchmarking.

Availability

The IRAS requires transfer prices to be comparable to industry standards. Comparable information is available through databases.

Limitation of double taxation and competent authority proceedings

In addition to the limited agreements dealing with the taxation of the international traffic of ships and aircraft, Singapore has a fairly extensive network of comprehensive double tax agreements modelled based on the OECD convention.

The majority of Singapore's treaties contain an 'Associated Enterprises' article which permits the respective tax authorities to adjust the profits of an entity where the transaction did not occur at an arm's-length price. However, very few of its treaties contain the accompanying relieving provisions in the article that effectively requires one country to reduce the amount of tax charged to offset the increased tax liability imposed by the other country as a result of reflecting the transaction at arm's length.

Where a treaty does not contain the relieving provisions, a taxpayer must apply to the competent authorities under the mutual agreement procedure (MAP) article to obtain relief from double taxation. See the Statutory rules section for details relating to this process.

Advance pricing agreements

The treaty provisions and the domestic tax provisions enable Singapore's competent authorities to accede requests from taxpayers for advance pricing agreements (APAs) and enter into such agreements. See the Statutory rules section for details relating to this process.

Funding

The IRAS has released transfer pricing guidelines on application of the arm's-length principle to related party loans. Domestic and cross-border loans are covered under this guideline.

The taxpayer should adopt the arm's-length methodology in related party cross-border loans. As time is needed to restructure loans to reflect an arm's-length rate of interest, the IRAS provides a transitional period of two years starting from 1 January 2009. From 1 January 2011 onwards, IRAS requires all related party cross-border loan arrangements to reflect arm's-length conditions.

Management services

A number of entities have been set up in Singapore to provide services to related parties in the region. Transfer prices for such services are typically determined on a cost plus basis. In the past, IRAS generally accepted the transfer price for management services where the service actually performed for the benefit of the payer can be identified and the transfer price reflects at least a 5% profit on the total cost of the service. Note that IRAS has now issued guidelines on related party services, which states that a 5% profit is accepted for only routine services. The IRAS would expect a higher profit in the case of greater value-added services provided by a Singaporean entity, for example, research and development.

Where a non-resident related party provides management services to a Singaporean entity, the fee charged to the Singaporean entity is generally deductible if the services provided can be identified and the fee is reasonable and appropriate, based on the costs actually incurred by the service provider. Further, there must be a direct benefit to the Singaporean entity to receive a deduction. No Singaporean withholding tax is levied on the payments made by Singaporean entities where services are rendered outside Singapore.

The IRAS is increasingly scrutinising intragroup recharges to ascertain that services have provided a direct benefit to the Singaporean entity. Taxpayers are required to

Singapore

justify the level of service received vis-à-vis the recharge and confirm that the recharges exclude any shareholder costs.

IRAS has also issued guidelines on the conditions where cost pooling or pass-through costs are acceptable.

Business profits

Singapore's comprehensive double tax agreements contain a 'Business Profits' article that provides, in general, that business profits of an enterprise are not taxable in Singapore unless that enterprise has a permanent establishment (PE) in Singapore. Where an enterprise has a PE in Singapore, only those profits attributable to that PE may be taxed in Singapore.

66.

Slovak Republic

Introduction

The Slovak tax system was established in 1993. Tax legislation attempted, in basic terms, to prevent deviations from arm's-length prices in related party transactions. One of the major milestones in Slovak transfer pricing history was December 2000, when Slovakia joined the Organisation for Economic Co-operation and Development (OECD). Thus, taxpayers could adopt the OECD Guidelines with some degree of certainty that the treatment would be acceptable to the Slovak tax authorities. Furthermore, the Slovak Ministry of Finance has issued an official translation of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published by the OECD. Slovak tax authorities' practical experience with transfer pricing principles are that of an under-developed countries' level, although they have increased significantly in the last few years.

Corporate income tax

The Slovak Income Tax Act and Slovak transfer pricing regulations cover transactions with foreign related parties. Generally, the prices in transactions between foreign related parties are required to be at arm's length. Foreign related parties are defined as a Slovak tax resident and/or a non-Slovak tax resident that are one of the following:

- Relatives.
- Entities that are economically or personally related.
- Entities with certain other relationships.

Economically or personally related means one of the following:

- When one entity directly or indirectly holds more than 25% of the share capital or voting rights of the other.
- An entity and its statutory representative or a member of its supervisory board.
- Two or more entities in which a third entity directly or indirectly holds more than 25% of the share capital or voting rights.
- Entities having the same person as their statutory representative or a member of their supervisory board.

However, according to the full extensive definition set in the Slovak Income Tax Act, all companies within the company group likely qualify as related parties.

Entities with certain other relationships are parties connected solely for the purpose of reducing the tax base. Furthermore, a Slovak permanent establishment (PE) and its foreign headquarters, as well as foreign PEs and their Slovak headquarters, are also considered foreign related parties for transfer pricing purposes.

Slovak Republic

In 2001, the transfer pricing legislation introduced a number of methods to determine the arm's-length price for cross-border transactions between related parties. These methods broadly equate to the transaction-based methods and profit-based methods according to the OECD Guidelines. The transaction-based methods listed include: comparable uncontrolled price, resale price, and cost plus methods. The profit-based methods listed include: the transactional net margin and profit split methods.

The Slovak taxpayer can also use a combination of these methods, or choose any other method, provided the method used is in accordance with the arm's-length principle. However, in general, taxpayers should primarily use transaction-based methods. The Slovak tax legislation has not yet adopted the latest OECD Guideline version, which removed the hierarchy of transfer pricing methods.

There are no formal advance pricing agreements (APAs) in Slovakia. However, the Slovak tax authorities can, in advance, approve a particular method of setting the price in transactions with foreign-related parties. They are obliged to issue a decision on a particular method to be used if requested by a taxpayer. However, they do not confirm prices used or publish any benchmarks.

The approved method can be used for up to five tax periods, and can be extended for another five tax periods if certain conditions are met. The tax authorities can cancel or amend their decision if the method was approved based on false or inaccurate information provided by the taxpayer, or if the relevant conditions had changed. The tax authorities may also cancel or amend their decision based on the request of the taxpayer proving that conditions have changed.

In addition, the tax authorities can approve a method for determining the corporate income tax base of a Slovak PE of a foreign taxpayer per the taxpayer's request. This method is usually based on one of the OECD transfer pricing methods.

For certain related party transactions the Slovak tax authorities generally accept as the arm's-length price value as appraised by an independent valuation expert.

From 2009, all Slovak taxpayers have to report a value of intragroup transactions performed in each particular tax year in their corporate income tax return forms.

Burden of proof

Generally, the burden of proof rests with the taxpayer.

At the beginning of 2009, the Slovak Ministry of Finance issued a guideline which set out the content of obligatory transfer pricing documentation (the Guideline). Under the Guideline, a Slovak company's obligatory transfer pricing documentation should include information that explains how the prices applied in material transactions with foreign related parties have been set, and justifies their arm's-length nature.

The transfer pricing documentation is required for all tax periods during which the Slovak taxpayer carries out material transactions with its foreign related parties. It must be in Slovak, unless the tax authorities agree to accept documentation in a different language.

Moreover, the Guideline introduces two types of transfer pricing documentation:

- Full transfer pricing documentation.
- Simplified transfer pricing documentation.

The full transfer pricing documentation is required only for material transactions undertaken by entities that prepare their financial statements under the International Financial Reporting Standards (IFRS) for Slovak statutory purposes. Other entities should maintain simplified transfer pricing documentation in order to justify prices applied in their material foreign-related-party transactions.

The full transfer pricing documentation under the Guideline is based in the EU recommendations, and should include general transfer pricing documentation (a master file) and specific transfer pricing documentation (a local file).

The master file includes the following information about the pricing policy within the entire group or related entities (Slovak and foreign):

- The identification of group members.
- The group ownership structure.
- A business description.
- Industry identification.
- The business strategy of the group.
- A description of the functions undertaken and the risks assumed by individual entities within the group.

The local transfer pricing documentation should contain the following specific information about the Slovak entity and its transactions with its foreign related parties:

- The identification of the entity and its ownership.
- A description of the company's business and industry.
- The company's organisational structure and a list of foreign related parties.
- The company's planned business strategy and business plan.
- A list and description of transactions or services provided to foreign related parties.
- An overview of the company's intangible assets.
- A description of the functions undertaken and the risks assumed by the Slovak company.
- Information on the choice and application of transfer pricing methods.
- Information on comparable data (benchmarking study).

Taxpayers are obliged to provide the transfer pricing documentation within 60 days of the tax authorities' request. Therefore, it is recommended to prepare the documentation at the same time the foreign-related-party transactions are carried out.

Value added tax

On 1 January 2010, an amendment to the Slovak VAT Act which introduced transfer-pricing rules for VAT was introduced. According to the amendment, if the actual price that a Slovak VAT payer charges for supplies of goods and services to an entity which is a related party, as defined in Slovak VAT law, is lower than the market value, then the tax base shall be the market value if the recipient is either:

- not registered for Slovak VAT, and
- a Slovak VAT payer (registered for Slovak VAT as a domestic or foreign entity) but does not have the right to claim the full input VAT for these goods and services.

Slovak Republic

Under the amendment, a related party to the VAT payer is, for example, a statutory body or statutory representative of the VAT payer, an entity who directly or indirectly owns or controls 10% or more of shares of the VAT payer supplying the goods or services, or one that is directly owned or controlled by 10% or more of shares of this VAT payer or employees of the VAT payer.

Other taxes

With respect to real estate tax, the value of the real estate, based on which the tax base is determined, should generally be set according to the appendix to the Real Estate Tax Act. In specific cases, it should be based on the arm's-length price, determined by an independent, court-approved valuation expert who must value the real estate under specific regulations.

Customs

Since its accession to the EU on 1 May 2004, Slovakia has followed the EU Customs Code, based on the transaction value. For sales between related parties, the price applied in any particular case should approximate the transaction value in sales of identical or similar goods between buyers and sellers who are not related.

Tax inspection procedures

The transfer pricing inspection and potential additional tax charges on the grounds of transfer pricing could be assessed for 11 years following the year or tax period concerned. Thus, the standard six or eight year statute of limitation period does not apply in case of transfer pricing.

According to the Slovak Act on Tax Administration, the tax administrator should impose a fixed penalty equal to three times the European Central Bank's interest rate on the difference in tax between that shown in the tax return and that determined by the tax administrator (but not less than 10%).

In the event of late payment of the tax liability declared in the tax return, the tax administrator can impose interest of four times the European Central Bank of Slovakia's interest rate on overdue tax. This applies to each day of late payment, up to a maximum period of four years.

Anticipated developments

As the tax authorities become more familiar with transfer pricing principles and begin to understand the background to transactions between related parties, the importance of having sufficient and technically sound documentation increases. The tax authorities started to make special transfer pricing tax inspections and have formed a specialised group of transfer pricing experts.

The tax office continues to train a specialised group of staff to handle transfer pricing audits and has already performed a number of transfer pricing tax inspections of multinational companies, resulting in significant additional tax charges.

As communicated by tax authorities, the number of tax inspections focused on transfer pricing area should significantly increase in 2012 in comparison to previous tax periods.

67.

Slovenia

Introduction

Slovene transfer pricing legislation, which generally embraces the Organisation for Economic Co-operation and Development (OECD) Guidelines, applies to cross-border and domestic inter-company transactions. Supporting transfer pricing documentation has been required since 2005. As of 2006, the transfer pricing documentation for cross-border inter-company transactions must be prepared concurrently; documentation for domestic inter-company transactions needs to be submitted only upon request from the tax authorities in the course of a tax inspection.

The introduction of Slovenia's transfer pricing rules has been accompanied by efforts to train Slovene tax inspectors in transfer pricing analysis using consultants from foreign revenue authorities.

Statutory rules

Definition of taxable basis between related parties

The arm's-length principle is described in Article 16 of the Slovene Corporate Income Tax Act (CITA), which is valid from 1 January 2007. In establishing a taxable person's revenues and expenses, the pricing of transfers of assets (including intangible assets) between related parties and inter-company services should not be less than the arm's-length amount for revenues, and not greater than the arm's-length amount for expenses.

Methods for determining the arm's-length price

Comparable market prices are determined by one or a combination of the methods specified in the OECD Guidelines. The traditional transactional methods specified in the OECD Guidelines include the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method.

Where these traditional transaction methods cannot be applied, the transactional profit methods (transactional net margin method and profit split method) may be used.

The Slovene Ministry of Finance issued regulations on transfer pricing which came into force on 1 January 2007. These regulations set out in more detail the application of the five pricing methods in a manner similar to that outlined in the OECD Guidelines.

Definition of related parties

Provisions in Articles 16 and 17 of the CITA differentiate between the definition of related parties, depending on whether the transactions are cross-border or domestic.

Cross-border controlled transactions are transactions between a taxable person (resident) and a foreign entity (non-resident) related in such a way that:

Slovenia

- the taxable entity directly or indirectly holds 25% or more of the value or number of shares of a foreign entity through holdings, control over management, supervision or voting rights; or controls the foreign entity on the basis of a contract or terms of transactions different from those that are or would be achieved in the same or comparable circumstances between unrelated parties
- the foreign entity directly or indirectly holds 25% or more of the value or number of shares of a taxable entity through holdings, control over management, supervision or voting rights; or controls the taxable entity on the basis of a contract or terms of transactions different from those that are or would be achieved in the same or comparable circumstances between unrelated parties
- the same entity directly or indirectly holds 25% or more of the value or number of shares, or participates in the management or supervision of the taxable entity and the foreign entity, or of two Slovene taxable entities, or they are under the same control on the basis of a contract or transaction terms that differ from those that are or would be agreed in the same or comparable circumstances between unrelated parties, and
- the same individuals or members of their families directly or indirectly hold 25% or more of the value or number of shares, holdings, voting rights or control over the management or supervision of the taxable entity and the foreign entity, or of two Slovene tax resident entities; or they are under their control on the basis of a contract or transaction terms that differ from those that are or would be agreed in the same or comparable circumstances between unrelated parties.

Domestic inter-company transactions are transactions between two taxable resident persons. Residents shall be related parties if either of the following conditions exists:

- They are related in terms of capital, management or supervision by virtue of one resident, directly or indirectly, holding 25% or more of the value or number of shares, equity holdings, control, supervision or voting rights of the other resident; or controls the other resident on the basis of a contract in a manner that is different from relationships between non-related parties.
- The same legal or natural persons or their family members directly or indirectly hold 25% or more of the value or number of shares, holdings, control, supervision or voting rights; or control the residents on the basis of a contract, in a manner that is different from relationships between nonrelated parties.

Related parties are also taxable and natural persons performing business, provided that such natural persons (or their family members) hold 25% or more of the value or number of shares or equity holdings; or participate in the management, supervision or voting rights of the taxable person; or control the resident on the basis of a contract in a manner that is different from relationships between non-related parties.

Notwithstanding the above provisions, the tax base may be adjusted only in cases when one of the residents: (1) has an unsettled tax loss from previous tax periods in the tax period concerned, or (2) pays tax at a rate that is lower than the standard corporate tax rate of 18%¹, or (3) is exempt from paying corporate tax.

Documentation

A taxable entity must maintain information about related parties, the types and extent of business transactions with these entities, and the determination of comparable

.....
¹ Statutory tax rate intended to be reduced to 15 % within the next 3 years.

market prices as prescribed by the Tax Procedure Act (TPA). The provisions of the TPA on transfer pricing follow the EU Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD). Therefore, companies need to prepare a masterfile and country-specific documentation as described below:

- The masterfile should contain at least the description of the taxable entity, group structure, and type of relationship, transfer pricing system, general business description, business strategy, general economic and other factors and competitive environment.
- The country-specific documentation should contain information about transactions with related entities (description, type, value, terms and conditions), benchmark analysis, functional analysis, terms of contracts, circumstances that have an influence on transactions, application of the transfer pricing method used and other relevant documentation.

The masterfile must be assembled concurrently, and no later than the submission of the tax return. The Ministry of Finance determines what information should be provided upon submission of the tax return.

If the masterfile is not in the Slovenian language, it must be translated on the request of the tax authorities within a minimum of 60 days.

Other regulations

The Slovene Ministry of Finance has issued explanatory regulations on transfer pricing and regulations on reference interest rates.

The regulations on reference interest rates define a methodology for determining a reference interest rate on inter-company loans between related parties, to be taken into consideration when determining revenues and expenses. The reference interest rate is the sum of a variable part of an interest rate (e.g. EURIBOR, LIBOR-USD) and a mark-up expressed in basis points, which is determined for a particular maturity period and depends on the credit rating of the taxable person (i.e. borrower).

Regulations on transfer pricing replaced the regulations on determination of comparable market prices and introduced some important changes. The most important changes are provisions on the use of cost contribution agreements and the use of the inter-quartile range. Regulations on the determination of comparable market prices (valid until 1 January 2007) prescribed the use of the arithmetic mean, while the new regulations on transfer pricing declare that the inter-quartile range should be used when determining an arm's-length price. Moreover, the use of multiple-year data is accepted. In addition, the regulations set out situations where business interdependence can arise without one party having at least a 25% share in the other party.

The new regulations also pay attention to the loss positions of related entities resulting from inter-company transactions. This approach tests whether comparable unrelated-party transactions would be profit-making by considering whether an independent entity would be in a loss position under the same circumstances.

Slovenia

Disclosure

Entities that have transactions with related parties must supply in the supplement to the corporate tax return certain information on the value of controlled transactions.

Supplements to the tax return concerning controlled transactions disclose the names of the entities involved, the type of relationship, and the total value of the controlled transactions for each related entity separately. A supplement containing information on interest rates between related parties discloses the total value of received and granted loans, classified by each related entity, and specifies whether a related entity has an adjusted tax base. The supplement must be completed only when the total value of received and granted loans in the tax period amounts to more than 50,000 euros (EUR) per related entity, as provided by regulations on the corporate income tax return, in force as of 29 May 2007.

Legal cases

The Slovene tax authorities began to perform tax inspections concerning the fulfilment of transfer pricing documentation requirements in the second half of 2006. So far, we are not aware of any legal cases on transfer pricing.

Burden of proof

Since documentation requirements for transfer pricing came into force in Slovenia, the burden of proof is placed on the taxpayer. Taxpayers must keep specific documentation proving that they apply transfer prices in line with the arm's-length principle. If proper transfer pricing documentation is in place, together with the corporate tax return, the burden of proof shifts to the tax authority.

When examining transfer prices, the Slovene tax authorities must determine the arm's-length nature of inter-company transactions using the method(s) previously applied by the taxpayer, provided that the taxpayer submitted prepared documentation, used one of the recognised methods and that the method used is supported by appropriate calculations.

Tax audit procedures

To date, the Slovene tax authorities have raised the transfer pricing issue only in the context of regular tax audits. However, recently we have experienced that Slovene tax authorities have also commenced specific transfer-pricing-oriented audits.

Additional tax and penalties

Any entity engaged in intra-group transactions must be able to support the prices agreed between related parties to meet the arm's-length criteria. Failure to comply with these laws may result in significant tax exposure and penalties.

Sanctions include adjustment of the tax base to increase the tax charge (or reduce a tax loss), as well as the following penalties:

- 30% of underpaid tax for micro and small legal entities (underpaid tax from EUR 1,500 to EUR 150,000).
- 45% of underpaid tax for medium and large companies (underpaid tax from EUR 2,000 to EUR 300,000).
- Additional fines of up to EUR 5,000 for the responsible representative of the entity.

For taxes not paid within prescribed deadlines, late payment interest is levied at a daily interest rate of 0.0274%.

If adequate transfer pricing documentation is not in place, the penalty is EUR 1,200 to EUR 15,000 for micro and small legal entities, EUR 3,200 to 30,000 for medium and large legal entities and up to EUR 4,000 for the responsible representative.

Resources available to the tax authorities

The Slovene tax authorities have a specialised group that is trained to perform transfer pricing examinations.

Use and availability of comparable information

Comparable information is required to support the arm's-length nature of related party transactions and should be included in the taxpayer's transfer pricing documentation. The arm's-length nature of transactions with related parties can be demonstrated by applying one or more of the prescribed acceptable methods. Acceptable methods include the traditional OECD methods or any combination of them. The comparable uncontrolled price method is the preferred method as defined in the regulations on transfer pricing. Additionally, the comparable uncontrolled price method, resale price method and cost plus method are preferable methods compared to the profit split method and transactional net margin method. In practice, it is often not easy to obtain information on comparable uncontrolled prices.

The Slovene tax authorities have access to the Amadeus database and local databases containing financial information for Slovene companies, such as GVIN and IBon. In accordance with the Slovenian Companies Act, companies and sole proprietors are required to submit annual reports that are publicly available.

The Slovene tax authorities have a preference towards using local comparable companies for benchmarking purposes, although a Pan-European benchmark may also be accepted.

Risk transactions or industries

Transfer pricing is an area of increasing interest for the Slovene tax authorities. So far, they have not concentrated on any particular industry, but special attention has been directed towards management fees and royalties charged between related parties.

Advance pricing agreements (APA)

Currently, there is no legal basis for an APA in Slovenia. Although the new tax legislation contains provisions on binding tax rulings in certain circumstances, obtaining a binding ruling for transfer pricing purposes is not possible.

Anticipated developments in law and practice

Although the Slovene tax authorities have not been considered aggressive, their approach to transfer pricing issues is starting to change. The expanded practical training and experience of tax inspectors is raising the profile of transfer pricing issues in tax audits. It is also expected that the tax authorities will have to deal with a higher number of complex transfer pricing issues.

Slovenia

OECD issues

Slovenia joined the OECD in 2010. Transfer pricing legislation generally reflects the arm's-length principle and methods provided by OECD Guidelines.

Joint investigations

There is no evidence of joint investigations.

Thin capitalisation

Thin capitalisation provisions restricting the tax deductibility of interest expenses on related party loans came into force in Slovenia on 1 January 2005. The tax deductibility of interest payments on loans granted by a related party (a party that owns at least 25% of the shares or voting rights in the taxpayer or vice versa) is generally restricted, where the amount of loans exceeds a certain multiple of the shareholder's share in the equity of the taxpayer in a particular tax period (*see below regarding the debt-to-equity ratio*). These rules do not apply to banks and insurance companies.

Loans from third parties for which the shareholder issues a guarantee, and loans granted by a bank that are linked to a deposit of the shareholder in the same bank, are also subject to the thin capitalisation rules. The size of the shareholder's share in the equity of the loan recipient is calculated as the average of the subscribed capital, retained net profits and the capital reserves held on the last day of each month in the taxation period.

The Slovenian tax provisions related to thin capitalisation are less rigorous than in some comparable EU tax jurisdictions.

The applicable debt-to-equity (D/E) ratio is as follows:

- 8:1 D/E ratio applies for the years 2005, 2006 and 2007.
- 6:1 D/E ratio applies for the years 2008, 2009 and 2010.
- 5:1 D/E ratio applies for the year 2011.
- 4:1 D/E ratio applies for subsequent years, starting from 2012.

Management services

For companies receiving management services, the general rules on the deductibility of expenses apply. In effect, this means that the payment is tax deductible where the company receives a benefit for the service provided, the payment is connected with the company's trade, and the cost does not exceed an arm's-length price.

A company providing management services should be remunerated for those services on an arm's-length basis. Usually, a company providing services is remunerated on a cost plus basis to represent a market value for the provision of the services. A service provider may, in general, divide its fee between the recipients of the services by applying a direct charge method or an indirect charge method. The direct charge method is used only when there is a clear connection between the services rendered by the management services provider and the costs resulting from the provision of those services for every recipient within the group. In all other cases, an indirect charge method is allowed.

68.

Spain

Introduction

During various years by now, the Spanish tax authority has been increasing, and continues to increase, its awareness of and attention to transfer pricing. The legislation enacted in 1995, the statutory regulations approved in 1997 and modifications effective as of 1 December 2006, include the general principles for dealing with transactions between related parties. They also state the procedure to be followed by taxpayers seeking advanced pricing agreements (APAs) and the basic procedure to be followed by tax auditors in the field for reassessing the transfer price agreed between related parties.

Article 16 of Spanish Corporate Income Tax Law (CITL) was modified by Law 36/2006, which came into force on 1 December 2006, and affects transactions carried out in fiscal years starting after that date. The legislation provides that transactions between related entities and persons, including domestic as well as cross-border transactions, should be valued and declared at arm's length for tax purposes. The current set of transfer pricing rules and regulations are closely aligned with international best practices, as provided in the Organisation for Economic Co-operation and Development (OECD) Guidelines and the European Union Joint Transfer Pricing Forum (JTPF). Previous to the current legislation, making adjustments to related party prices was a power of the Spanish tax administration only. It is also important to note that the modifications that were introduced by the current legislation were included as part of the Bill of Measures Against Tax Fraud, which highlights the level of importance given to transfer pricing in Spain.

Statutory rules

Spain's legislation concerning transfer pricing is contained in Articles 16 and 17 of Law 36/2006, modifying the CITL, in Royal Decree 1793/2008 of 3 November, amending the CITL Regulations and in Article 41 of Law 35/2006, modifying the Personal Income Tax Law (PITL).

The legislation provides that for corporate tax purposes related party transactions should reflect arm's-length pricing. The transfer pricing methodologies described in the Spanish transfer pricing legislation largely follow those contained in the OECD Guidelines. The legislation includes the profit-based method transactional net margin method (TNMM) which was not formally accepted in the previous legislation. Furthermore, this legislation specifies the existence of a transfer pricing methodologies hierarchy and specifies that, where possible, the transactional methods should be used to establish an arm's-length price in preference to profit-based methods.

Article 41 of the PITL establishes, as a general principle, that transactions between related persons or entities will be priced in accordance with the arm's-length principle.

Spain

The procedure for establishing the arm's-length value and, where necessary, for substituting the value declared in a taxpayer's return is set out in Articles 16 and 17 of the CITL.

The procedure to be followed by tax authorities when seeking to apply the arm's-length principle through the course of a tax inspection is stated in Article 16 of the Corporate Income Tax Regulations (CTR). A brief description is as follows. First, if the other party of the related party transaction has also been taxed under the CITL or PITL, it is notified by the tax authorities that the transaction has been placed under scrutiny. This notification explains the reasons for the adjustment to the company's profit and the methods, which could be used in determining the normal market value. The related party has 30 days to present any facts or arguments that it believes are pertinent to the matter.

Having examined both related parties' arguments, and immediately prior to preparing the document in which the arm's-length value shall be established, the methods and criteria to be taken into account are made available to the parties. The parties then have 15 days in which to formulate additional arguments and whatever documents and evidence they deem appropriate.

Either party has the right to dispute the outcome of the proceedings, in due course. If they do not, the normal market value established by the tax authorities becomes effective for all tax periods under assessment in accordance with Articles 16 and 17 of the CITL. If the outcome is indeed contested by either of the related parties, its application is suspended pending a final decision. In the meantime, tax assessments are deemed to be provisional.

The Spanish CITL includes provisions dealing with APAs. APAs can be unilateral or bilateral, and normally refer to pricing arrangements but can also cover research and development (R&D) expenses, management fees and thin capitalisation. Separate provisions deal with contributions made for R&D purposes and management fees.

Documentation

From 19 February 2009 onwards, Spanish taxpayers are required to produce group-level and taxpayer-specific documentation for each tax year. Before 2009, no requirement for formal documentation existed, with the exception that during an inspection, explanations could be demanded, as with any other transaction that influences tax results.

In this sense, Article 16.2 of the CITL establishes as a general rule that related persons or entities must keep available for the tax authorities such documentation as from the end of the voluntary return or assessment period in question. The royal decree implements this statutory requirement by drawing on the principles contained in the EU Code of Conduct on transfer pricing documentation and requires the taxpayer to produce, at the request of the tax authorities, documentation, which, in turn, is divided into two parts:

- documentation relating to the group to which the taxpayer belongs, and
- documentation on the taxpayer itself.

With regard to the first year in which the documentation obligations must be applied, the documentation obligations must be deemed to apply to transactions performed on or after 19 February 2009.

The royal decree also establishes the following instances in which there is no documentation requirement for related party transactions:

- Transactions carried out within a consolidated Spanish fiscal group.
- Transactions carried out by economic interest groups and temporary business associations.
- Transactions involving the purchase or sale of publicly traded shares.

At the same time, the royal decree establishes reduced documentation obligations for (1) related party transactions involving small companies (net revenues for the consolidated group of less than 8 million euros (EUR) in the previous tax year) and (2) individual persons. Finally, it should be noted that documentation is required for transactions with entities, related party or not, resident in tax havens.

Legal cases

Under the former legislation (1978 CITL), the Central Treasury and Tax Court (*Tribunal Económico Administrativo Central* (TEAC), an administrative body included within the Tax Administration but acting independently of the tax audit authorities), had created a solid administrative doctrine that was consistently applied. It also established some important principles for dealing with transfer pricing issues. These principles are set out below:

Comparable uncontrolled market price

- The establishment of a comparable uncontrolled market price is extremely difficult and requires that:
 - the same geographical market is used as a reference
 - similar or identical goods be compared
 - the volume of transactions compared is identical
 - the comparison be made at the same stage of the production/distribution process, and
 - the transactions being compared are carried out within the same period of time.

Transfer pricing adjustments

- Where the above information is not available, transfer pricing adjustments may be made by a tax inspector in accordance with the OECD Guidelines (i.e. using the resale price or cost plus), taking the following issues into consideration:
 - To make an adjustment to reported profits successfully, the authorities must prove that the transaction has not been carried out at market value. The fact that the transactions are between related companies does not automatically mean that the transfer price does not comply with the arm's-length standard.
 - The legal bases and reasons behind the normal market value proposed by the authorities must be disclosed; otherwise the taxpayer could be deprived of information necessary to defend its position.

Intragroup services

- Referring to intragroup services, the Ministry of Finance issued some rulings on the matter stating that:

Spain

- for valuation purposes, any method included in the 1979 OECD Guidelines could be applied
- the burden of proof lies with the taxpayer. The taxpayer is therefore required to prove that:
 - the services have in fact been provided
 - the service provider incurred in expenses when rendering such services, and
 - the service provided added economic value to the related entity receiving such services.

Additionally, under the former legislation, the courts ruled on some legal cases that followed the above-mentioned principles.

Regarding the current legislation, the Spanish tax authorities and the jurisprudence issued by the tribunals have widely used the OECD Guidelines to apply or interpret the Spanish transfer pricing rules and regulations.

In particular, the TEAC is making an extensive and intensive use of the OECD Guidelines. Some interesting TEAC's resolutions are mentioned below:

- RTEAC 7 June 1994; RTEAC 22 October 1997; RTEAC 29 January 1999.
- RTEAC 9 March 2000; RTEAC 1 December 2000; RTEAC 26 March 2004.
- RTEAC 8 October 2009; RTEAC 22 October 2009.

Until recently, the Spanish High Court of Justice (STS) ruled on just a few cases regarding transfer pricing issues. In line with the heightened interest given to transfer prices in 2007, these rulings went against the taxpayer. The rulings dealt with various related party transactions, including management fees, customs regulations and purchase of active ingredients.

- STS 11 February 2000; STS 15 July 2002.
- STS 4 December 2007; STS 22 January 2009; STS 30 November 2009.

Management services and R&D cost-sharing arrangements

The section of the legislation dealing with management services is now included within a more general definition of 'services'. The deduction of expenses for services provided by related parties is subject to the condition that the services provided produce or can produce an advantage or benefit to the receiver.

Where it is not possible to separate the services provided by the entity (i.e. directly charging), it is possible to distribute the total price for the services between all beneficiaries of the services in accordance with rational distribution criteria. These criteria need to take into account not only the nature of the service but also the circumstances surrounding the provision of services as well as the benefits obtained (or that can be obtained) by the beneficiaries of the services.

The deduction of expenses derived from cost-sharing arrangements (not only related to R&D) between related parties is subject to the following:

- The participants to the arrangement must be able to access the property (or the rights to the property having similar economic consequences) of the resulting assets or rights being subject of the cost-sharing arrangement.

- The contribution of each participant must take into account the anticipated benefits or advantages that each participant expects to obtain in accordance with rational criterion.
- The agreement must contemplate variations in circumstances and participants, establishing compensatory payments and any other adjustments that may be considered necessary.
- The agreement must comply with the documentation requirements to be established at a later date.

Burden of proof

The statutory regulations state that taxpayers should value transactions with their related parties at market prices and also indicate how that value has been calculated (Article 16 of the CITL and Article 41 of the PITL).

This represents an important change to the rules that has been introduced by the current legislation (previously the burden of the proof lay with the tax authorities).

Should any discrepancies regarding the suitability of the transfer prices arise in the course of a tax review, it is in the taxpayer's interest to present as much evidence as possible in support of its prices. Detailed evidence presented by the taxpayer helps reduce the likelihood of the authorities proposing an adjustment and imposing penalties. For these reasons, it is necessary that the taxpayers comply with the obligation to produce documentation.

Tax audit procedures

Selection of companies for audit

Spanish tax inspectors operate on three levels: national, regional and local. National and regional specialist units are responsible for all tax affairs dealing with companies or groups of companies which may deserve close attention for reasons such as size, importance of operations, a distinguished reputation in an economic sector, volume of sales, etc. Such companies and groups are subject to tax audits on a recurring basis. Smaller companies are dealt with at the local level. Transfer pricing issues, historically, were considered as part of a general tax audit and not the subject of a special investigation by itself. However, with the current legislation, transfer pricing audit activity has increased significantly. Numerous audits have been initiated whose scope is limited to an analysis of the arm's-length nature of inter-company prices.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

In principle, the tax authorities are empowered to collect all the information and data necessary to conduct a tax audit. In general, taxpayers are obliged to provide the tax authorities with such information. Failure to present the accounting registers and documents, which companies are required to keep by law, or failure to provide any data, reports, receipts and information relating to the taxpayer's tax situation, may be considered as resisting or hindering the tax audit.

In general terms, all taxpayers are obliged to present, by law or under a specific request by the tax authorities, any relevant information for tax purposes they may have with respect to third parties, in connection with business, financial or professional relationships held therewith. Any information presented to or obtained by the tax

Spain

authorities is considered to be confidential and can be used only for tax purposes and may not be disclosed to third parties, except in those cases stated by law.

The audit procedure

Each inspector is assigned a Personal Confidential Tax Audit Plan for the period, which includes all the taxpayers to be audited by his/her team.

Each taxpayer is entitled to be informed upon commencement of a tax audit, the nature and scope of the audit about to take place, as well as its rights and obligations during the course of such proceedings. The tax audit proceedings must be concluded within 12 months, although, under certain circumstances, this period may be extended to an additional 12 month period.

Inspections are normally conducted at the company's main offices or at the tax authorities' offices.

The procedure is deemed to be completed when the tax auditor considers that all the necessary information required to put together a reassessment proposal has been obtained. Prior to the tax auditor drawing up his/her proposal, the taxpayer is given the opportunity to formulate allegations. A tax inspection usually concludes with a reassessment proposal, which the taxpayer can accept or reject in part, or in whole.

Under the royal decree, tax inspectors must file a separate transfer pricing assessment, distinct from any assessments related to other income tax obligations. The contents of the transfer pricing assessment must include a justification of the arm's-length value as determined by the tax inspector and an explanation of how the arm's-length value was determined.

Revised assessments and the appeals procedure

In the event that the taxpayer does not accept the inspector's proposal, a writ of allegations may be presented to the inspector's superiors. Based upon this writ and the tax inspector's extended report, the superior officer can confirm, modify or cancel the additional assessment.

If the taxpayer is dissatisfied with this decision, an appeal may be filed with the office or directly with the TEAC. At this stage of the procedure, the additional assessment must be paid or guaranteed. An appeal against the decision passed by the TEAC may be filed with the ordinary courts of justice.

Additional tax and penalties

With regard to the documentation requirement, the provision of incomplete, inaccurate or false documentation or where the declared values do not coincide with the values derived from the documentation would imply penalties.

The penalty applied depends on whether or not the tax administration assesses a transfer pricing adjustment:

- if there is no adjustment, a penalty of EUR 1,500 is imposed for each missing, inaccurate or false data item; or EUR 15,000 for a collection of missing, inaccurate or false data item, and

- if there is an adjustment, a penalty of 15% of the adjusted amount is imposed, with a minimum of double the penalty that would have been assessed if no adjustment had been made.

However, prior to imposing a penalty under the general regime, the tax authorities must prove that the taxpayer has behaved in a negligent manner. The taxpayer is considered to have acted with due diligence when he/she presents a reliable and full statement and makes the relevant self-assessment under a reasonable interpretation of the regulations, including compliance with the documentation requirement.

A special procedure exists for imposing penalties, which is independent of the normal tax audit procedure. Such a procedure may be commenced by the tax inspector or by a special officer assigned by the chief tax inspector. The tax inspector must provide all relevant data or proof to justify the penalty being imposed. The taxpayer may formulate allegations and present its consent to, or disagreement with, the proposed penalty. The penalty is automatically reduced by 30% if the taxpayer agrees with the penalty proposal.

The taxpayer may appeal against the proposed penalty without necessarily paying or guaranteeing the amount of the penalty being imposed.

Resources available to the tax authorities

A specialist unit dealing with transfer pricing issues has been established. The regional and national tax offices, which are responsible for the larger companies or multinational companies, normally deal with transfer pricing issues during the course of a general tax audit.

In addition, significant resources are being made available to improve inspectors' ability to successfully undertake audits, and active training is taking place. Tax inspectors currently act on their own, although this does not rule out the possibility that they could receive assistance from in-house experts. Additionally, tax inspectors are able to exchange information under the principles established in the OECD Model Tax Convention and in the European Directive 2004/56 on Mutual Assistance.

Use and availability of comparable information

The current transfer pricing legislation, for the first time, explicitly recognises the transactional net margin method as an accepted method for justifying the arm's-length nature of prices.

Availability

Annual accounts (including the notes to the accounts and directors' report) are officially registered and therefore publicly available. Databases containing detailed financial information of Iberian companies are available. In certain industries (e.g. the pharmaceutical industry), more detailed information concerning product pricing and profit margins may be obtained. Spanish tax authorities have a natural tendency to employ local comparable companies for benchmarking purposes.

The tax authorities have confirmed their use of databases such as AMADEUS and SABI (the Bureau Van Dijk database containing companies located within the Iberian Peninsula).

Spain

Tax authorities have also confirmed that they do not use secret comparables, although very often they request information from other companies that operate in the same sector. This information may be requested individually for specific transactions or in a general manner. In some cases, such information has been used by the authorities to justify a transfer pricing reassessment.

Risk transactions or industries

Transfer pricing is an area of increasing interest for the Spanish tax authorities. So far, they have not concentrated on any particular industry, although emphasis has been placed on the automobile, computer/software and pharmaceutical industries.

Special attention has been directed towards management fees, royalties and loans. In addition, the Spanish tax authorities are quite sensitive to so-called 'business transformations' and may assert that a permanent establishment (PE) exists of a foreign party to which significant business functions and risks have been transferred.

Regarding management fees, and as noted, the Spanish tax authorities expect to see the application of rational and continuous cost-allocation criteria and actual evidence of the benefits received from the services.

Limitation of double taxation and competent authority proceedings

In principle, when a transfer pricing adjustment affects transactions between a Spanish company and a non-resident, the mechanisms laid down in the relevant double taxation treaty should be applied. Where the non-resident is within the EU, the provisions of the Arbitration Convention relating to the elimination of double taxation (EC Directive 90/436) can be applied. In relation to MAP proceedings arising from the mechanisms laid down in the double taxation treaties or the provisions of the EU Arbitration Convention, the Royal Decree 1794/2008 of 3 November, approving the regulations on direct taxation-related mutual agreement procedures, establishes different regimes (and the phases within each regime), depending on whether the procedure is initiated by the Spanish or the foreign competent authorities, and depending on which tax administration (Spanish or foreign) has made (or makes) the assessment. In addition, this royal decree regulates the procedure to allow for the suspension of the tax payments when a MAP is initiated.

Advance pricing agreements (APAs)

Spanish law provides taxpayers with a statutory right to seek APAs. The general regulations are contained in paragraph seven of Article 16, and Royal Decree 1793/2008 regulates in detail the procedure for processing and deciding on APAs between related persons or entities, whether of a unilateral nature with the Spanish tax authorities, or bilateral or multilateral, involving other tax authorities.

Article 16.7 of the CITL mentions that the procedure applying to APAs is contained in the CTR. The APA filing procedure is specified in Articles 22 through Article 29 nonies of Chapter VI of Title I of the CTR, which came into force on 19 November 2008. Unilateral, bilateral and multilateral APAs are possible in Spain.

The tax inspection department of the Spanish national tax agency (AEAT) is the administrative body in charge of dealing with APA requests. The procedure for applying for an APA is a two-step process. Step one is a prefiling waiting period of one

month, after which the taxpayer is informed of the basic elements of the procedure and its possible effects. Step two is the actual filing, which takes approximately six months in the case of unilateral APAs.

The information provided to the tax administration in the prefiling and filing stages is used exclusively within the context of the APA, and is applicable only for such purposes. The final resolution is effective for the period of time decided in the agreement, but cannot exceed four years. Additionally, it can be determined that the APA affects the operations of the year in which the APA is agreed as well as the operations of the prior year, as long as the time limit for the tax return/declaration has not been passed.

If the taxpayer's proposal is not approved, the taxpayer has no right to appeal the decision. Taxpayers often file an alternative APA after negotiating any points of contention of the initial proposal with the tax authorities.

The Spanish tax authorities have shown a positive response in the processing and ruling of APAs. Furthermore, providing that no significant changes in the underlying conditions of the APA occur, a taxpayer may request an APA renewal.

Liaison with customs authorities

In practice, there is little communication between the income tax and the customs authorities, despite the fact that there is nothing to prevent an exchange of information. Interestingly, transfer pricing adjustments for income tax and corporate tax purposes do not necessarily need to be reflected in returns filed for customs or for any other indirect taxes.

Laws 35 and 36/2006 introduced some points related to the value added tax. Concerning this tax, it is necessary to evaluate the operations according to the arm's-length standard when there is a directive which provides this. These laws also provide for the liability in cases of collaboration in fraud.

OECD issues

Spain is a member of the OECD and endorses the OECD Guidelines. Actual endorsement of the OECD Guidelines is stated in Law 36/2006, which now includes the transactional net margin method in the Spanish legislation. This method was informally accepted before the current legislation in some specific cases, given appropriate justification; however, it is now formally and explicitly accepted as a transfer price method.

Joint investigations

There is nothing in Spanish law to prevent the authorities from joining with authorities of another state to establish a joint investigation of a multinational company or group. In fact, on more than a few occasions the Spanish authorities have followed such procedures.

Thin capitalisation

On 30 March 2012, the Spanish Government announced the 2012 budget. Together with the budget announcement, the Government approved Royal Decree-Law 12/2012, which introduces a number of relevant changes in the corporate tax area, amongst which is a new thin capitalisation regime.

Spain

The Spanish government has followed the trend set by other European governments and has introduced an interest expense-capping rule that replaces the previous thin capitalisation rules in Spain. The interest expense-capping rule, which applies to both related-party and unrelated party debt, limits the tax relief for net interest expense to 30% of the taxpayer's EBITDA. For entities being part of a tax consolidation, this 30% limit applies to the level of the tax group.

Interest disallowed under the interest expense-capping rule can be carried forward 18 years. On the other hand, when the interest expense in a given year is below the 30% limit, the new rule allows this unused capacity to be carried forward five years.

The interest expense-capping rule does not apply if either (i) the net interest expense does not exceed one million euros; (ii) the taxpayer is not part of a group of companies (as defined in Spanish company law); or (iii) the taxpayer is a financial institution.

New anti-debt-push-down legislation

The aforementioned Royal Decree includes specific language to deny the deductibility of interest from indebtedness with group companies – whether resident in Spain or not – when the debt has been used to acquire shares in other group companies, unless the taxpayer is able to prove that the transaction is supported by valid economic reasons.

As potentially non-tax driven transactions, the Explanatory Memorandum cites group restructurings directly connected to an acquisition from a third party, or cases where there is a true management in Spain of the entities acquired.

The Royal Decree-Law entered into force on 31 March 2012 but the above changes apply retroactively to tax years beginning on or after 1 January 2012.

69.

Sweden

Introduction

On 1 January 2007, the Swedish legislation dealing with transfer pricing was extended substantially. The statutory rule of the Swedish Income Tax Act (SITA) adopting the arm's-length principle for transactions between related enterprises was supplemented by formal documentation requirements. Parallel to this legal framework, two cases did, during the 1990s, establish important principles for dealing with transfer pricing issues. These principles concern, in particular, the areas of thin capitalisation and the circumstances in which transfer pricing adjustments may be made.

It is worth noting that, in general, the Swedish Tax Agency (STA) is very interested in transfer pricing, using the regular tax audit as an opportunity to investigate transfer pricing issues. During the last few years, the STA has shown an increased focus on transfer-pricing-related issues through a number of detailed questions in tax audits, including questions about what comparable transactions or companies have been used as a basis for determining the transfer prices. Furthermore, a number of new cases show an increased focus on transfer pricing. A highly skilled, specialised team has also been established within the STA to continuously develop the general awareness within the transfer pricing area.

Statutory rules

Sweden has only one statutory rule on transfer pricing. Originally included in the tax code in 1929, it is now found in Chapter 14 Section 19 SITA. This section adopts the arm's-length principle for transactions between related enterprises and authorises an increase in the taxable income of a Swedish enterprise equal to the reduction of income resulting from transactions that are not at arm's length.

Besides the arm's-length rule, Chapter 19 Section 2b of Law 2001:1227 introduced documentation requirements for all corporations registered in Sweden that conduct cross-border controlled transactions. It is now compulsory to prepare written documentation on all cross-border transactions with associated companies. The statutory addendum came into effect as of 1 January 2007.

Added, as of 1 January 2010, the Law (2009:1295) on Advance Pricing Agreements Regarding International Transactions (Law on APAs) entered into force in Sweden. The Swedish legislation describes an Advance Pricing Agreement (APA) as a contract between a taxpayer and the STA, in two or more countries, specifying the transfer pricing policy and the transfer pricing methodologies that a taxpayer may use on its intra-group cross-border transactions. The STA is the competent authority for the administration of the APAs.

Sweden

Other regulations

In connection with the documentation requirement, administrative guidelines (SKVFS 2007:1) were issued by the STA on 14 February 2007. Moreover, the STA published regulations that provide further details as well as examples related to the transfer pricing documentation requirements. Guidelines and regulations are applicable retroactively as of 1 January 2007 and are further commented on below. Generally, the documentation requirements cannot be considered to be materially more demanding for the taxpayers, from an international comparison perspective.

Legal cases

During the last few years, relatively few transfer pricing cases have reached the lower courts and the Court of Appeal. However, there have been two important cases from the Supreme Administrative Court that should be noted. The first, Mobil Oil (1990), concerned thin capitalisation and the second, Shell Oil (1991), concerned the pricing of crude oil and freight. The tax authorities lost both cases.

The principle established by the Mobil Oil case is that, generally, thin capitalisation cannot be challenged in Sweden using the arm's-length rule.

The Shell case clearly demonstrates three points. First, the STA bears the full burden of proof in transfer pricing matters. Second, consideration of whether an arm's-length price has been charged should not be restricted to the facts arising in a single year, but rather, a span of years should be considered. Third, if a transfer pricing adjustment is to be justified, there must be a deviation from arm's-length pricing that is significant in size. Moreover, the Shell case was the first case in which the courts referred to the principles laid down in the Organisation for Economic Co-operation and Development (OECD) Guidelines on transfer pricing.

In Sweden a much debated court case ruling (Diligentia-case) was released from the Supreme Administrative Court during 2010. The case involved a Swedish tax payer that chose to replace an external loan with a loan from a Swedish related party to a higher interest rate, claiming that the loan was unsecured although the company's assets were unclaimed as no external loans existed. The STA argued that the intra-group loan was in fact secured and consequently the interest rate exceeded what could be deemed to be a market rate. The Swedish Supreme Administrative Court's verdict was in line with the STA's argumentation. The verdict stated that the insight and control of a shareholder can have an impact on the interest rate of a related party loan, but this must be evaluated on a case-by-case basis. It should be noted that the verdict is based on paragraph 16.1 SITA since the transaction took place between two Swedish entities and not 14.19 SITA which regulates cross border transactions. Thus, its application in a cross-border situation is uncertain.

Following the Supreme Administrative Court's verdict the STA decided to adopt the approach that all intra-group loans, more or less regardless of facts and circumstances also in cross-border cases, should only be deemed comparable with secured loans since, in their view, ownership automatically equals a degree of insight and control which replaces the need for security even in cases where external loans with better right to the underlying assets exist.

Currently there are many cases pending related to this issue and in 2011 the Lower Administrative (tax) Courts came with six verdicts in which this principle was applied

to cross-border transactions. The verdicts have been appealed and the current situation in Sweden is uncertain. The STA arguments are contradictory to the arm's-length principle and economic theory, wherefore we believe that intra-group loans should still be priced in accordance with comparable external loans, i.e. no particular concern should be taken for insight and control by comparing unsecured loans with secured external loans. If at all to be considered, in PwC's opinion the same type of insight and control which can be argued to exist in shareholder loans is comparable with the insight and control required by lenders for most loans.

Other cases concerning for instance support services, usually provided from the parent company to the benefit of subsidiaries, have also been dealt with by Swedish courts. This large number of cases – by Swedish standards – in a short period of time further illustrate that the STA have acquired additional resources and have increased their focus on transfer pricing issues.

Burden of proof

The STA bears the full burden of proof when trying to establish that a transfer pricing adjustment is necessary. To support the adjustment, the STA must show that:

- the party to whom the income is transferred is not liable to taxation in Sweden on that income
- they have reasons for believing that a community of economic interests exists between the contracting parties
- it is clear from the circumstances that the contractual conditions have not been agreed upon for reasons other than economic community of interest
- the adjustment does not depend upon consideration of the facts applying to one year in isolation, and
- there has been a significant deviation from the arm's-length price, sufficient to justify an adjustment.

Documentation requirements

According to the documentation requirements in force since 1 January 2007, transfer pricing documentation has to provide for the following information:

- General description of the company, the organisation and its activities.
- Information about the nature and extent of the transactions.
- Functional analysis.
- Description of the transfer pricing method chosen.
- Benchmark analysis.

Companies entering into transactions of limited value can benefit from simplified documentation requirements. Transactions of limited value are defined as intra-group transactions of goods for a value of less than approximately 27.7 million Swedish kronor (SEK) per company within a multinational enterprise, and for other transactions, a value of less than approximately SEK 5.5 million. The concept of other transactions does not include the transfer of an intangible asset. If a transfer of intangible property occurs, no simplified documentation requirement applies.

The simplified documentation requirement stipulates that the following information should be provided, in a summary or schematic form:

Sweden

- Legal structure of the group.
- Organisation and operations of the tested party.
- A short description of the counterparties to the transactions, including their main activities.
- Actual transactions – nature, extent, value – together with the transfer pricing method applied.
- How the arm's-length principle is met.
- Comparable transactions, if appropriate and if any are identified.

The EU Code of Conduct and the EU TPD are explicitly accepted in Swedish legislation.

Transfer pricing documentation may be submitted in Swedish, Danish, Norwegian or English language.

The audit procedure

Selection of companies for audit

The 250 largest Swedish multinational groups are, on average, audited every five years. A few hundred foreign-owned companies are audited more regularly. In recent years, the STA has taken a more risk based approach. This means that the STA is more likely to audit high risk companies, from a tax avoidance perspective. Whether a company is classified as high risk is based on a score card system. Transfer pricing is currently given a high priority in Sweden, and the audits present an opportunity for the authorities to focus on the companies' transfer pricing policies.

During the course of the audit, the STA may examine all intra-group transactions. The audits are always conducted at the company premises, with key personnel being interviewed. The conduct of the taxpayer during the examination is likely to affect the outcome of the audit, and the early assistance of a competent tax adviser is therefore highly recommended. Where the STA believes that the arm's-length standard has not been applied, it might sometimes be possible to achieve a negotiated settlement.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The STA may request copies of any information that is kept on the premises of the taxpayer, and it has the authority to search the premises if it considers this to be necessary.

Revised assessments and the appeals procedure

An appeals procedure is available to the taxpayer, but it is a time-consuming process. The procedure on tax cases in the first instance of the Administrative Courts normally takes two to three years, and perhaps just as long in the Administrative Court of Appeal.

Additional tax and penalties

Penalties are normally levied at a rate of 40% of the additional tax due. Penalties paid are not tax-deductible. There is no separate penalty charge for non-compliance with the transfer pricing documentation requirements.

In theory, the tax penalty may comprise a 'serious penalty' which prevents the application of the Arbitration Convention. However, this has never been put into practice.

Resources available to the tax authorities

The resources available for the STA to conduct transfer pricing audits have historically been limited. Today, a specialised transfer pricing team is established in the STA which is continuously recruiting more inspectors and acquiring new competence within the transfer pricing area. The effect of this team is clearly shown in the increased number of cases brought before the courts. This specialised team assists the general tax auditors in the STA with transfer pricing issues as well as performs its own targeted audits towards large companies.

Use and availability of comparable information

In accordance with the legislation, the determination of an arm's-length price has to be based upon prices that would be agreed between unrelated parties in a comparable situation. In determining the relevant price, the STA prefers the traditional transactional methods, but with no preferred order of use. If none of these methods can be used, then a transactional profit method may be used. The STA considers the transactional net margin method (TNMM) to be the most frequently used method to test the arm's-length character of transfer prices in practice. The TNMM approach is also used to test another method (i.e. a secondary method for sanity check purposes).

The financial statements of all Swedish companies are publicly available in Sweden. Databases containing this information may be accessed in the search for comparables. The STA has also gained access to the most common databases used for comparability searches, such as the European database AMADEUS and various royalty databases. In recent tax audits, the STA has prepared extensive lists of questions regarding the audited company's comparable data.

Risk transactions or industries

Related party transactions within all industries can be subject to audit. The most common issues scrutinised by the STA regarding intra-group transactions relate to financial transactions (such as interest rates) and business restructuring, including particularly valuations and transfers of intangible property. Particular focus is also directed at sizeable MNEs reporting low or negative operating margins.

Following the implementation of documentation requirements, audit procedures commonly include scrutiny of the complete transfer pricing documentation including all transactions and benchmarks applied. In this context, it can be noted that it is becoming more and more common that the STA performs benchmarks by means of in-house resources.

Limitation of double taxation and competent authority proceedings

Swedish law, currently, has no regulation that automatically relieves a company from juridical and/or economic double taxation caused by an adjustment of its transfer prices. The problem of double taxation is, instead, usually handled through bilateral tax treaties. Swedish tax treaties are usually based on the OECD Model Tax Convention. Some older agreements existing between Sweden and developing countries are based on the UN Model Tax Convention.

Sweden has entered into bilateral tax treaties with the majority of countries in which Swedish-based multinational enterprises conduct business. These agreements provide

Sweden

a good basis for the elimination of juridical and/or economic double taxation for both Swedish multinationals and foreign multinational companies conducting business in Sweden.

The competent authority procedure functions fairly well in Sweden. According to the Ministry of Finance, full or partial relief has historically been obtained in more than 90% of cases where competent authority relief has been claimed. The competent authority's responsibility and the mutual agreement procedures (MAPs) were recently transferred to the STA. However, one problem with competent authority claims is the amount of time necessary to settle each case. After the transfer of responsibility for the MAPs to the STA, the effectiveness of these procedures has increased considerably. Delays in current processes are often the result of delays in the other countries. The normal handling period for the competent authority procedures is about two years.

Sweden has signed the EU Arbitration Convention which applies from 1 November 2004. The EU Arbitration Convention constitutes a powerful incentive for the STA to make every effort to ensure that the administrative process is more efficient, and to reach a mutual agreement in relation to all MAPs within the set time limit of two years.

Advance pricing agreements (APAs)

As of 1 January 2010, the Law (2009:1295) on Advanced Pricing Agreements Regarding International Transactions (law on APAs) entered into force in Sweden. The STA was appointed as competent authority for the administration of APAs.

Under the law on APAs, any corporation which is (or is expected to become) liable to taxation, in accordance with Swedish taxation regulations and which is subject to the provisions of a tax treaty, can apply for an APA. The application shall be made in writing and shall contain all information deemed necessary to enable the STA to make a fair decision as to the appropriateness of the taxpayer's suggested transfer pricing set-up. Prior to filing an application, the taxpayer may request a pre-filing meeting with the STA to discuss the conditions of a potential APA and what information should be included in the application.

A Swedish taxpayer can apply for either a bilateral or a multilateral APA. The APA is based on a mutual understanding between the countries involved for a predetermined period of three to five years.

The STA is authorised to grant an APA if the relevant transaction can be regarded separately from any other intra-group transactions, and if sufficient information is provided to the STA to enable it to determine whether the proposed set-up is at arm's length. Some of the basic information which must be filed in order for the STA to grant an APA is a functional analysis, an economic analysis and a comparables search, which supports the selection of transfer pricing methodology.

An APA is granted only if the mutual understanding between the countries involved reflects the basis of the taxpayer's application or if the taxpayer approves any amendments proposed in the STA's decision. An APA is normally not granted if the transaction is considered to be of limited importance or of minor value.

In cases where a taxpayer seeks an APA, the STA charges an administration fee which is based on the type of application. The following fees apply in relation to each country involved in the relevant transaction:

- SEK 150,000 (approx. 17,000 euros [EUR]) for an application of a new APA.
- SEK 100,000 (approx. EUR 11,000) for an application regarding renewal of a previous APA.
- SEK 125,000 (approx. EUR 143,000) for an application regarding renewal of a previous APA (including amendments).

Anticipated developments in law and practice

The current documentation guidelines provide for a general framework. The documentation guidelines issued by the STA clarify certain aspects of the legislation, but certain areas may lead to conflicts in interpretation for which it may be up to case law to solve.

Liaison with customs authorities

We are currently not aware of any cooperation between customs authorities and the STA, since they are separate government bodies.

OECD issues

Sweden is an OECD member state. There was a Swedish representative on the OECD Transfer Pricing Task Force, and Sweden has agreed to the OECD Guidelines.

Joint investigations

The STA has taken part in simultaneous tax audits from time to time and is more likely to join with other Nordic countries in such audits. Also, the STA has taken part in a few simultaneous audits with the US and German tax authorities, respectively.

Thin capitalisation

A principle established by the Mobil Oil case is that the arm's-length principle cannot be used to challenge a taxpayer on the grounds of thin capitalisation. Furthermore, there are no rules dealing specifically with thin capitalisation and no set permissible debt-to-equity ratios. Interest paid to a foreign associated entity is deductible for tax purposes without any restrictions as long as arm's-length interest rates are applied. However, in special situations with unique circumstances, interest deductions may be challenged and therefore, even if the tax authorities have not yet successfully challenged any instances of thin capitalisation, taxpayers should remain cautious in this area.

70.

Switzerland

Introduction

Switzerland does not have specific transfer pricing regulations but respectively adheres to the Organisation for Economic Co-operation and Development (OECD) Guidelines. As far as is predictable, Switzerland has also no plans to issue any domestic provisions on transfer pricing in the near future. Swiss tax authorities, however, are becoming increasingly concerned that taxpayers may transfer profits without economic justification to countries with strict transfer pricing rules and documentation requirements in order to avoid challenges by the respective local tax authorities. In this context, Swiss tax authorities take an increasing interest in a company's transfer pricing position in order to defend their own position. In addition, some cantonal tax authorities have begun to particularly focus on low-risk/low-profit entities located in Switzerland. Further, the tax authorities have begun to also focus tax audits on principal companies in Switzerland, which would include transfer pricing. To clarify transfer pricing issues, Switzerland offers an informal procedure for agreeing pricing policies in advance.

Statutory rules

Whilst Swiss tax law neither contains an explicit definition of the arm's length principle, nor specifically addresses the issue of transfer pricing between related parties, there is some legal authority for adjusting the profits of a taxpayer on an arm's length basis. This legal authority is found in Article 58 of the Federal Direct Tax Act as well as in Article 24 of the Harmonisation of the Cantonal Tax Laws Act, which both define the calculation of a taxpayer's taxable net profit. Importantly, Articles 58 and 24 deny a tax deduction for expenditure that is not commercially justifiable, and this provides the basis for an adjustment to profits for non-arm's length terms.

Other regulations

Services

Other regulations deal with the requirement for Swiss subsidiaries and permanent establishments (PEs) of foreign companies to include a profit markup when recharging the cost of performing services to a foreign-related company. No markup is required, however, where there is evidence that the marked up price would be substantially different from the price that would have been paid in a comparable uncontrolled situation. In addition, an instruction issued in Circular Letter No. 4 on 19 March 2004 provides guidance on the treatment of certain services that do not require a cost plus methodology (e.g. certain financial services and general management services) and encourages a review of the methods and margins (or prices) charged for rendering such services when evaluating whether such charges were made on an arm's length basis. Nevertheless, in most cases, the past practice of charging cost plus 5%–10% should meet the third-party comparison test and remain acceptable to the tax authorities under the new regulations.

Note that, since the cantonal authorities are not bound by the instructions of the Federal Tax Administration when assessing taxes, there is some room for differences in approach between cantons. Therefore, it is possible that the cantonal authorities may adopt different methods of calculating the base of costs to be marked up.

Interest payments

Switzerland maintains regulations concerning permitted tax-deductible interest rates on loans. The Federal Tax Administration regularly issues instructions on the safe harbour maximum and minimum interest rates as set by reference to the prevailing interest rates in the Swiss market. If a loan is in a foreign currency, the relevant market interest rates apply, which is, effectively, an application of the arm's length principle. In practice, there is an interdependence of permissible interest rates and the permissible amount of debt in the context of thin capitalisation. If companies deviate from the safe harbour rates, it is strongly advised that they maintain documentation to support the arm's length nature of the rates applied, as there have been an increasing number of audits in this area.

Legal cases

Several cases on transfer pricing have been brought before the Swiss courts, especially concerning the interpretation of 'costs which are not commercially justifiable' (e.g. non-arm's length transactions of management services, licence fees or excessive interest rates on loans made by a shareholder to a company), the use of company assets by the shareholder on privileged terms, and the restructuring of sister companies by means of non-arm's length transactions.

Burden of proof

The burden of proof within Switzerland lies with:

- the taxpayer regarding the justification of tax-deductible expenses, and
- the tax authorities regarding adjustments which increase taxable income.

This effectively means that a taxpayer has to prove to the Swiss tax authorities that the price it has paid for its tangibles, intangibles and any services it has received from a related party satisfies the arm's length principle (i.e. justifies their tax deductibility). On the other side, the Swiss tax authorities' responsibility is to prove that the compensation for any services rendered by the taxpayer or any tangibles or intangibles transferred to a related party does not reach an arm's length level. However, if a taxpayer fails to produce the documents required by the tax authorities, this burden of proof also reverts to the taxpayer. Therefore, Swiss taxpayers should maintain appropriate documentation to justify all income and expenses resulting from related party transactions.

Tax audit procedures

In general, the attitude of the Swiss tax authorities towards transfer pricing in the course of tax audits has become more aggressive, especially when non-Swiss-headquartered companies are in a loss position.

Selection of companies for audit

Companies can be selected for investigation if relevant profit-level indicators (e.g. gross margin, net margin or return on capital) differ significantly from what is considered reasonable, or if the company is thinly capitalised.

Switzerland

Provision of information and duty of the taxpayer to cooperate with the tax authorities

The tax authorities may request any information that is relevant for properly assessing a company's profits. If the taxpayer does not comply, fines may be imposed and the burden of proof moves from the tax authorities to the taxpayer.

The audit procedure

The normal tax audit procedures are performed by the cantonal tax authorities in respect of cantonal and federal taxes. It is normal in Switzerland for the outcome of such an investigation to be decided as a result of negotiation, but if no agreement can be reached, an adjustment is imposed. In practice, the conduct of the taxpayer during the investigation can significantly affect the size of any adjustment – cooperation is more likely to lead to a satisfactory resolution.

It has been noticed, however, that the Federal Tax Department is becoming more aggressive and is intensifying audit procedures, in particular regarding withholding tax in connection with hidden distribution of profits based on non-arm's length transactions and with respect to Swiss value added tax (VAT).

Revised assessments and the appeals procedure

If the taxpayer disagrees with the assessment, he or she is entitled to make a formal appeal to the tax authorities. If the appeal is partly or entirely dismissed, then the taxpayer has the right to appeal to the Cantonal Tribunal and ultimately to the Swiss Federal Supreme Court.

Additional tax and penalties

Penalties apply where an adjustment is required as a result of a transfer pricing investigation in connection with a criminal proceeding (e.g. in the case of tax fraud). These penalties are not tax deductible. The level of penalties imposed depends on the extent to which the taxpayer has defaulted and can be set as a multiple of between one and three times the additional tax revenue.

No penalties apply on transfer pricing adjustments during a normal tax assessment.

Further, for Swiss withholding tax purposes, any transfer pricing adjustment and the repayments or the issuance of credit notes by the Swiss company due to adjustments made by foreign tax jurisdictions and to the extent not agreed in a mutual agreement procedure are considered as deemed dividend distributions and are therefore subject to 35% Swiss withholding tax or grossed-up to 54% if the Swiss withholding tax charge itself is not borne by the beneficiary. However such Swiss withholding tax might be partially credited or refunded based on a potential double tax treaty between Switzerland and the corresponding foreign tax jurisdiction.

Resources available to the tax authorities

The resources available to the Swiss tax authorities depend to a great extent on the canton involved. Zurich, for example, has its own experts, while small cantons are largely dependent on the experts within the Federal Tax Administration or the newly created State Secretariat for International Financial Matters (SIF).

Use and availability of comparable information

If challenged by the Swiss tax authorities, taxpayers must demonstrate that any transfer prices were based on sound economic and commercial reasoning. Documentary evidence, such as board minutes detailing the assumptions made and the expectations of the pricing policy, would normally be required. Furthermore, there is generally no publicly accessible information on which to base a local comparables study.

A pan-European benchmarking analysis generally supports the defence of transfer prices in Switzerland.

Risk transactions or industries

All transactions between related companies are equally likely to be challenged. No single industry sector or type of entity, with exception of low-risk/low-profit entities, appears to be more likely targeted than any other. However we are noticing a more aggressive approach with respect to structures involving offshore tax jurisdictions.

Limitation of double taxation and competent authority proceedings

Switzerland's competent authority under the tax treaties is the SIF and the competent authority process is well established. Once a decision is final under Swiss law, competent authority procedures are the only means for a taxpayer to avoid double taxation.

Advance pricing agreements

No formal procedure for agreeing pricing policies in advance with the tax authorities exists in Switzerland. The advance pricing agreements (APAs) procedure is therefore informal in its nature. APAs are available to all industries (unilateral and bilateral).

Anticipated developments in law and practice

Since the Swiss Tax Authorities believe that transfer pricing issues cannot be resolved through the provisions of domestic legislation, no significant changes to the existing statutory rules are expected. Indeed, the Swiss approach to transfer pricing issues is to follow the OECD Guidelines as closely as possible.

Swiss Tax Authorities have experienced and educated tax officers regarding transfer pricing issues and the use of the options for tax adjustments granted under the existing Swiss tax legislation. This may have particular implications on costs related to the provision of services, licence fees and costs for tangible goods charged to Swiss companies, since the burden of proof in justifying the deductibility of expenses lies with the Swiss taxpayer.

We also perceive that tax authorities in certain cantons are increasingly insisting on an arm's-length remuneration for assumed intellectual property transferred in connection with a transfer of business opportunities.

Liaison with customs authorities

The customs authorities assess customs duties and levy VAT on imported goods (the ordinary VAT rate is 8%). Consequently, information is regularly exchanged between the customs and VAT authorities. Since the VAT authorities themselves

Switzerland

form a subdepartment of the Federal Tax Authorities, the trend towards exchange of information between the VAT and the income tax resp. withholding tax authorities is increasing.

Consequently, transfer pricing adjustments should be considered for income tax, withholding tax as well as VAT purposes. An adjustment to the returns made for customs duty purposes is generally not required, since Swiss customs duty is based on weight and not on monetary value (although there are a few exceptions).

OECD issues

Switzerland is a member of the OECD and has accepted the initial as well as all the updated OECD Guidelines on transfer pricing without reservation.

In an instruction issued 4 March 1997, the Director of the Federal Tax Administration informed the cantonal tax authorities about the contents of the OECD Guidelines on transfer pricing and asked the authorities to observe these guidelines when adjusting profits or when assessing multinational enterprises in the canton.

Joint investigations

The Swiss authorities do not join with the tax authorities of another country to participate in a joint investigation. However in case the tax treaty allows an exchange of information, Swiss tax authorities are obliged to share certain and specific information (i.e. with jurisdictions where a tax treaty is in place, which contains similar or the same regulations of article 26 of the OECD Model Tax Convention).

Thin capitalisation

As previously noted, the Federal Tax Administration frequently issues instructions in connection with minimum and maximum permissible interest rates. If interest rates charged are not within the specified range, then the rate may be adjusted. In conjunction with this practice, specific legislation indicates the permissible debt-to-equity ratios. At the federal level, an instruction was released in June 1997 according to which the debt-to-equity ratio must be determined based on the fair market value of a company's assets. The Federal Tax Administration believes that the amount of available borrowings should be determined depending on the category of assets (receivables, participations, loans, property, installations, machinery, intangibles). Regarding finance companies, the safe harbour ratio is 6:1. The same rules apply to Cantonal Tax Law based on Article 29 (a) of the Act on Harmonisation of Cantonal Tax Laws.

Some flexibility is available in the application of these rules, particularly where they interact with the instructions on permissible interest rates. Thus, where the combination of a modest interest rate with excessive indebtedness results in an interest charge that is arm's length, given the amount of debt that would normally be permissible, it is unlikely that any adjustment would be made to the actual interest paid. Obviously, an excessive interest rate on a high amount of debt would not be acceptable.

Management services

The charging for management services by Swiss service companies and PEs is subject to instructions from the Federal Tax Administration. Specific guidelines regulate the costs to be recharged and the method of calculating an appropriate profit element. Generally, a cost plus approach is deemed appropriate (*see Other regulations section, above*).

71.

Taiwan

Introduction

Article 43-1 of the Income Tax Act (ITA) was intended for dealing with situations where special transactional arrangements are made between related parties not complying to arm's-length principle, thereby reducing tax liabilities in Taiwan, when it was included in ITA in 1971. However, because the provision failed to explicitly specify standards to determine non-arm's-length business operations or transactions and related (tax) adjustment methods, it had been practically difficult to follow.

On 28 December 2004, the Ministry of Finance (MOF) promulgated Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's-Length Transfer Pricing (TP Assessment Regulations), which set forth detail of the arm's-length nature of related party transactions that should be assessed, and the relevant documentation requirements.

Statutory rules

TP Assessment Regulations consist of seven chapters and 36 articles, with detail in the following aspects:

- Scope of related parties.
- Codification of arm's-length principle.
- Accepted transfer pricing methods.
- Documentation requirements
- Advance pricing agreements.
- Transfer pricing investigation and assessments.

Burden of proof

Under the transfer pricing assessment regulations, the taxpayer is obligated to conform to relevant regulations in disclosing information on related party transactions and to prepare relevant transfer pricing documentation to comply with the laws and regulations while filing the annual income tax return.

Documentation

When filing income tax returns, profit-seeking enterprises, except for those which have a turnover amount and controlled transaction amount less than the disclosing threshold established by the MOF, shall disclose information regarding their related parties and the controlled transactions with their related parties in prescribed formats. The information required in the prescribed disclosure formats is as follows:

- Related-party organisation chart.
- Detailed list of related parties.
- Summary table of related-party transactions.

Taiwan

- Detailed declaration of related-party transactions.

A profit-seeking enterprise should prepare the following documents when it files its income tax return, and submit them to the tax authority when requested within the submission deadline if it is under a transfer pricing investigation:

- A comprehensive business overview.
- A description of organisation structure.
- A summary of related party transactions.
- A transfer pricing report.
- A statement of affiliation (in the case of a subsidiary) and a consolidated business report of affiliated enterprises (of a parent company), as stipulated in Article 369-12 of the company act.
- Other documents concerning related parties or controlled transactions that affect pricing.

The transfer pricing report should include the following items:

- Industry and economic analysis.
- Functional and risk analysis of all the participants of the controlled transaction.
- Compliance status of the controlled transaction with the arm's-length principle.
- A description of the search for comparables and relevant information of the comparables.
- A comparability analysis.
- A description of the selection of the most appropriate transfer pricing method and the related comparability analysis.
- The result of the transfer pricing analysis.

Profit-seeking enterprises conducting controlled transactions are generally required to prepare transfer pricing reports. However, to alleviate taxpayers' burden and compliance costs, MOF established a safe harbour rule on 30 December 2005, and subsequently revised the safe harbour thresholds on 6 November 2008. Profit-seeking enterprises whose controlled transactions meet the requirements regulated under the safe harbour rule may replace their transfer pricing report with other evidentiary documents which can sufficiently prove that the results of such transactions are at arm's length.

The applied transfer pricing methods specified by the MOF available for each transaction type are as follows:

	Tangible asset transactions	Intangible asset transactions	Provision of services	Use of funds
Comparable uncontrolled price method	v		v	v
Comparable uncontrolled transactions method		v		
Resale price method	v			
Cost plus method	v		v	v
Comparable profit method	v	v	v	
Profit split method	v	v	v	

If the taxpayer intends to apply a transfer pricing method other than one of the previously mentioned methods specified by the MOF, pre-approval by the MOF is required.

Audit targets

On 2 August 2005, the MOF announced key criteria for its selection of audit targets. These criteria include any of the following:

- Profit-seeking enterprises with a gross profit margin, operating margin or return on sales ratio that is lower than that of other enterprises in the same industry.
- Profit-seeking enterprises that make a loss or a profit far less than that of other overseas affiliated entities, while the worldwide enterprise's group makes a profit as a whole.
- Profit-seeking enterprises whose profitability in the year under review and the previous two years fluctuates abnormally.
- Profit-seeking enterprises that do not disclose controlled transactions in the prescribed forms.
- Profit-seeking enterprises that do not evaluate whether the result of a controlled transaction is at arm's length in compliance with Article 6 of the transfer pricing assessment regulations or do not prepare the required evidentiary documents.
- Profit-seeking enterprises that have controlled transactions with related parties but without a reasonable arm's-length price.
- The previous and subsequent years of income tax filing of profit-seeking enterprises that do not provide required evidentiary documents of controlled transactions in compliance with Article 22 of the transfer pricing assessment regulations upon tax authorities' transfer pricing investigation and assessment adjustment.
- Profit-seeking enterprises that are involved in significant or frequent controlled transactions with affiliated entities located in tax havens or in countries with a low tax rate.
- Profit-seeking enterprises that are involved in significant or frequent controlled transactions with affiliated entities that enjoy tax incentives.
- Profit-seeking enterprises that are involved in other arrangements that intend to avoid or reduce tax liabilities in Taiwan.

Audit procedure

When a profit-seeking enterprise is perceived to enter into controlled transactions that are not consistent with the arm's-length principle, the collection authorities in charge may initiate an investigation. A profit-seeking enterprise must present the evidential documentation as listed here within one month of receiving a written notice of an investigation from the competent tax authority. Those who cannot present such documentation within the prescribed period under special circumstances must apply for an extension before the original due date. The extension may not exceed one month and is limited to one time only.

Should the tax authority deem it necessary to request additional supporting documents subsequent to its first review, the profit-seeking enterprise should provide the additional supporting documents within one month.

Taiwan

Audit procedures, assessment and corresponding adjustments

The MOF is principally responsible for setting policies and issuing statutory interpretations; the various regional bureaus of the National Tax Administration undertake the task of concrete implementation.

The tax authorities may choose from two approaches to conduct the investigation based on whether the enterprises being audited provide the transfer pricing documentation as required.

If an enterprise provides adequate transfer pricing documentation, the authorities may assess its taxable income based on such documentation.

If an enterprise fails to provide the mandated documentation, the authorities may assess the taxable income based on the information gathered from internal and external sources.

In either case, the taxable income of the taxpayer is assessed in accordance with the regulations. However, where there is a failure to provide information regarding comparables, the authorities in charge may assess tax on adjusted taxable income based on the standard profit margins regulated by MOF.

If an arm's-length adjustment, approved by the MOF, is made by a collection authority in charge, that authority shall also make a corresponding adjustment to the taxable income of the counterparty of the transaction if the counterparty is subject to income tax obligation in Taiwan. If the arm's-length adjustment results from an income tax assessment of a foreign tax jurisdiction under the tax treaty framework, the collection authority in charge shall also make a corresponding adjustment to the taxable income of the counterparty which is liable for the income tax obligation in Taiwan, if such adjustment is perceived as reasonable by the Taiwanese tax authorities.

Revised assessments and the appeals procedure

If a taxpayer refuses to accept the tax authority's decision as final, the taxpayer may attempt to protect its interests by filing for administrative remedy and litigation.

Additional tax and penalties

If an enterprise is engaged in related party transactions, it must determine the transaction results in accordance with the transfer pricing assessment regulations and use the results as its basis to determine its taxable income.

Where a profit-seeking enterprise fails to comply with the regulations, thereby resulting in a reduction of tax liability in Taiwan, and the collection authority in charge has made adjustments and assessed the taxable income of the enterprise in accordance with the Income Tax Act and the transfer pricing assessment regulations, a fine may be imposed. Article 110 of the Income Tax Act stipulates that in addition to the tax liability assessed, a fine will be imposed at two to three times the tax amount underreported, depending on the circumstances, for any of the following:

- The declared price of a controlled transaction is no less than two times the arm's-length price as assessed by the tax administration, or no more than 50% of the assessed arm's-length price.

- The increase in taxable income of the controlled transaction as adjusted and assessed by the collection authority in charge is 10% or more of the annual taxable income of the enterprise, and 3% or more of the annual net business revenue.
- The profit-seeking enterprise fails to submit a transfer pricing report and is unable to provide other documents evidencing that the results of the transaction are at arm's length.
- In other cases where evidence of tax shortfall discovered by the collection authority in charge leads to significant amount of tax omission or underreporting.

Advance pricing agreements (APAs)

The transfer pricing assessment regulations also provide rules for advance pricing agreements (APAs) and specify the following particulars:

- The criteria and time period for applying for an APA.
- Materials that must be provided in an application for an APA.
- Notification of significant changes in conditions and agreement termination.
- Period for audit and evaluation by the tax authority.
- Signing procedures and application period of an APA.
- Content of an APA.
- Submission of annual APA reports.
- Efficacy of an APA.
- Handling of changes in factors affecting prices or profits.
- Extension of an APA.

A profit-seeking enterprise may apply for an APA if it meets all of the following requirements:

- The total amount of the transactions being applied for under the advance pricing arrangement shall be no less than 1 billion New Taiwan dollars, or the annual amount of such transactions shall be no less than TWD 500 million.
- No significant tax evasions were committed in the past three years.
- Documentation required for an APA application, such as a business overview, relevant information of the related parties and controlled transactions, transfer pricing reports, etc. shall be provided within the prescribed time limit.

Taxpayers deemed qualified to apply for an APA should file an application before the end of the first fiscal year covered by the APA. The collection authority in charge shall notify the taxpayer in writing within one month whether the application is accepted. Once the application is accepted, the taxpayer should provide all required documents and report within one month from the date the notification is received, with a possibility to ask for an extension of the deadline for another month.

The collection authorities in charge shall review and reach a conclusion within a year. Under special circumstances, the evaluation period may be extended by six months, and if necessary, by an additional six months. There is no deadline for bilateral APA cases.

The collection authorities in charge will carry out discussions with the applicant in the six months following the date the conclusion is reached. An APA shall be signed between the collection authority in charge and the applicant upon an agreement being

Taiwan

reached between both parties. Once an agreement is signed, both sides are obligated to follow its terms.

During the applicable period of the APA, the applicant must submit an annual report on the execution of the APA to the tax authority during the annual tax filing period. The applicant also must retain evidential documentation and reports as required.

OECD issues

Although Taiwan is not a member of the Organisation for Economic Co-operation and Development (OECD), the MOF nonetheless consulted the OECD Transfer Pricing Guidelines and the legislation of other countries including US, UK and Japan, in drafting Taiwan's transfer pricing regulations.

Liaison with customs authorities

Although there is certain mechanism for exchange of information between the inland tax authority and the customs authority, since the method used to determine arm's-length transfer prices of imported goods for custom purpose may not necessarily follow that for income tax purpose, transfer pricing adjustments for income tax purpose do not bind the custom authority in calculating the import duties of those imported goods. Because the assessment period of custom duties is six months from importation, the custom authority generally would not allow any price adjustment after the said assessment period. For transfer price adjustments within the said assessment period, a recalculation of custom duty based on the said adjustment is possible in theory, but not often accepted by the custom authority in practice if it leads to a reduction of custom duties on the imported goods.

Thin capitalisation

Thin capitalisation rules were included in ITA on 26 January 2011 and took effect from 1 January 2011. The rules are designed to disallow the deduction of excessive related party interest expense pertaining to the portion of related-party debt that exceeds a certain prescribed debt-to-equity ratio.

A special assessment rule stipulates the scope of related parties, the determination of the debt and equity position, the safe harbour ratio and disclosure documentation requirement, promulgated on 22 June 2011 and applicable to the income tax returns for year 2011 onward. The prescribed debt-to-equity ratio is set at three-to-one for non-financial enterprises. Enterprises in the financial industries are currently not subject to thin capitalisation rules.

Special topics

Transfer pricing on permanent establishment

On 11 January 2007, the MOF issued a ruling which specifies application of transfer pricing assessment regulations when determining operating profit attributable to the permanent establishment (PE) of a foreign enterprise in Taiwan in accordance with a double taxation agreement (DTA).

If under a DTA between Taiwan and a foreign country, an enterprise of the other contracting state has a PE in Taiwan, the profit attributable to the PE is subject to income tax in Taiwan, and should be determined in the following manner:

The PE shall be deemed as carrying out business transactions with the enterprise of the other contracting state in a capacity of a completely independent enterprise, under same or similar conditions for the same or similar activities. The income attributable to the PE shall be determined in accordance with transfer pricing assessment regulations. Sufficient documentation proving that the attribution of income to the PE is in compliance with transfer pricing rules must be ready for audit by a collection authority in charge. Where an enterprise of the other contracting state deducts for income tax purpose the expenses incurred for carrying out the business of the PE, it should apply the Taiwan Income Tax Law, profit-seeking enterprise income tax assessment regulations, transfer pricing assessment regulations and other relevant rules.

If the enterprise of the other contracting state attributes all income from sale of goods or provision of services in Taiwan to its PE, it is not subject to transfer pricing documentation requirements.

Management service fees

Management service fees charged to Taiwan entities have come under scrutiny by the tax authorities. The tax authorities have challenged (1) the necessity of management services and (2) that the Taiwan entity realised actual benefits. The burden of proof has been heavily placed on the taxpayer to persuade the tax authorities that management expenses are necessary. There is no specific outline of acceptable evidence, but detailed records of all expenses charged should be kept in the event the tax authorities challenge management charges.

72.

Thailand

Introduction

While there is no detailed transfer pricing provisions under the Thai tax law, there is a general requirement that companies transact on an arm's-length basis. On 16 May 2002, the Revenue Department introduced its transfer pricing guidelines in the form of Departmental Instruction (DI) No. Paw. 113/2545. The purpose of the transfer pricing guidelines is to assist taxpayers in setting arm's-length prices for their transactions with related parties and also to assist revenue officers in reviewing taxpayers' transfer prices for compliance with the arm's-length principle.

Taxpayers are required to self-assess and file corporate income tax returns within 150 days of the last day of their accounting period. In order to ensure compliance, the Revenue Department regularly conducts business operation visits/tax investigations to review major issues and comprehensive tax audits. The burden of proof lies with the taxpayers.

During an operation visit/tax investigation, transfer prices may be reviewed. The Thai Transfer Pricing Guidelines set out the information/documents required to be reviewed by the revenue officers. Having well-prepared transfer pricing documentation in place reduces the risk of adjustments to prices under the general provisions of the Revenue Code based on what the revenue officer considers to be reasonable transfer prices. In the event that an adjustment is unavoidable, transfer pricing documentation can also help mitigate the size of the adjustment.

While the corporate income tax rate in Thailand has been reduced from 30% to 23% in 2012, and to 20% in 2013 and 2014, the Revenue Department's budget has significantly increased each year. In 2012, there has been the substantial increase in transfer pricing investigation activity by the Revenue Department. The transfer pricing group actively performs transfer pricing investigations. In addition to its normal selection of targets for transfer pricing investigation, its strategy is to investigate, simultaneously, competitors within the same industry sector and group companies within the supply chain. Domestic as well as cross-border related party transactions have been challenged by the Revenue Department during its tax investigations.

Statutory rules

There are only general provisions under the Revenue Code designed to guard against tax avoidance arising from transactions between related parties conducted at higher or lower than market price.

On the revenue side, the Revenue Code empowers revenue officers to:

- make pricing adjustments on the transfer of properties, rendering of services and lending of money without compensation or with compensation below the market price without justifiable reason, and
- make adjustments on the cost price of imported goods by comparison with the cost of the same type of goods imported into another country.

On the expense side, the Revenue Code empowers revenue officers to:

- disallow a purchase of goods at a price higher than market price without justifiable reason as a tax-deductible expense
- disallow an expense that is not expended for the purpose of acquiring profits or for the purpose of business in Thailand, and
- disallow an expense determined on and payable out of profits after the termination of an accounting period.

These tax provisions apply to domestic as well as cross-border transactions.

Components of the transfer pricing guidelines

DI No. Paw. 113/2545 has the following major components:

- Clause 1 states that a company established under Thai law or under a foreign law must calculate its net profit for the purposes of corporate income tax according to Section 65 of the Revenue Code.
- Clause 2 defines the term ‘market price’ as compensation for goods or services or interest that independent contracting parties determine in good faith in the case of a transfer of goods, provision of services or lending of money, respectively, which is of the same type as the related parties’ transaction on the same date. In this regard, the term ‘independent contracting parties’ is defined as parties without direct or indirect relationships in terms of management, control or shareholding.
- Clause 3 suggests pricing methods for determining market price, namely comparable uncontrolled price, resale price, cost plus and other methods (i.e. transactional net margin method and profit split method).
- Clause 4 lists the documentation that is required to be kept at the office of the taxpayer. This documentation includes ownership structure, budget, strategy and business plan, details of related party transactions, functional analysis, pricing policy, etc. Where taxpayers can prove through such documentation that the result of their price setting under the selected method is the market price, revenue officers are obliged to use the taxpayers’ methods for determining taxable income and expense for the purpose of calculating corporate income tax.
- Clause 5 allows taxpayers to enter into an advance pricing agreement (APA) with the Revenue Department. To apply for an APA, taxpayers must submit a letter requesting an APA together with relevant documents to the Director-General of the Revenue Department in order to set the criteria, methods and conditions with which the taxpayer must comply.

Legal cases

No legal cases concerning transfer pricing have been decided by the courts since the introduction of DI No. Paw. 113/2545. To date, cases involving transfer pricing issues have been settled during the investigation stage, and details are not made available to the public.

Thailand

Burden of proof

The burden of proof lies with the taxpayer to clear alleged transfer pricing abuses. The transfer pricing guidelines are designed to assist taxpayers in their efforts to determine arm's-length transfer prices.

In the event of a dispute, the taxpayer must be able to substantiate, with supporting documents, to the satisfaction of the revenue officers, the Board of Appeals, or the courts, as the case may be, that its transfer prices have been determined in accordance with the arm's-length principle.

Tax audit procedures

Taxpayers are not required to submit their transfer pricing documentation with their annual corporate income tax returns. They are, however, expected to submit it within two weeks to one month of a revenue officer's request.

There is no specific transfer pricing audit; it is undertaken as part of the normal tax audit process. However, the Revenue Department begins the investigation process by issuing a letter requesting taxpayers, under their supervision, to provide information and documents on the adopted transfer pricing practices. Targets are selected for investigation based on their analysis of the tax returns submitted, and information obtained from the 'business operation visit', whereby the revenue officers visit companies under their supervision at least once a year to understand the business and ensure tax compliance.

The criteria used by the Revenue Department to select targets for transfer pricing investigation include, but are not limited to:

- Low profits compared with competitors.
- No tax payment for an extended period of time.
- Decline in profits after a tax holiday expires/business restructuring.
- Profits in promoted business, but losses/lower profits in non-promoted business.
- Drastic fluctuations in profits from year to year.
- Varied profitability by product.
- Payment of royalties/management fees.
- Significant related party transactions.

The transfer pricing documentation is reviewed by the Revenue Department's transfer pricing team. Based on this review and analysis, the revenue officers typically raise questions and require more detailed explanations and related documents. Depending on how well the transfer pricing practices are documented and the completeness of the supporting documents, the request for additional information and documents can take many rounds.

The Revenue Department's tax investigation process is as follows:

- Collect and analyse accounting and tax information/documents.
- Challenge and invite the taxpayer's representative to discuss the transfer pricing (and any other tax) issues identified, and possibly request additional documents.
- Review additional documents and consider explanations.
- Inform the taxpayer's representative of the Revenue Department's opinion.

- The taxpayer is requested to file amended tax returns if in agreement with the Revenue Department's opinion.
- For transfer pricing issues, the Revenue Department issues a summons to audit all taxes if the taxpayer does not accept its opinion.
- Taxpayers may enter into the appeals process to resolve the dispute if they disagree with the tax assessment.

The Revenue Department generally requires six months to analyse the information/documents and reach a conclusion. After notifying the taxpayer of the outstanding issues, the clarification and negotiation process between the taxpayer and the Revenue Department may take an additional three to 12 months.

In a case where the revenue officers accept the taxpayer's explanations and supporting documents, the challenges will be dropped. However, the revenue officers will then generally redirect their focus to other tax issues, including corporate income tax, value added tax (VAT), withholding tax, specific business tax, etc.

In the event that the revenue officers do not accept the taxpayer's explanations and supporting documents, they will advise the taxpayer to voluntarily file amended tax returns to make the required tax adjustments and to pay a surcharge. If the taxpayer disagrees with the opinion of the revenue officers, a summons will be issued for a comprehensive tax audit. The comprehensive tax audit covers all taxes under the Revenue Code (i.e. corporate income tax, VAT, and stamp duty). After having completed the audit, the Revenue Department will issue the notification of a tax assessment.

Revised assessments and the appeals procedure

After receiving notification of a tax assessment from the Revenue Department, the taxpayer is required to make an adjustment to the tax return and pay the tax shortfall together with the related penalty and surcharge. In the event that the taxpayer disagrees with the Revenue Department, the taxpayer is allowed to appeal to the Appeals Division of the Revenue Department. The Por. Sor. 6 form must be completed and submitted to the Appeals Division within 30 days from the date of receipt of the notification of the tax assessment.

The Board of Appeals (BOA) will consider the taxpayer's argument and may invite or issue a warrant to the taxpayer or witnesses for questioning or to provide additional testimony or supporting evidence. The appeals process on average takes three months (not including the waiting period). Upon completion, the BOA's ruling will be mailed to taxpayers.

In the event that the taxpayer disagrees with the BOA's ruling, the taxpayer may bring the case to the Tax Court within 30 days from the date of receipt of the notice of the ruling. It should be noted that if a taxpayer fails to cooperate with the Revenue Department and does not comply with the summons, the taxpayer is not allowed an appeal with the Appeals Division. Furthermore, the Tax Court will not accept an appeal case if the taxpayer fails to file the appeal with the Appeals Division.

The Tax Court normally takes one to three years to reach a verdict (not including the waiting period). If the taxpayer disagrees with the ruling of the Tax Court, the taxpayer is allowed to appeal to the Supreme Court within one month from the date of the

Thailand

announcement of the Tax Court's judgment. The ruling process at the Supreme Court may take an additional one to three years (not including the waiting period).

Additional tax and penalties

In the case of a tax assessment resulting from a comprehensive tax audit, the taxpayer is liable to a penalty equal to the additional amount of tax payable. Revenue officers have the power to reduce the penalty 50% if they are of the opinion that the taxpayer had no intention of evading taxes and has cooperated fully during the tax audit. The Director-General of Revenue Department has the power to waive the penalty if the taxpayer can demonstrate that it cooperated fully during the audit and had no intention of evading the tax.

In addition, the taxpayer is liable to a surcharge of 1.5% per month or fraction thereof of the tax payable or remittable exclusive of penalties. In a case where the Director-General of Revenue Department has granted an extension of the deadline for the remittance of the tax and the tax is paid or remitted within the extended deadline, the surcharge will be reduced to 0.75% per month or a fraction thereof. Unlike the penalty, the surcharge may not be waived.

There will be no penalty, only a surcharge, if there is tax payable in the case of voluntary filing of an amended tax return (i.e. no comprehensive tax audit).

Resources available to the tax authorities

The Revenue Department has all taxpayers' financial information. All taxpayers are required to file their audited financial statements together with their corporate income tax returns. The Revenue Department also has access to the Business-on-Line database, which contains key financial data of all companies registered under Thai law, as well as other databases.

Other sources of information include other government agencies, such as the Customs Department, the tax authorities from treaty partners through the Exchange of Information Article, disgruntled employees, etc.

Use and availability of comparable information

Comparable information may come from internal as well as external sources. The revenue officers use internal data, if and when available, to determine whether the taxpayer's transfer prices are at arm's length.

External comparable information is also used, especially if internal comparable information is not available. There is an abundance of potential comparable data, as all companies established under Thai law are required to file their audited financial statements with the Ministry of Commerce. This information is available to the public but can only be retrieved by photocopying the hard copy documents.

Risk transactions or industries

No particular industry is more at risk of being subject to tax investigation than any other. However, as Thailand is a manufacturing base for automotive makers and electronic goods manufacturers, a relatively greater number of taxpayers in the automotive and electronics industries have been investigated. Taxpayers in other industries, such as pharmaceuticals, consumer products, petrochemicals, computers, etc. also have been investigated.

The Revenue Department has begun to focus on the following related party transactions as part of its investigation:

- Sales and purchases of goods, assets and services.
- Transfer and use of know-how, copyrights and trademarks.
- Management and administrative fees.
- Loan and interest payments.
- Research and development expense allocation.
- Commission payments.

Limitation of double taxation and competent authority proceedings

Thailand has entered into conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to tax on income with 55 countries. The conventions include mutual agreement procedures (MAP), whereby if a taxpayer considers that the tax assessment of one or both of the contracting states results or will result for the taxpayer in taxation not in accordance with the provisions of the conventions, the taxpayer may present the case to the competent authority of the contracting state. The competent authorities shall endeavour to resolve any difficulties or doubts arising by mutual agreement.

It should, however, be noted that most of the treaties that Thailand has with other countries do not allow for correlative adjustment.

In the event that a taxpayer disagrees with a tax assessment of the Revenue Department, the taxpayer is entitled to seek a ruling from the Revenue Department. The ruling process, which normally takes six to 12 months, is expected to take longer in the immediate future due to the potential change in the process resulting from the recent political turmoil. The MAPs between competent authorities will also take much longer than in the past.

The Thai Revenue Department has completed the negotiation of a few transfer pricing MAP discussions with the National Tax Authority (NTA) of Japan in April 2012.

Advance pricing agreements (APAs)

Clause 5 of DI No. Paw. 113/2545 allows taxpayers to enter into an APA with the Revenue Department. To enter into an APA, the taxpayer must submit a letter requesting the APA together with the relevant documents to the Director-General of the Revenue Department in order to set the criteria, methods and conditions with which the taxpayer must comply.

Thailand has so far concluded six APAs. All are bilateral and with Japan. Since the issuance of the guidelines on APAs in April 2010, there has been a substantial increase in the number of APA applications in Thailand. A number of companies have requested for bilateral APAs with Japan and other countries. Currently, there are 14 bilateral APAs in the Revenue Department's pipeline.

Liaison with customs authorities

The current level of interaction between the Revenue Department and other government departments, such as the Customs Department, is low. However, taxpayers should ensure that information provided to the various government departments is consistent.

Thailand

OECD issues

Thailand is not a member of the Organisation for Economic Co-operation and Development (OECD). However, the tax authorities generally have adopted the arm's-length principle and authorise the use of transfer pricing methodologies (e.g. comparable uncontrolled price, resale price method, cost plus method, transactional net margin method, and profit split method) endorsed by the OECD Guidelines in order to determine the market price of a transaction.

The comparable uncontrolled price method, the resale price method, or the cost plus method are preferred over the transactional net margin method and the profit split method. However, there is no hierarchy of these three methods. Other methods may be used if the three traditional transaction methods were found to be inappropriate. There is also no hierarchy of these other methods.

Joint investigations

Cross-border cooperation is common in general tax areas. Such cooperation has tended to take the form of foreign tax authorities requesting information from the Thai Revenue Department. However, recently the Revenue Department has increasingly been requesting information support from foreign tax authorities in those countries that have entered into double taxation agreements with Thailand.

Thin capitalisation

Thailand currently has no thin capitalisation legislation.

Management services

The Thai Revenue Department is currently increasing its focus on management service fees. The point of concern is whether the management service fees that a taxpayer pays to a related party are for the direct purpose of acquiring profits for the company's business in Thailand and whether the fees paid are commensurate with the benefits received.

Service providers

All costs related to the services provided must be included in determining the service charge.

Service recipients

Generally, service recipients need to substantiate that:

- services are rendered
- services benefit the service recipient, and
- service fee paid was consistent with the arm's-length principle.

The service recipient must have documents to support the above. Contracts and documents showing the costs incurred by the service provider are not sufficient. The service recipient should keep proper documentation in respect of the services rendered, showing that the services were for the benefit of the service recipient. A benchmarking study should also be maintained to demonstrate that the service fee (as well as other transfer prices) was consistent with the arm's-length principle.

73.

Turkey

Introduction

Specific transfer pricing rules are valid in Turkey as of the beginning of 1 January 2007 under Article 13 of the Corporate Income Tax Law (the CITL) No. 5520 with the title 'Disguised Profit Distribution through Transfer Pricing'.

The regulations under Article 13 follow the arm's-length principle, established by the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), and are applicable to all financial, economic, commercial transactions and employment relations between related parties. Details on the application of Article 13 are provided in a communiqué regarding disguised profit distribution through transfer pricing.

Statutory rules

The legal framework that defines the current Turkish TP implementation methodology is included under the CITL and the related communiqué(s).

The Turkish TP legislation is part of the Turkish CITL. The arm's-length principle, which is defined in line with OECD Guidelines and Article 9 of the OECD Model Tax Convention, is enacted in Article 13 of the CITL along with a detailed definition of related parties, as well as the introduction of methods to be applied in the determination of the arm's-length price. According to the law, related parties must set the transfer prices for the purchase and sales of goods and services as they would have been agreed between unrelated parties.

A comprehensive definition of what constitutes a related party is found in Article 13 of the CITL. Related party definition of the Turkish Transfer Pricing regulations is very broad and it includes direct or indirect involvement in the management or control in addition to the existence of shareholder/ownership relationship. In addition to transactions with foreign group companies, it also includes transactions with entities that are based in tax havens or in jurisdictions that are considered to be harmful tax regimes by the Turkish government.

For the purposes of the CITL, the term 'corporation' covers:

- capital stock companies
- cooperatives
- public economic enterprises
- economic enterprises of associations or foundations, and
- joint ventures.

Turkey

Within this framework, the concept of ‘related party’ is broadly defined under Article 13 of the CITL No. 5520 as follows:

- Shareholders of the corporation (without any threshold).
- Legal entities or individuals related to the corporation or its shareholders.
- Legal entities or individuals which control the corporation directly or indirectly in terms of management, supervision or capital.
- Legal entities or individuals which are controlled by the corporation directly or indirectly in terms of management, supervision or capital.
- Spouses of shareholders of the corporation.
- Ascendants and descendants of shareholders or their spouses.
- Persons who are linked to shareholders or their spouses up to third degree by direct blood relationship or marriage.

Moreover, by taking into account whether the taxation capacity of the source country (the tax burden on corporate income earned in the source country to be measured by taking into account all taxes that are similar to personal and corporate income taxes) is the same with that of Turkey and the issue of exchange of information, transactions made with persons located in regions or countries to be announced by Council of Ministers will be deemed as if they were made with related parties.

The Transfer Pricing rules define certain methods for the determination of arm’s-length transfer prices. The methods adopted are comprehensively explained by the OECD Guidelines and are as follows:

- Comparable uncontrolled price method.
- Cost plus method.
- Resale price method.

The law states that if the above-mentioned methods cannot be used by the company for certain situations, the taxpayer will be free to adopt other methods. This means companies can also choose other methods such as the transactional profit methods of the OECD Guidelines (namely, profit split and transactional net margin method) for the determination of the arm’s-length price, if they can prove that the above-mentioned traditional transaction methods cannot be used.

According to the General Communiqué No. 1, the other methods are defined as the following:

- Profit split method.
- Transactional net margin method.

If none of the aforementioned methods can be applied, the method determined by the taxpayer may be used as the most appropriate method for the transactions.

Comparable uncontrolled price method

In the comparable uncontrolled price method (CUP), if the internal comparables are sufficient to reach an arm’s-length price, there is no need to find an external comparable. If there is no internal comparable, external comparables should be used after making a comparability analysis and the necessary adjustments.

Cost plus method

In the cost plus method, all the direct costs, indirect costs, common costs related to service or product and operation costs should be considered.

If there is a difference between the accounting systems of related and unrelated transaction processes, the necessary adjustments should be made.

Resale price method

The resale price method evaluates the arm's-length character of a controlled transaction by reference to the gross profit margin realised in comparable uncontrolled transactions, and is most useful where it is applied to marketing operations, such as distributors.

Profit split method

The profit split method is based on the distribution of the operating profit or loss among related parties according to their functions performed and risks assumed.

Transactional net margin method

The transaction net margin method (TNMM) is applied according to the net operating profit margin that is found by considering the costs, sales or any other appropriate base.

Tax havens

In addition to inter-company transactions between related parties, the transfer pricing provisions of the CITL cover transactions between unrelated parties, where the foreign party is located in one of the tax havens to be identified by the Turkish Council of Ministers. However, such a list has not been published yet as of 30 September 2012.

Payments for services, commissions, interest and royalties to parties located in a tax haven are subject to a 30% withholding tax under the CITL. However, if the transactions involve the import of a commodity or the acquisition of participation shares or dividend payments, the withholding tax is not applicable as long as the pricing is considered to be arm's length.

Deemed dividends

When it is determined by tax inspectors that the price applied in a related party transaction is not at arm's length, the outcome is a tax adjustment on corporate tax as well as additional dividend tax on the disguised profit distribution. This requires that if the counterparty is a non-resident taxpayer, individual or any tax-free person; corporate dividend tax should be paid over the disguised profit distribution.

Adjustments

Any transfer pricing-related adjustments deemed necessary by the tax inspectors will be made to the taxpayers' earnings after they pay their respective corporate taxes.

Disguised profit distributions through transfer pricing are not accepted as deductible for CIT purposes. The corporate tax base of the taxpayer will be adjusted, and relevant corporate tax will be calculated together with the penalties and late payment interest.

Besides, the disguised profit which is wholly or partly distributed to a related party will be treated as:

Turkey

- deemed dividend, if the corporation distributing the disguised profit is a resident taxpayer,
- remittance, if the corporation distributing the disguised profit is a non-resident taxpayer.

In both cases, the amount of disguised profit will be subject to a withholding tax.

However, pursuant to Article 5(1)(a) of the CITL No. 5520, if the related party receiving the disguised profit is a resident corporate taxpayer, the disguised profit will be evaluated within the context of 'participation exemption'. Accordingly, no withholding tax will be imposed and adjustment will be made on the tax return.

Documentation requirements

The legislation requires documentation as part of the transfer pricing rules wherein Turkish taxpayers should keep documented evidence within the company in case of any request by the tax authorities. The documentation must represent how the arm's-length price has been determined and the methodology that has been selected and applied through the use of any fiscal records and calculations, and charts available at the taxpayer.

The transfer pricing regulations in Turkey have three basic documentation requirements:

- Electronic corporate tax return form about transfer pricing, controlled foreign company and thin capitalisation.
- Annual transfer pricing report.
- Transfer pricing documentation for taxpayers during the application of an APA and annual report for taxpayers under an APA.

According to General Communiqué No. 1, all corporate taxpayers should submit a form as an attachment to their annual corporate tax return. The form constitutes the following parts:

- Information about the taxpayer (tax ID number, corporate name, taxation period, etc.).
- Information about the related parties within the scope of the form (corporate name, country of residence).
- Total amount of transactions that occurred between related parties.
- The methods used for the related party transaction.
- Information about the controlled foreign company of the company (corporate name, country of residence, etc.).
- Information about thin capitalisation.

On the other hand, corporate taxpayers are obliged to prepare an annual transfer pricing report in line with the format that is stated in the General Communiqué No.

1. An annual transfer pricing report should be prepared until the last day of CIT declaration day, which is 25 April for taxpayers whose fiscal year is calendar year. The report shall compose different levels of information depending on:

- whether the taxpayer is registered to the Major Taxpayers Tax Office, and
- whether the taxpayer is operating in free trade zones in Turkey.

According to the above-mentioned distinction:

- corporate taxpayers that are registered to the Major Taxpayers Tax Office shall prepare a report that comprises information about both their domestic and cross-border related party transactions, and
- corporate taxpayers that are operating in free trade zones (FTZ) in Turkey shall prepare a report that comprises information about their transactions with their related parties in Turkey.

All other Turkish corporate taxpayers shall prepare a report that comprises information about their cross-border related party transactions.

Documentation deadlines are as follows:

Preparation deadline		Submission deadline
Transfer pricing form		Corporate tax return submission (as an attachment to the corporate tax return) on the 25th day of the fourth month following the end of the fiscal year
Annual transfer pricing report	Corporate tax return submission on the 25th day of the fourth month following the end of the fiscal year	15 days upon request

Disposition of the annual transfer pricing report is mentioned in the related legislation as follows:

- General information: Information about the field of activity of the taxpayer, economic conditions in this field, market conditions and business strategies.
- Information about related parties: Information about tax ID numbers, addresses, telephone numbers, etc. of the related parties and the field of activity of the related parties as well as economic conditions in this field, market conditions and business strategies, functions they generate, risks they assumed and assets they owned.
- Information about the details of related party transactions: Detailed information about all transactions and agreements between related parties.
- Information about transfer pricing analysis: Detailed information about comparability analysis, criteria that are used to choose for the comparable transactions (whether there are corrections on determination of the comparability the detailed information for that; information, documentation and calculation that shows the applied TP method is the most suitable as well as the comparison of the applied method to the other methods; detailed information about the calculations used to find the arm's-length price or profit margin; whether an arm's-length price range is determined, and the detailed information on this range).
- Conclusion: A summary includes the methods and arm's-length prices of the intercompany transactions.

Taxpayers that apply for an APA shall prepare application documents, and once an APA is concluded with the Revenue Administration, the taxpayer shall prepare a separate annual report that takes transfer pricing into consideration from the APA's

Turkey

point of view. The documents and information required for the annual report of APA is separately defined in the legislation.

The administration can demand additional information and documents for the annual transfer pricing report, the APA application and other corporate taxpayers that have related party transactions when deemed necessary. If the documents are written in a foreign language, their translation into Turkish is obligatory.

Other documents

Corporate and individual income taxpayers must prepare transfer pricing documentation. The type of information that is required is outlined in General Communiqué No. 1 as follows:

- Organisation chart and definition of the company's activities, definition of related parties (tax ID numbers, addresses, telephone numbers, etc.) and property relations amongst them.
- All the information that includes the functions undertaken and the risks assumed by the company.
- The product price lists in the transaction year.
- The production costs in the transaction year.
- Invoice information and the number/value of transactions made with related or unrelated parties in the transaction year.
- All the contracts with related parties in the transaction year.
- Financial statements of the related parties.
- Internal pricing policy of the company, which is applied to related party transactions.
- The associated information if related parties use different accounting standards and methods.
- Information related to the ownership of intangible property and amounts received or paid for intangible rights.
- Reason for choosing the transfer pricing method applied and informative documents related to the application of the transfer pricing method (internal and/or external comparability analysis).
- Calculations used to determine the arm's-length price or profit margin and detailed information related to assumptions.
- Method used to determine the arm's-length price range, if any.
- Other documents used to determine the arm's-length price.

Language for documentation

TP documentation should be prepared in Turkish.

Other regulations

In addition to the specific transfer pricing regulations, additional requirements or rules covering transfer pricing contained in other legislation include:

- Turkish tax procedural law article with regard to the determination of the market value of goods.
- Turkish value added tax (VAT) law article stating if the tax base for goods and services is unknown, the market prices based on the nature of the transactions will be the tax base.

- Turkish income tax law Article 41 includes partnerships and individuals subject to income within the scope of transfer pricing.
- Case law on an excessive number of decisions of Turkish tax courts after cases have been discussed at courts where tax inspectors challenged the transfer prices and eventually the disguised profit distribution of the taxpayer.
- Case law on tax rulings on the subject.

Legal cases

In recent years, the Turkish Ministry of Finance significantly increased its number of transfer pricing audits against companies, with a particular emphasis on the pharmaceutical, automotive and fast moving consumer goods sectors. In the course of these audits, the Ministry of Finance has focused on the following transfer pricing issues:

- Pricing of raw materials traded amongst related parties, with the government relying on industrial benchmarking studies that omit relevant risks and functions.
- Continual losses in previous years by companies that operate primarily through related companies abroad.
- Management fees and indirect cost allocations.
- Yearend adjustments.

It is expected that the companies will face different levels of tax audits under the subject of transfer pricing in the coming couple of years as the current rules seem to become a trendy subject to the tax inspectors.

Burden of proof

In Turkey, the burden of proof lies with the party making the claim under Article 3 of Turkish tax procedural law. Establishing proof includes an examination of the substance of the business event that gives rise to the transaction.

According to the requirements of the transfer pricing law, companies should be ready to provide evidence in order to explain why they chose to implement a specific transfer pricing method. Moreover, responsibility for safe-keeping of the workings/accounts and sheets for this issue rests with the taxpayers.

In the case of a tax audit, if the tax inspector claims the application of the transfer pricing method by the company is against the law, then the burden of proof will shift to the inspector. If a situation is claimed to be clearly lacking in economic, commercial and logical justification, the plaintiff is liable to prove his claim.

Tax audit procedures

The structure of tax audit institution has changed recently and the taxpayers are separated into two classes, which are large and small scope taxpayers. The taxpayers that are registered to the Large Taxpayers Tax Office are always monitored by the tax inspectors. Besides a new transfer pricing audit department established, that conducts only transfer pricing audits.

Revised assessments and the appeals procedure

Assessments are made by the tax inspectors at the end of the tax audit. There is no administrative appeals procedure, but a special reconciliation with the tax authority is possible. If parties cannot reconcile at the end of the reconciliation process, then the

Turkey

taxpayer is able to go to court. Likewise, the taxpayer can choose not to reconcile prior to the reconciliation process and go to court.

Additional tax and penalties

There are no specific transfer pricing penalties. The penalty provisions of the tax procedural law apply to those who do not submit the required documentation and/or where transactions are found to be inconsistent with the arm's-length principle. Briefly, if the profit that is distributed in a disguised manner through transfer pricing shall be deemed as dividends distributed, then necessary adjustments on taxes will be made at the hands of the party receiving the deemed dividends. In this respect, the taxes assessed in the name of the company distributing dividends in a disguised manner must be finalised and paid.

There is no specific tax loss penalty in Turkish tax legislation for transfer pricing adjustments. The general tax loss penalty provisions in the Turkish tax procedural law are applicable. The general tax loss penalty is equal to one fold of the unpaid tax. Additionally, there is a delay interest applied on a monthly basis (1.4% effective from 19 November 2010) for the period between the normal due date of the additional tax assessed and the date of assessment. Further, there is no specific reduction provision for transfer pricing-related tax loss penalty assessments; general rules in the Turkish tax procedures code are applicable. Taxpayers may appeal to the Ministry of Finance for a reduction in the tax loss penalty through settlement procedures with the tax authorities either before or after the imposition of the assessment.

Resources available to the tax authorities

During the tax audits, tax returns of the comparable companies may be used by the tax authority. Besides there is special audit unit under Turkish Revenue Administration to deal with transfer pricing issues. Both the local tax inspectors and the transfer pricing specialist tax auditors pose a high level of industry-specific knowledge, and they may use a variety of sources for benchmarking such as financial data published by listed companies as well as data from other taxpayers. The lack of statistical information for determining the profit margin of specific activities and the lack of local databases directly affect the accuracy of benchmarking studies.

Moreover, as mentioned in the *Documentation requirements section, above*, by using the annual form, inspectors may assess the amount of related party transactions in a year and initiate an investigation accordingly.

Use and availability of comparable information

As previously mentioned in the *Statutory rules section, above*, taxpayers may use both internal and external comparables. However, available local data in Turkey is limited because only publicly held companies are obliged to declare their financial data.

Turkish transfer pricing legislation neither provides a clear guidance on benchmarking studies nor prohibits the use of databases.

Therefore, it might be inferred that foreign comparables should be acceptable, provided that differences in geographic markets (if any) can be eliminated through appropriate adjustments and/or analyses. Besides, comparable company sets should be updated on an annual basis according to the most recently available data.

An important point to be considered for Turkish taxpayers regarding the use of ‘publicly available comparable data’ for the purpose of benchmarking (which is an OECD principle) is when determining transfer-pricing-related assessments Turkish tax auditors would highly tend to use their own ‘secret comparables’ to which only they have access, by virtue of their public authority. Turkish taxpayers are advised to be ready to challenge this approach, which is contrary to the relevant OECD principles.

Risk transactions or industries

Tax authorities use special software to determine the company they audit. This software includes all the financial information of the taxpayers and they are selected with the help of including but not limited to the following criteria: net sales amount, fluctuation in the profit margin, recent year losses, having loss in the current year, paying management or license fees to abroad related parties, having related party transactions with the companies that are based in low tax regime countries etc. Accordingly the number of transfer pricing audits has been increasing in recent years and it is expected to continue. Besides, tax authorities request the transfer pricing reports even if there is no transfer pricing audit. The numbers of the companies that are requested to submit their transfer pricing report to the tax authorities are increased dramatically in 2012. Lastly, in many cases transfer pricing audits may trigger VAT and customs related audits.

Limitation of double taxation and competent authority proceedings

Turkish tax treaties (currently with 74 jurisdictions) contain relevant mutual agreement procedure (MAP) articles. Countries that have signed a double tax treaty with Turkey may, in theory, pursue competent authority relief as a means of preventing double taxation arising from tax adjustment. However, in practice there are very rare cases where MAPs are initiated, meaning the MAP has not been tested by Turkish taxpayers as a means of preventing double taxation.

Advance pricing agreements

Methods to be used in determining the price regarding purchases or sales of goods or services with related parties may be agreed with the Ministry of Finance upon taxpayer’s request. This approved method will be certain for a maximum period of three years within the terms and conditions of the agreement. If the administration identifies that the demand for the agreement interests more than one country and if there are already APAs considering the other country/countries, the administration may consider the possibility of a bilateral or multilateral agreement.

The APA process begins with the written application of the taxpayer after application fee (38,000 Turkish liras [TRY] for 2012) is paid. The taxpayer submits to the TRA the requested information and documents with the application. Information and documents submitted are subjected to a preliminary assessment by the TRA. If the information and documents do not allow the TRA to make a sufficient assessment, the TRA may request additional information and documents or meet with the taxpayer.

Following the completion of necessary data, an analysis is made regarding comparable transactions, assets used, applicable methods, agreement terms and other relevant aspects. As a result of the analysis, the TRA may accept the taxpayer’s application as it is or approve it on condition that necessary modifications are made or reject it.

Turkey

Nine months prior to the end of the validity of the agreement, a taxpayer may apply for its renewal.

In view of practices throughout the world, it is observed that APA process changes according to complexity level and type (unilateral, bilateral or multilateral) of the agreement and completion of the process cannot be completed earlier than 18 to 24 months in average.

Anticipated developments in law and practice

Regarding the legislations no development has been anticipated in recent years; however regarding the practice, Turkish Tax Authorities has been focusing on transfer pricing applications of the taxpayers and this approach is expected to continue in the following years. In this respect, a new transfer pricing unit that consists of transfer pricing auditors has been established under the roof of ministry of Finance. In line with this development both the transfer pricing tax audits and the number of the companies that are asked to submit their transfer pricing reports increased dramatically in the last years.

Liaison with customs authorities

The customs rules in Turkey are not specifically coordinated with the transfer pricing rules. The customs authorities have their own legislative guidance for the treatment of inter-company transfers of imported/exported material. Additional TP regulations may create the need to incorporate customs practices into joint legislation. There have been joint efforts by customs and tax authorities to work on the transactions and to investigate import prices in specific industries. For example, reports have been written by a customs inspector that challenged import prices.

OECD issues

Turkey is a member country of the OECD and acknowledges the organisation's transfer pricing guidelines. On the other hand, as Turkey's transfer pricing regulations are new and at the development stage, they have yet to fully incorporate all the principles contained under the OECD Guidelines. The current transfer pricing law provides an impetus for the adoption of improved transfer pricing regulations in accordance with best international practice.

Thin capitalisation

The thin capitalisation issue is rearranged under Article 12 of the CITL. According to the Article, if the ratio of the borrowings from shareholders or from persons related to the shareholders exceeds three times the shareholder's equity of the borrower company at any time within the relevant year, the exceeding portion of the borrowing will be considered as thin capital.

The scope of the term 'related parties' consists of shareholders and the persons who are related with the shareholders that own 10% or more of the shares, voting rights or right to receive dividends of the company.

The shareholder's equity of the borrower company is defined as the total amount of the shareholder's equity of the corporation at the beginning of the fiscal year, or the difference between the assets and liabilities of the company. If the company has negative shareholder's equity at the beginning of the year, then any borrowings from related parties will be considered as thin capital.

If thin capitalisation exists, the interest paid or accrued, foreign exchange losses and other similar expenses calculated over the loans that are considered as thin capital are treated as non-deductible for CIT purposes. Moreover, the interest paid or accrued and similar payments on thin capital will be treated at the end of the relevant fiscal year as deemed dividends and will be subject to withholding tax.

Management services

Although in the past the law did not provide definitive legislation relating to management services, the new transfer pricing article takes the OECD Guidelines as a basis. Through these developments, management services may be subject to greater scrutiny under the transfer pricing regulations.

As per Turkish transfer pricing regulations, management services refer to one of the following:

- The services performed by the corporate headquarters to other related group companies.
- The services rendered by one group company to another.

These services are usually considered as services that ensure intra-group management, coordination and control functions. The costs of these services are undertaken by the parent company, a group company that is responsible for this purpose or another group company (group services centre).

From the perspective of Turkish transfer pricing-regulations, the following points have to be taken into consideration:

- Whether the service has been actually rendered.
- Whether the receiver company(s) needs the service.
- Whether the price of those services is at arm's length.

Because of the uncertainty of management services and their prices, management service fees are always an easy target for the tax audits to attack. The payments that fail the above-mentioned points may be criticised from a transfer pricing point of view and may be non-deductible for CIT purposes.

74.

United Kingdom

Introduction

In recent years, the most significant change has been the introduction by Her Majesty's Revenue and Customs (HMRC) (the successor to the Inland Revenue) of a new framework for handling all transfer pricing enquiries. The Transfer Pricing Group (TPG) was introduced in April 2008, and all enquiries are now subject to its governance and procedures (*see Tax audits, below*).

Transfer pricing disputes in the United Kingdom (UK) are usually resolved by negotiation between HMRC and the taxpayer. Until recently, there was little case law, but in 2009 the tax tribunal found in favour of HMRC in *DSG Retail and others v HMRC*, the UK's first substantive transfer pricing case (*see Legal cases, below*).

A large amount of guidance material is published by HMRC on its interpretation of the law and how it assesses transfer pricing risks. This is in HMRC's International Manual, which is available to the public via the HMRC website (www.hmrc.gov.uk) (*see Other regulations and guidance, below*).

Tax and Reputation

During late 2012 the House of Commons Public Accounts Committee (PAC) launched investigations into tax avoidance by multinational companies. In particular this focused on examples of three high profile inbound multinationals which were seen to have implemented structures which resulted in those companies not paying their fair share of corporation tax due to the transfer pricing arrangements that these companies had in place. This has raised the profile of transfer pricing as an issue in the media and has led to a national debate on the morality of taxation. The resulting potential for reputational damage as a result of this increased media and public scrutiny on transfer pricing means that multinationals should give greater consideration to how their tax strategy is communicated externally to interested stakeholders. Whereas in the past, such stakeholders would have been limited to shareholders and HMRC, this list may now have expanded to customers, employees, regulators and other government departments.

Statutory rules

The UK's current transfer pricing rules – TIOPA 2010, Part 4 – were enacted in February 2010 and took effect for all accounting periods ending on or after 1 April 2010. TIOPA 2010 represents a restatement of the previous rules which were contained in ICTA 1988, Schedule 28AA, including later amendments, and which took effect for all accounting periods ended on or after 1 July 1999. TIOPA 2010 was part of the UK government's tax law rewrite project to update and consolidate a wider body of personal and corporate tax legislation.

The UK rules are widely drafted and are intended to cover almost every kind of transaction. Since 1 April 2004, the rules have applied to UK-to-UK transactions, and thin capitalisation rules have been brought wholly within the transfer pricing regime (see *Thin capitalisation*, below).

Self-assessment

UK enterprises are required to self-assess their compliance with the arm's-length principle in filing tax returns. Where an enterprise would have lower taxable profits or greater allowable losses calculated on the basis of the actual provision for the transaction as shown in their accounting records than if calculated on the basis of the arm's-length provision, it is regarded as an 'advantaged person'. Such companies and partnerships must identify and make transfer pricing adjustments when submitting their tax returns under self-assessment. An important implication of this approach is the potential for interest and penalties for 'carelessness'. Penalties are discussed at *Additional tax and penalties section*, below.

The rules apply a 'one-way street' approach. Taxpayers are required to make transfer pricing adjustments where these result in increased taxable profits or reduced allowable losses in the UK, but are not permitted to make adjustments that result in decreased taxable profits or greater allowable losses. A decrease in the taxable profits or increase in allowable losses of the UK enterprise may be effected only through the operation of the competent authority procedures of the relevant double tax agreement (DTA) or, in the case of a UK-to-UK adjustment (see below), through a 'compensating adjustment'. This allows a 'disadvantaged person' involved in the transaction to calculate their tax on the same basis by making a 'compensating adjustment' to their taxable profits or losses. Such an adjustment can be made only by a disadvantaged person, and can be made only in respect of a transaction where a transfer pricing adjustment has been made by an advantaged person.

The participation condition

The legislation applies to transactions where the 'participation condition' is met. This is widely defined in the legislation but generally means a transaction or series of transactions involving entities where one party controls the other, or both parties are under common control. The parties exerting control may include companies, partnerships and, in certain circumstances, individuals.

'Control' for the purposes of this legislation is defined in CTA 2010, Section 1124 (formerly ICTA 1988, Section 840). It is important to note that control is not confined to situations where one party is the majority shareholder in the other. Effectively, control exists where one party has the power to ensure that the affairs of another party are conducted in accordance with the first party's wishes.

The concept of control set out in CTA 2010, Section 1124 is subject to important extensions for transfer pricing purposes under TIOPA 2010, Part 4 (and formerly ICTA 1988, Schedule 28AA):

- The rules apply to many joint venture companies where two parties each have an interest of at least 40%.
- Attribution rules are used to trace control relationships through a number of levels in determining whether parties are controlled for the purposes of the transfer pricing rules.

United Kingdom

Further changes known as the ‘acting together’ rules affecting financing deductions were made with effect from 4 March 2005. These changes were triggered by structures adopted by private equity houses but have wide-ranging effect beyond private equity (see *Thin capitalisation*, below).

Concept of ‘provision’

The legislation uses the concept of ‘provision made by means of a transaction or a series of transactions’ to describe the situations to which the legislation applies. Provision is undefined within the legislation, although it is understood that the use of the term is intended to allow the wider consideration of all the terms and conditions surrounding a transaction or series of transactions in deciding whether it has been conducted at arm’s length. According to HMRC, ‘provision’ is broadly analogous to the phrase ‘conditions made or imposed’ in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention and embraces all the terms and conditions attaching to a transaction or series of transactions. While it might be argued that the term ‘provision’ is arguably wider than the phrase ‘conditions made or imposed’, HMRC takes the view that the scope of the UK legislation can be no wider than the scope of Article 9, as informed by the OECD Transfer Pricing Guidelines.

In a recent tax case, *DSG Retail and others v HMRC (TC00001)*, the tribunal accepted a broad interpretation of the term ‘provision’, in line with Article 9 of the OECD Model Tax Convention, which refers to ‘conditions made or imposed between two enterprises’. The court also accepted that a provision may exist where there is no formal or enforceable conditions (e.g. a contract), accepting that Schedule 28AA (the applicable legislation in the case), which refers to ‘informal arrangements and understandings’, applied (see *Legal cases*, below).

OECD Guidelines

The legislation is drafted to explicitly require that the rules be ‘construed in such manner as best secures consistency’ between the domestic legislation and Article 9 of the OECD’s Model Tax Convention and the OECD Guidelines. Legislation was passed in Finance Act 2011 to update the definition of ‘the transfer pricing guidelines’ to refer to the revised OECD Guidelines published in July 2010. As a result, from 1 April 2011, HMRC will use the 2010 OECD Guidelines in analysing a company’s transfer prices (although the changes will influence HMRC thinking for prior years as well, for example in the area of comparability).

Branches and permanent establishments

TIOPA 2010, Part 4 (and formerly ICTA 1988, Schedule 28AA) cannot be applied to dealings between a branch or permanent establishment and the company of which it is a part, since the two are not separate legal entities. Instead, other sections of the legislation as well as the ‘Business Profits’ article of the relevant DTA operate to tax the appropriate amount of profit in the UK. In the case of an overseas branch or permanent establishment of a UK company, the profits of the branch were taxed as part of the profits of the UK company, until the introduction of the exemption of foreign branches as part of the latest corporate tax reform programme. In the case of a UK branch or permanent establishment of an overseas company, income arising directly or indirectly through or from the branch remains taxable in the UK under CTA 2009. The transfer pricing rules in TIOPA 2010, Part 4 can of course be applied to transactions involving related parties of the legal entity to which the branch or permanent establishment belongs. Hence, an overseas associated company of a UK company is also a related party in relation to an overseas branch or permanent establishment of that UK

company, and TIOPA 2010, Part 4 could be applied to transactions between the two overseas enterprises.

Secondary adjustments

HMRC does not make secondary adjustments, such as deemed distributions or deemed capital contributions, when it makes a transfer pricing adjustment, as there is no basis in UK law for such adjustments.

Where the primary adjustment is made by a treaty partner, HMRC considers the merits of claims to deduct interest relating to the deeming of a constructive loan by a treaty partner following a transfer pricing adjustment. The claim would, however, be subject to the arm's-length principle and would be considered in the light of relevant provisions relating to payments of interest.

Where a treaty partner applies a secondary adjustment by deeming a distribution to have been made, this is now normally exempt from tax in the UK under the recently introduced dividend exemption rules. Any withholding tax on the deemed dividend would likewise not be eligible for relief in the UK.

UK-to-UK transfer pricing

When it was originally enacted, ICTA 1988, Schedule 28AA included an exemption for UK-to-UK transactions, subject to certain restrictions. With effect from 1 April 2004, the government removed the exemption for UK-to-UK transactions from the transfer pricing legislation, primarily due to its concern that the existing rules might be held to be in breach of the Treaty of Rome, now the Treaty on the Functioning of the European Union (TFEU).

As there is no consolidated tax return in the UK, the UK-to-UK transfer pricing potentially has an impact where there is tax at stake, either because of particular tax planning arrangements or where some more routine aspect of the tax system (such as losses in one company in the group which cannot be offset) means that there is tax to be collected. One particular area where the amended rules have an effect is where no charge is currently made, for example, for services or for the use of assets (including intellectual property).

However HMRC has no great desire to tie up resources investigating UK-to-UK transactions where the tax risk is low and experience of the level of such enquiries by HMRC since UK-to-UK rules were introduced generally supports this. Additionally, there is a corresponding adjustment mechanism to effect relief on the counter side of a UK-to-UK transaction for which an adjustment has been assessed.

Concessions and exemptions

There are limited exemptions from the UK transfer pricing rules for small- and medium-sized enterprises (SMEs), where the definition of SMEs is assessed at a group level. Groups with more than 250 employees, turnover of more than 50 million euros (EUR) or a balance-sheet worth of more than EUR 43 million do not qualify for the exemption, nor do SMEs entering into transactions with a tax-haven entity. Because denomination of these thresholds are in euros (as the definition of SMEs is an EU one), exchange rate movements may have an impact on a given SME group's qualification for exemption from the transfer pricing rules from one year to the next. The exemption does not apply where the enterprise has transactions with or provisions which include a related enterprise in a territory with which the UK does not have a double tax treaty

United Kingdom

with an appropriate nondiscrimination article. Such transactions remain subject to the UK's transfer pricing rules.

HMRC has also reserved the right to direct that the rules apply to medium-sized companies where it considers that transfer pricing has been manipulated egregiously.

Other regulations and guidance

HMRC manuals are prepared for internal use by the tax authority and are updated periodically. They are also publicly available, including online versions accessible on the HMRC website. In general, these manuals provide a detailed description of how the tax authority interprets the existing legislation and a rationale and explanation of its development. The International Manual contains guidance on the principles of double taxation relief, an introduction to DTAs and guidance on controlled foreign companies (CFCs) legislation, guidance on transfer pricing, cross-border financing and thin capitalisation legislation, and practical advice to HMRC officials on conducting enquiries in these areas.

The transfer pricing sections of the International Manual were substantially rewritten in 2012 in order to make this guidance more clear, and to ensure that the manual was consistent in the messages that it gave. In terms of transfer pricing, the International Manual provides guidance on the factors HMRC should consider when applying the legislation, such as the circumstances indicating the presence of potential transfer pricing issues to address and matters to consider when deciding whether to pursue an enquiry and how enquiries are to be progressed through the TPG governance framework. The manual contains training and instructional material aimed at specialists in the TPG and at HMRC staff in local offices who are part of the team dealing with transfer pricing enquiries. The practical guidance on transfer pricing covers the following main areas:

- Governance.
- Risk assessment.
- Working an enquiry.
- Examining TP reports.
- Gathering evidence.
- The interaction with direct taxes.

In addition, HMRC has issued statements of practice relating to advance pricing agreements (APAs), advance thin capitalisation agreements (ATCAs) and mutual agreement procedures. These statements also explain how HMRC interprets the relevant UK legislation and views its obligations under income tax treaties and how it applies these in practice.

Legal cases

Until recently, the few cases brought before the courts on transfer pricing issues in the UK had largely concerned procedural and interpretative issues rather than the substantive application of the rules. The early case law, such as *Watson v Hornby* (1942), *Sharkey v Wernher* (1955) and *Petrotim Securities Ltd v Ayres* (1963), established the principle of arm's-length prices for transactions between related parties as now embodied in the legislation. Two more recent cases are of importance in the interpretation and application of the legislation which preceded ICTA 1988, Schedule 28AA.

Ametalco UK v IR Commrs (1996)

The facts of Ametalco concerned the nature of the transactions to which the transfer pricing legislation could be applied. The UK company had, at the request of its parent, advanced an interest-free loan to a related company. Under the provisions of ICTA 1988, Sections 770 to 773, the tax authority claimed the right to impute notional interest on the loan and tax the consequent notional income in the hands of the UK lending company.

The Revenue maintained that the legislation applied to all types of transaction, including loans or advances of money, and, in its view, this type of transaction was covered by ICTA 1988, Section 773 as a business facility of whatever kind. Various arguments to refute this position were advanced by the taxpayer, but these were rejected by the Special Commissioners who decided in favour of the Revenue.

This case was important in relation to the old legislation, since it clarified the position with regard to the applicability of the legislation to loans and interest in general, and interest-free loans in particular.

Glaxo Group Ltd v IR Commrs (1995)

In *Glaxo Group Ltd*, several companies in the Glaxo group had many years of open (unagreed) assessments as a result of unresolved appeals. The Revenue suspected that the companies had been engaged in transactions with related parties on a non-arm's-length basis and sought to increase the open assessments to reflect transfer pricing adjustments.

Glaxo contended that transfer pricing adjustments had to be effected by raising new assessments and not by amending existing open assessments. There was then a six-year time limit on new assessments (except in cases involving fraud or negligence) and this would have limited the adjustments the Revenue could make. It was held by the Special Commissioners that transfer pricing adjustments could be made to the open assessments.

Special Commissioners decision – Waterloo plc and other v IR Commrs (2001)

In this case, the Special Commissioners considered the transfer pricing rules in connection with the costs associated with the operation of international share plans by Waterloo plc (the name of the company was made anonymous in the published judgment). The Special Commissioners held that Waterloo plc should be taxed as if it had charged a fee to its overseas subsidiaries for providing share benefits to their employees, and that an upward adjustment to Waterloo's taxable profits should be made under the transfer pricing rules.

The Special Commissioners decided that providing the ability for the employees of the subsidiaries to participate in the option arrangements was a 'business facility'. The Special Commissioners accepted that the options were remuneration for the employees. The parent company therefore provided some of the remuneration of employees of the subsidiaries, by means of the totality of the arrangements. Provision of remuneration to the subsidiaries was the valuable business facility in question.

The business facility was made directly to the subsidiaries employing the individuals who participated in the option arrangements. ICTA 1988, Section 770 as amended by Section 773(4) required a 'giving' of facilities to a recipient – not a clear transaction

United Kingdom

with a sale and a purchaser – therefore, there was no need to identify a transaction directly between the parent and the subsidiary. The Special Commissioners decided that there was a clear, valuable benefit from the share scheme to the subsidiary employing the relevant employees, and the value of that benefit was capable of being calculated. On a wider level, the case provides a presumption that ICTA 1988, Section 773(4) allowed the Revenue to tax the total facility provided intra-group and did not require a transaction-by-transaction analysis: “the phrase ‘business facility’ is a commercial not a legal term, and ... that where a commercial term is used in legislation, the test of ordinary business might require an aggregation of transactions which transcended their juristic individuality” (paragraph 57 of the published decision).

Following this reasoning, Waterloo plc failed in its argument that ICTA 1988, Section 770 did not apply because the transactions took place between persons not under common control (i.e. the share scheme trustee and Waterloo plc).

The Revenue issued guidance on its view of this case and, subsequently on the application of the arm’s-length principle to share plans in light of the accounting rules for share-based payments under IFRS, which apply to accounting periods beginning on or after 1 January 2005.

In addition to these court cases, appeals on transfer pricing – which are now heard in the first instance by the tax tribunals rather than the Special Commissioners – create a rebuttable presumption on the interpretation of the legislation and can establish the facts of a case and the transfer pricing methodologies that should be applied.

Tax tribunal decision – DSG Retail and others v HMRC (TC 00001) (2009)

This case was the first UK litigation in which issues of transfer pricing methodologies and the application of the OECD Transfer Pricing Guidelines was heard in detail.

This is widely known as the Dixons case because it concerns the sale of extended warranties to third-party customers of Dixons, a large retail chain in the UK selling white goods and home electrical products. The DSG group captive (re)insurer in the Isle of Man (DISL) insured these extended warranties for DSG’s UK customers. Until 1997 this was structured via a third-party insurer (Cornhill) that reinsured 95% on to DISL. From 1997 onwards the warranties were offered as service contracts that were 100% insured by DISL. The dispute concerned the level of sales commissions and profit commissions received by DSG.

The First Tier Tax Tribunal rejected the taxpayer’s contentions that the transfer pricing legislation did not apply to the particular series of transactions (under ICTA 88 Section 770 and Schedule 28AA) – essentially the phrases ‘facility’ (Section 770) and ‘provision’ (Schedule 28AA) were interpreted broadly so that there was something to price between DSG and DISL, despite the insertion of a third party and the absence of a recognised transaction between DSG and the other parties involved.

The tribunal also rejected potentially comparable contracts that the taxpayer had used to benchmark sales commissions on similar contracts on the basis that the commission rate depended on profitability, which itself depended on the different level of loss ratios expected in relation to the products covered. A much more robust looking comparable provider of extended warranty cover offered as a benchmark for the market return on capital of DISL was also rejected owing to its differing relative

bargaining power compared to DISL. This third-party re-insurer was considered to be a powerful brand providing extended 'off-the-shelf' warranty cover through disparate distributors – the tribunal noted that DSG had a strong brand, powerful point of sales advantage through access to customers in their shops and could easily have sourced the basic insurance provided by DISL elsewhere.

The overall finding of the tribunal was that, to the extent that 'super profits' were available, these should be distributed between the parties according to the ability of each party to protect itself from normal competitive forces and each party's bargaining power. The tribunal noted in this context that DISL was entirely reliant on DSG for its business. According to the facts of this case, the super profits were deemed to arise because of DSG's point-of-sale advantage as the largest retailer of domestic electrical goods in the UK and also DSG's past claims data. DISL was considered to possess only routine actuarial know-how and adequate capital, both of which DSG could find for itself.

As a result, the tribunal thought that a profit-split approach was the most appropriate, whereby DISL was entitled to a market return on capital, with residual profit over and above this amount being returned to DSG via a profit commission.

This decision is important in an understanding of HMRC's approach to transfer pricing and to future litigation in this area. It offers valuable insights into consideration of:

- The level of comparability demanded to support the use of comparable uncontrolled prices.
- Selection of the appropriate 'tested party' in seeking to benchmark a transaction.
- The importance of bargaining power.
- The tribunal's acceptance and approval of profit split as the most appropriate methodology.
- HMRC's expectation that a captive insurer that is underwriting 'simple' risks, particularly where the loss ratios are relatively stable and predictable, and that does not possess significant intangibles or other negotiating power, should not expect to earn more than a market return to its economic capital.

It is debatable whether this success in the tribunal will encourage HMRC to take more transfer pricing cases to litigation. Litigation is a costly process for both sides, and subsequent cases may not go as well as this case did for HMRC. At present there does not appear to be a pipeline of transfer pricing cases in the UK awaiting litigation, indeed, all the indications are HMRC will be keener to resolve disputes with taxpayers on a more collaborative basis and will be more inclined to take cases to facilitative mediation rather than litigation (*see Anticipated developments in law and practice, below*).

Burden of proof

Under the UK's current legislation, the burden of proving that transfer prices are at arm's length falls on the taxpayer. The act of submitting the return under self-assessment implicitly assumes that the taxpayer has made all necessary adjustments to taxable profits to take account of non-arm's-length pricing.

Where HMRC considers there has been tax revenue lost as a result of negligence or carelessness (for accounting periods ending on or after 1 April 2009), the burden of

United Kingdom

proving that this was a result of the taxpayer's negligence or carelessness, rather than for the reasons given by the taxpayer, falls on HMRC.

Tax audits

Under self-assessment, a company submits a corporation tax return and its statutory accounts, with a due date for submission normally within 12 months after the end of the accounting period to which the return relates. HMRC may commence an enquiry into the return by issuing a formal notice by the local tax inspector with responsibility for the company, within specified time limits. Once an enquiry has been initiated, the scope may extend to anything covered in the tax return, including transfer pricing. HMRC is not obliged to state reasons for initiating an enquiry.

Transfer pricing enquiry governance and management

In 2008, HMRC revised its practices and procedures through the introduction of the Transfer Pricing Group, largely to achieve the objectives set out in the Varney Report on Links with Large Business. Specifically, HMRC aims to provide greater certainty, an efficient risk-based approach to dealing with tax matters, a speedy resolution of issues and greater clarity through effective consultation and dialogue.

In specific relation to transfer pricing, HMRC stated that it aims to conclude most enquiries within 18 months, with only the most high-risk and complex cases taking 36 months. The introduction of the TPG and its governance framework together with resources available to the transfer pricing teams dealing with enquiries is intended to enable HMRC to deliver this objective.

Transfer pricing team

Working enquiries on a team basis marks a significant change from HMRC's previous approach to transfer pricing. The size and make-up of a transfer pricing team is dependent on the scale and complexity of the enquiry. The team is usually led by the HMRC customer relationship manager (CRM) of the business and consists of other members of the case team working for the CRM as well as members from various disciplines, including at least one transfer pricing specialist from the TPG.

The TPG consists of dedicated transfer pricing specialists based in the Large Business Services or in Large and Complex (part of Local Compliance) and other specialists, such as economists, systems analysts and specialist investigators. The role of the transfer pricing specialist is to support the team as appropriate, from providing specialist advice to hands-on involvement.

Practices and procedures

When the TPG was set up, each enquiry or potential enquiry to which the transfer pricing governance applied was subject to a process involving five stage gates consisting of the business case, enquiry decision, action plan, six monthly review and resolution review. HMRC has since streamlined this approach into three stages. These stages aim to provide a structured and consistent approach in relation to the management and governance of enquiries.

The three stages of TP Governance are:

- Making sure the selection of a case is appropriate.
- Ensuring there is effective progress in a case.

- Reaching the appropriate conclusion in a case

HMRC has stated that all three aspects are essential to the process and all are mandatory for HMRC case officers. Therefore, the selection stage will require that a business case is made, and approved, before an enquiry is commenced. The second, progress, stage brings together the former action plan requirement and the progress review requirement into one ongoing review process which is linked, where appropriate, through a new template to existing casework control mechanisms in place within HMRC. The resolution phase is unchanged from the old stage gate five in requiring approval for any settlement proposals.

Triggers for a transfer pricing enquiry

HMRC identified the following risk areas that are most likely to trigger a full transfer pricing enquiry:

- The existence of tax haven entities – HMRC identifies groups with entities located in tax havens and seeks to establish whether their profitability is commensurate with the level of functions, assets and risks relating to these entities. For example, limited functions undertaken by entities located in tax havens that enjoy healthy profits may give rise to a transfer pricing enquiry.
- Lower returns in the UK than in the group generally – HMRC identifies businesses with profit margins that are lower in the UK than in the group generally and seeks to establish why this is the case.
- The UK business produces only a routine, low-margin profit – HMRC identifies companies that possess the resources to generate high-margin profits, yet produce only a routine, low-margin profit. To understand the potential profitability of a particular entity, HMRC is interested in whether there is, for example, heavy investment in the entity, a highly skilled and remunerated technical or R&D workforce or intangibles (e.g. trade names, know-how, patents).
- Royalty or management fee payments from the UK business that do not appear to make commercial sense and which substantially impact on the UK profits. Examples of such payments include:
 - A brand name unknown in the UK.
 - Technology to which significant value has been added by processes carried out in the UK.
 - Nebulous bundles of intangibles.
 - Poor performance over a number of years. Persistent losses attract the attention of HMRC, and HMRC looks for evidence that there is a clear prospect of a return to profits in later years to justify the risk of continuing losses.
- Changes in the risk profile and hence the reward of the UK business. Examples of this include:
 - Distributor becomes commissionaire (and net profits decrease).
 - Full manufacturer becomes contract manufacturer.
 - R&D activities that once generated royalties move to contract basis.
 - Cost-sharing arrangements are introduced.

HMRC concedes that consideration should be given to both the potential tax at risk and the level of difficulty in establishing the arm's-length price, although there is no *de minimis* limit in the UK's transfer pricing legislation.

The International Manual provides further detailed practical guidance and examples of HMRC's approach and interpretation of transfer pricing principles.

United Kingdom

Information powers

Changes to HMRC's general information powers were introduced with effect from 1 April 2009. HMRC can require any person to provide them with information or to produce documents by way of a written notice. It must allow the person a reasonable period of time to produce the information or documents. The person receiving the information notice may appeal against it, unless the notice is to produce the statutory records that the person is obliged to keep or if the tax tribunal approved the issue of the notice.

Penalties may arise for failing to comply with an information notice, or concealing, destroying or otherwise disposing of documents, or providing inaccurate information, or a document containing an inaccuracy, in response to an information notice.

If the taxpayer does not provide information in response to HMRC's requests, where considered necessary, HMRC may enter a company's premises and inspect the premises, assets and documents on those premises that relate to transfer pricing issues under enquiry. HMRC cannot search premises, nor search for assets or documents. Normally, HMRC must give the occupier of the premises at least seven days' notice of an inspection. An unannounced or short-notice inspection is possible, but this must be agreed by an authorised HMRC officer or approved by the tax tribunal.

HMRC also has powers enabling it to obtain information from third parties where it considers such information would be helpful in progressing enquiries. However, such powers are used rarely and only in extreme circumstances, since these powers are viewed by the HMRC itself as controversial and requiring sensitive handling. Failure to provide information as requested is more likely to result in an estimated assessment being raised, for which the company must then provide the evidence to refute it.

HMRC does not have the power to directly obtain information on non-UK-resident parents of UK companies, nor on fellow subsidiaries (in non-UK-controlled groups) that are not UK resident. Note, however, that the UK has an extensive double tax treaty network, and, as a result, is able to request such information under the Exchange of Information article. HMRC also increasingly uses the provisions of the EU Mutual Assistance Directive that provides for Member States to exchange information on taxpayers and embark on 'simultaneous controls' where the tax position of a taxpayer and related entities are of interest to more than one member state (*see Joint investigations, below*).

Revised assessments and the appeals procedure

Where there is an open enquiry or HMRC has issued a closure notice, amended the taxpayer's return or made a 'discovery' assessment, the taxpayer may ask for the case to be listed for hearing by the tax tribunal. Alternatively, the taxpayer may require HMRC to review the point at issue, or HMRC may offer the taxpayer a review (Tax Management Act 1970 section 49A). If a review takes place, HMRC may uphold, vary or cancel its original view of the matter, and must notify the taxpayer of its conclusion within the following 45 days, or other agreed period (TMA 1970 section 49E). If HMRC's review is unfavourable and the taxpayer does not wish to accept it, the taxpayer must file an appeal to the tax tribunal within 30 days; otherwise HMRC's review conclusions are treated as having been agreed.

The tax tribunal has also made it clear that it will expect parties to disputes involving complex facts such as transfer pricing to have sought an internal review or considered other forms of dispute resolution, such as facilitative mediation using an independent mediator, before such cases are brought before the tribunal.

The taxpayer or HMRC may appeal against a decision of the First Tier tax tribunal on a point of law (but not a question of fact). This appeal is normally then heard by the Upper Tier Tax Tribunal and from there to the Court of Appeal and, possibly, the UK Supreme Court, although few tax cases are heard by this court. If a question of European law is involved, any of these courts can refer the case to the European Court in Luxembourg.

Additional tax and penalties

Specific penalty provisions for transfer pricing have not been formulated and the general rules are to be applied. These general rules were considerably revised with effect for return periods beginning on or after 1 April 2009. For earlier periods, the previous legislation in Finance Act 1988 needs to be consulted.

For return periods ending on or after 1 April 2009, penalties may be levied for certain acts or omissions, depending on the offence. The penalties of most relevance to transfer pricing are for:

- Failure to notify chargeability to tax.
- Failure to provide information or documents under a formal notice to do so (*see Information powers, above*).
- Filing an incorrect tax return.

Interest is normally charged on tax underpaid and is calculated from the day on which the tax was originally due.

There are two requirements for a penalty to be chargeable: (1) a loss of tax or an increased claim to a loss or repayment; (2) the inaccuracy is careless, deliberate or deliberate and concealed. There is no penalty if the inaccuracy occurs due to a mistake or despite taking reasonable care. In determining the level of the penalty in cases where losses are claimed, tax penalties apply in the same way as if there were additional tax. For returns relating to earlier periods, a penalty may be due if an incorrect return is fraudulently or negligently submitted.

Interest or penalties paid are not tax-deductible. In some cases the professional fees incurred in the course of the HMRC enquiry are also not tax-deductible.

One of the main concerns of business in relation to transfer pricing and penalties is what is meant by ‘carelessness’ (or ‘negligence’ under the previous rules), given that what is an arm’s-length price is a matter of judgment and there is not usually one ‘right’ answer. HMRC’s view is that where a taxpayer can show that it has made an honest and reasonable attempt to comply with the legislation, no penalty is imposed, even if there is an adjustment. Indeed, the onus is usually on HMRC to show that there has been a careless or deliberately careless inaccuracy by the taxpayer before a penalty can be charged.

United Kingdom

While there is no legal definition of ‘carelessness’, taxpayers are obliged to do what a reasonable person would do to ensure that their returns are made in accordance with the arm’s-length principle. HMRC suggests that this would involve but would not necessarily be limited to:

- Using their commercial knowledge and judgment to make arrangements and set prices that conform to the arm’s-length standard.
- Being able to show (e.g. by means of good quality documentation) that they made an honest and reasonable attempt to comply with the arm’s-length standard.
- Seeking professional help when they know they need it.

The emphasis is very clear that to avoid any suggestion of carelessness, the taxpayer must have set and documented a reasonable transfer pricing policy and must in practice implement and apply that policy correctly and consistently. HMRC has also made it clear that documentation does not in itself relieve a taxpayer from the possibility of a penalty if that documentation does not show that the business had good grounds for believing its arrangements and prices to be in accordance with the arm’s-length principle.

Range of penalties

The amount of penalty that may be charged reflects the degree of culpability. Whereas there is no penalty for a mistake, failure to take reasonable care may incur a penalty of up to 30% of the potential lost tax revenue. If the inaccuracy is deliberate but not concealed, a maximum penalty of 70% may be charged, rising to a 100% penalty if the inaccuracy is deliberate and concealed. All penalties can be mitigated depending on the quality of the disclosure.

Where an inaccuracy has resulted in an amount of tax being declared later than it should have been, the potential lost revenue is 5% of the delayed tax per year or part of a year.

These changes in the UK’s penalty regime are expected to result in a significant increase in the number of penalties generally applied to companies. It remains to be seen what specific impact they will have on transfer pricing enquiries, where the incidence of penalties have previously been very low.

Documentation requirements

Notwithstanding the change in the burden of proof on transfer pricing with the introduction of self-assessment, unlike many other transfer pricing regimes, the UK has not issued specific regulations governing the documents that a taxpayer is required to prepare to support its transfer pricing. Instead, the UK has preferred to rely on the general rule for self-assessment that ‘requires taxpayers to keep and preserve the records needed to make and deliver the correct and complete return’.

There has been some relaxation of HMRC’s expectations on documentation in conjunction with the removal of the UK-to-UK exemption in 2004. In particular, whilst HMRC requires that there be evidence available to support arm’s-length pricing at the time a tax return is submitted, the material recording of that evidence may be prepared and provided to HMRC in response to a specific request rather than as a matter of course. Failure to respond to such a request within a reasonable time exposes a company to the risk of penalties.

HMRC provides guidance in its International Manual on record-keeping requirements. HMRC specifies the following four classes of records or evidence that need to be considered:

- Primary accounting records – The records of transactions occurring in the course of the activities of a business that the business enters in its accounting system. These records are needed to produce accounts and the results (in terms of value) of the relevant transactions. In the context of transfer pricing rules, these are the actual results. They may or may not be arm's-length results and are generally created at the time the information entered the business accounting system.
- The tax adjustment records – The records that identify adjustments made by a business on account of tax rules in order to move from profits in accounts to taxable profits, including the value of those adjustments. These adjustments might include the adjustment of actual results to arm's-length results due to transfer pricing rules. These records do not need to be created at the same time as primary accounting records, but do need to be created before a tax return is submitted for the period in question.
- The records of transactions with associated businesses – The records in which a business identifies transactions to which transfer pricing rules apply.
- The evidence to demonstrate an arm's-length result – The evidence with which a business demonstrates that a result is an arm's-length result for the purpose of transfer pricing rules. This evidence needs to be made available to HMRC in response to a legitimate and reasonable request in relation to a tax return that has been submitted. Although the business would need to base relevant figures in its tax return on appropriate evidence, it is possible that, when the return is prepared, the material recording of that evidence may not exist in a form that could be made available to HMRC.

HMRC also quotes the discussion of documentation requirements in Chapter V of the OECD Transfer Pricing Guidelines that the demonstration of an arm's-length result should be “in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance”.

To be able to support the view that the pricing method chosen results in arm's-length terms, it is often necessary to include in that documentation a study of third-party comparables, usually requiring a comparison with comparable third-party transactions or with profitability earned by third parties. Without this, HMRC may regard any documentation as incomplete. To be satisfied that these comparables are truly comparable, or to evaluate the results obtained, it may well be necessary to carry out a detailed analysis of the risks and functions undertaken by a particular business.

Acceptable transfer pricing methods

HMRC has stated that the comparable uncontrolled price (CUP) method is the simplest and most accurate of the OECD methods and is the preferred method where there are comparable uncontrolled transactions. However, where it is difficult to identify comparable uncontrolled transactions in practice, HMRC looks to use another OECD-approved method, including TNMM and profit splits and looks for the most appropriate method in the circumstances of the case. This reflects HMRC's long standing acceptance of profit-based methods as well as the 2010 OECD Guidelines, which abolished the hierarchy of methods.

United Kingdom

Resources available to the tax authorities

The key resource for transfer pricing enquiries is the TPG (as discussed in *Tax audits section* above). Within the TPG, a centralised specialist transfer pricing unit, which is part of HMRC's Corporate Tax, International and Anti-Avoidance (CTIAA) directorate, has responsibility for the policy on transfer pricing and technical aspects of the legislation. It has traditionally been involved in the transfer pricing enquiries into large multinational groups, as well as housing the mutual agreement procedure (MAP) and the advance pricing agreement (APA) programme management.

Use and availability of information on comparables

HMRC has widely adopted the principles in the OECD Guidelines, including the revisions made in 2010 and, therefore closely follows the OECD guidance on comparability. Information on comparables plays a crucial element in defending transfer pricing policies in the UK.

Availability of company information

All UK companies, public and private, are required to prepare statutory accounts and file these with the Registrar of Companies at Companies House. Certain companies, such as small- or medium-sized companies, need to provide only abbreviated accounts with a limited amount of detail. Copies of these accounts are publicly available, but their usefulness may be limited by the amount of detail given.

HMRC has access to its own sources of comparable data and also uses commercially available databases of company results. These contain a summary of each company's financial results for several years, hence facilitating access to potentially comparable information. In practice, HMRC also generally accepts pan-European searches based on European company data.

HMRC and company advisers are bound by confidentiality considerations in respect of information obtained through work on other companies for the purposes of disclosure to third parties. In reality, both parties accrue considerable expertise and knowledge through the consideration of relevant issues, which can be used in future enquiries. However, HMRC does not overtly use 'secret comparables' to challenge taxpayer prices, although it might use them in selecting cases for enquiry.

Risk transactions or industries

No transactions or industries are excluded from the scope of the transfer pricing legislation. If a particular industry or issue has come to the attention of the TPG, HMRC is likely to use the information and experience gained in dealing with one taxpayer in enquiries into other similar taxpayers. Within the TPG, there is increasing specialisation in certain industry sectors, such as financial services, automotive, consumer goods and pharmaceuticals. Oil and gas cases are also dealt with by specialists within the Oil Office of HMRC's Large Business Service (LBS). The LBS has also established industry specialists within a number of offices to focus on particular sectors.

In short, all transactions and industries are at risk of a transfer pricing enquiry in the UK. There has been a tendency in the past for queries to be raised not in connection with specific industries but in respect of certain inter-company transactions. In particular, focus was given to transfer pricing related to interest, royalties and management fees, rather than the transfer pricing of goods and services. However this

is changing with more experience and the specialist approach introduced by the TPG. The risk-based approach to enquiries explained at *Tax audits section* should now inform the focus of most HMRC enquiries.

More recently HMRC is showing particular interest in the transfer pricing of debt as its experience on this topic has increased significantly with ATCA programme.

Limitation of double taxation and competent authority proceedings

In connection with the operation of the mutual agreement procedure (MAP), the following points should be noted:

- The designated competent authority in the CTIAA directorate deals with cases presented under the MAP in respect of transfer pricing; HMRC may provide a unilateral solution to instances of economic double taxation, or consult under the MAP to try to reach agreement with the other tax authority in a way that eliminates the double taxation.
- There is no guarantee that a corresponding adjustment will be made, since the two tax authorities are not required to reach a resolution under the MAP although an increasing number of the UK's double tax treaties now include an arbitration clause and for EU related adjustments, and arbitration is available under the European Arbitration Convention (*see below*).
- If a UK company is considering seeking a corresponding adjustment as a result of an adjustment by an overseas tax authority, a protective claim should be made as soon as possible to avoid a situation where the time limit for a corresponding adjustment has expired.
- The provisions of TIOPA 2010, Sections 124 and 125 (formerly ICTA 1988, Section 815AA) clarify the time limits applicable to the MAP. In the absence of a specific time limit in a treaty, a time limit of six years from the end of the accounting period to which the adjustment relates applies for making claims in respect of cases presented to the UK competent authority.
- TIOPA 2010, Sections 124 and 125 explain how an agreement reached under the MAP is put into effect in the UK. The UK legislation also enables consequential claims to be made within 12 months of the notification of a solution or mutual agreement. This allows, for instance, additional loss-relief claims to be made even though the normal time limits for a loss claim may have expired.
- There is no formal method of making a case under the MAP in the UK. The taxpayer should simply apply in writing stating the details of its case, including the years concerned, the nature of the case and details of the parties involved.

It is worth noting that some competent authority procedures may take several years to complete, with no guarantee of a satisfactory outcome. However, regular meetings between HMRC and certain other tax authorities where the competent authority cases are likely to be most numerous, such as the Internal Revenue Service (US), the NTA (Japan) and the SLF/DGI (France), help considerably to resolve MAP cases.

HMRC has traditionally taken a robust line in relation to engaging in MAP discussions before a transfer pricing adjustment has been made in the UK. This is in contrast to many other tax authorities that allow MAP proceedings to commence before an adjustment is finalised. However, HMRC has recently issued a Statement of Practice on MAPs which has marked a softening of this line by suggesting that HMRC may now be

United Kingdom

willing to take part in MAP discussions before a transfer pricing enquiry is concluded in particular circumstances. Nonetheless, MAP is not seen by HMRC as an alternative to the normal enquiry process.

Arbitration

As a member state of the EU, the UK has signed up to the arbitration procedures of the EU Arbitration Convention. The convention provides that where the tax authorities concerned cannot resolve differences through a mutual agreement procedure within two years, they will be subject to mandatory arbitration procedures, if the taxpayers concerned wish to proceed to arbitration. The arbitration procedure consists of an advisory commission including independent experts who give an opinion within a specified timescale. Both tax authorities must act on this opinion or agree within six months on another course of action that resolves in full the double taxation.

The benefit of the convention is that it should ensure that the competent authorities resolve cases fully within a specified timescale of two years. While an increasing number of claims are being made under the convention, very few cases have gone forward to arbitration, although a large number of claims are now, in theory, approaching the time limit.

The UK has also included arbitration provisions in its most recent double tax treaties, such as those signed with France, Germany and the Netherlands. The method of arbitration to be used is not specified and will presumably be determined on a case-by-case basis.

Advance pricing agreements (APA)

The UK has had formal APA procedures since 1999. Before 1999, APAs were possible only by means of an agreement under a double tax treaty. A recently updated Statement of Practice 2/10 (the Statement) provides guidance on HMRC's interpretation of TIOPA 2010, Part 5 (formerly Sections 85 to 87 of Finance Act 1999). This legislation allows for APAs and establishes the APA procedures. In the new Statement, which supersedes SP 3/99, HMRC explains how it applies the legislation in practice. The revised Statement has resulted in two significant changes in HMRC's approach, by relaxing the 'complexity' threshold for accepting APA applications and encouraging more unilateral APAs.

Applicants and scope

A UK business may request an APA in respect of transactions that are subject to TIOPA 2010, Part 4 (formerly ICTA1988, Schedule 28AA). APAs may also be requested by non-residents trading in the UK through a permanent establishment or branch, and by UK residents trading through branches or permanent establishments outside the UK. No fee is payable in the UK for an APA.

APAs may involve transfer pricing methods covering different types of related party transactions or only for particular types of transactions, as well as other intra-group arrangements, including transfers of tangible or intangible property and the provision of services. APAs may relate to all the transfer pricing issues of the business or be limited to one or more specific issues.

Historically HMRC expressed its preference for including the tax authority of the related party in the discussions and concluding a bilateral APA. However in the new

Statement it recognises that unilateral APAs may be agreed in certain circumstances such as where the other side of the transaction does not have a formal APA programme, or where the conclusion of a bilateral agreement would provide little additional benefit to either party.

Process

TIOPA 2010, Section 218(1) (formerly Section 85(1)(c) of Finance Act 1999) provides that the APA process is initiated by a business making an application for clarification by agreement regarding the application of the statutory provisions. The APA process typically comprises four stages: an expression of interest, the formal submission of application, evaluation of the proposed methodology and critical assumptions and, finally, drawing up the agreement.

At the expression of interest stage, or at the stage when a formal proposal is submitted, HMRC may exercise its discretion by declining the request for an APA. In that event, HMRC advises the business of the reasons for doing so, and allows the business the opportunity to make further representations. A business may withdraw an APA request at any time before final agreement is reached.

HMRC has stated that it anticipates that all proposals will need to be supported by most of the following information:

- The identification of the parties and their historic financial data (generally for the previous three years).
- A description of the transfer pricing issues proposed to be covered by the APA and analysis of the functions and risks of the parties, and projected financial data of the parties in relation to the issues.
- A description of the worldwide organisational structure, ownership and business operations of the group to which the taxpayer belongs.
- A description of the records that will be maintained to support the transfer pricing method proposed for adoption in the APA.
- A description of current tax enquiries or competent authority claims that are relevant to the issues covered by the proposed APA.
- The chargeable periods to be covered by the APA.
- The identification of assumptions made in developing the proposed transfer pricing method that are critical to the reliability of its application.
- A request for a bilateral APA.
- If applicable, representations from the business that HMRC should exercise its discretion in exchanging information, where the business considers such information to be trade secrets.

Information supplied by a business in relation to an APA contributes to the pool of information held by HMRC about that business. HMRC explicitly states that the information may be used for purposes other than evaluating the APA request. In addition, HMRC has suggested they may now be more likely to share information on unilateral APAs with the appropriate treaty partners that may be impacted.

Nature and term

An executed agreement between the business and HMRC determines the treatment of the transfer pricing issues for a specified period of time. The terms of a bilateral APA also reflect the agreement reached between the two tax authorities. If HMRC does

United Kingdom

not reach an agreement with the business, HMRC issues a formal statement stating the reasons.

APAs usually operate prospectively, relating to the accounting periods beginning after the application is made, although HMRC does allow 'roll-back' of APAs in certain circumstances, which can sometimes be very helpful in resolving existing transfer pricing disputes. HMRC expects most APAs to be for a maximum term of five years.

HMRC considers that APA information is subject to the same rules of confidentiality as any other information about taxpayers and that the unauthorised disclosure, even of the existence of an APA, is a breach of that confidentiality.

APA monitoring and renewal

The APA identifies the nature of the reports that the business is required to provide under the APA legislation. The agreement also provides for the timing of the submission of these reports, which is typically required annually, coinciding with the filing date for the tax return.

The annual report addresses whether the agreed-upon method was applied during the year, the financial results produced by the method, and whether there was a mismatch between prices actually charged and those obtained by applying the arm's-length standard under the agreed methodology. The business also must provide details of compensating adjustments made, and an assessment of the continued applicability or otherwise of the critical assumptions used in the APA.

HMRC has the power to nullify an APA when the business has fraudulently or negligently provided false or misleading information regarding the APA application. When considering using this power, HMRC takes into account the extent to which the terms of the APA would have been different in the absence of the misrepresentation.

An APA may provide for modification of its terms in specific circumstances. For example, an agreement may provide that when there has been a change that makes the agreed methodology difficult to apply but that does not invalidate a critical assumption, the agreement may be modified with the consent of the parties.

A business may request the renewal of an APA. The request should preferably be made no later than six months before the expiration of the APA's current term. However, HMRC usually accepts requests made before the end of the first chargeable period affected by the renewal. If the transfer pricing issues have changed, or a different method is being proposed, the business must make a new APA application.

Penalties and appeals

A tax-g geared penalty is imposed when a business has acted carelessly in making an incorrect return and tax has been lost as a result. When a return is made in accordance with an APA, and false or misleading information was submitted carelessly in the course of obtaining the APA, the agreement is treated as if it had never been made. The business has the right to appeal against the amount of additions to profits arising as a result of the revocation or cancellation of an APA.

Advance thin capitalisation agreements

In 2007, HMRC introduced the advance thin capitalisation agreement (ATCA) to provide certainty to financing transactions. These are unilateral APAs and are based

on the same statutory provisions as the normal APA. The process is designed to offer assistance in resolving transfer pricing issues in relation to financing transactions that, for any particular period, have a significant commercial impact on an enterprise's profit or losses.

ATCAs may cover the treatment of a single applicant's financial instrument or the treatment of the overall debt position of a group, depending on circumstances. HMRC issued guidance in relation to which situations are suitable for ATCAs in a Statement of Practice 04/07. This guidance states that situations suitable for ATCAs include, but are not limited, to the following:

- Intragroup funding outside the scope of treaty applications (e.g. involving a quoted Eurobond or discounted bond).
- Financing arrangements brought into TIOPA Part 4, (formerly ICTA 1988 Schedule 28AA by the 'acting together' rules [see *Statutory rules, above*]).
- Financing arrangements previously dealt with under the 'treaty route' (i.e. as part of a claim made by the recipient of the interest to benefit from reduced rates of withholding tax under the provisions of a double tax treaty).

While the ATCA normally applies prospectively in relation to accounting periods beginning after the application is made, it is possible that an ATCA may be applied retrospectively or rolled back as an appropriate means for amending a self-assessment return or resolving outstanding transfer pricing issues in earlier years.

Anticipated developments in law and practice

One development is HMRC seeking to make more use of collaborative dispute resolution tools to resolve long-running and difficult transfer pricing enquiries as an alternative to litigation. Facilitative mediation is being explored, but it is likely to be used only in a small number of cases.

There are also indications that HMRC is becoming more involved in joint audits with other tax authorities as part of greater collaboration and cooperation between tax authorities, which has been endorsed by the OECD's Forum on Tax Administration (see *Joint investigations, below*).

Liaison with customs authorities

In April 2005, the UK government integrated the Inland Revenue and HM Customs & Excise into a single department (Her Majesty's Revenue & Customs, HMRC). The Inland Revenue's Large Business Office (LBO) and Oil Taxation Office and Custom's Large Business Group were also integrated to form a single HMRC Large Business Service (LBS). The Revenue and Customs tax functions within HMRC are able to exchange information freely and work together to compare information on particular groups and industries.

OECD issues

The UK is a member of the OECD and has approved the OECD Guidelines. The UK legislation in TIOPA Part 4 (and formerly ICTA 88, Schedule 28AA) is required to be construed in a manner that best ensures consistency with the Guidelines (see *Statutory rules, above*). As noted, TIOPA 2010 formally recognises the OECD Guidelines as a result of an amendment to the legislation made in Finance Act 2011 HMRC applies the updated 2010 Guidelines from 1 April 2011.

United Kingdom

Joint investigations

HMRC is able to participate in simultaneous tax examinations with another tax authority using the exchange of information provisions in their respective double tax treaty or, in the case of an EU member state or other signatory, under the provisions of the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters. Such bilateral or multilateral examinations were comparatively rare, although there is now increasing participation by HMRC in 'simultaneous controls' under the Council of Europe/EU Convention, which include transfer pricing enquiries.

HMRC was proactively involved with the OECD's Forum on Tax Administration in developing proposals for joint audits on transfer pricing cases, whereby HMRC officials may be part of a team including officials from one or more other tax authorities. Together the team would make a joint assessment of transfer pricing risks across an MNE, or might jointly audit those risks that affected both tax authorities or divide up the risks between them. This would have the advantage of reducing the cost to a multinational group of dealing with a number of different audits covering the same transactions, as well as potentially resolving risks of double taxation.

Thin capitalisation

Statutory rules

TIOPA 2010, Part 4 (and formerly ICTA 88, Schedule 28AA) includes provisions that incorporate financial transactions. (Until 1 April 2004, thin capitalisation was generally dealt with separately from transfer pricing legislation). Furthermore, general legislation enables HMRC to challenge the deductibility of interest paid by a UK company on a loan from a related party for which the interest rate is excessive or the amount of the loan itself is excessive. This domestic legislation compensates for the position existing under many older double tax treaties where there is an argument that the tax treaty does not provide the authority for the amount of the loan to be questioned. The measure for determining whether the amount of the loan or the interest rate is excessive is the arm's-length principle – that is, whether a third party would have loaned the company that amount of money or at that interest rate. The legislation seeks to align the UK position with Article 9 of the OECD Model Tax Convention.

The consequence of a successful challenge by HMRC is that any interest found to be excessive, by reference to the interest on the part of the loan found to be excessive or by reference to the rate of interest, is not allowed as a tax deduction.

There is no formal UK safe harbour debt-to-equity ratio or acceptable interest cover. However, historically, it has often been suggested that a debt-to-equity ratio of 1:1 and interest cover of 3:1 could be considered to be 'safe' HMRC had explained its tendency to accept these ratios on the basis that they reflect historical averages and that its resources are better used to examine cases with more extreme ratios.

However, more recently, HMRC has stressed that each case is examined individually and the acceptability of a ratio could well be influenced by the averages for the particular industry sector, and those may be different from those noted above. Other ratios are increasingly considered, including the ratio of debt to earnings and other forms of interest cover. Other factors that HMRC would consider are factors that a third-party lender would consider, such as the consolidated debt-to-equity ratio of

the borrower's group and the ability of the group to pay interest and repay capital. An acceptable ratio is, therefore, often a matter of negotiation.

HMRC provides clearance in many cases for loan arrangements, under the ATCA procedure, as described above in *Advance pricing agreements section*. This involves the provision of detailed documentation of the loan arrangements and valid projections of the taxpayer's interest cover or debt-to-equity ratio. Guidance is given in the International Manual. This guidance, which was significantly updated in a new version released in March 2010, shows how the basic pricing rule under self-assessment is more broadly formulated than the previous legislation.

The guidance goes on to cover:

- Factors HMRC takes into account in determining whether interest is excessive.
- Cases where interest is not recharacterised.
- Circumstances where transactions should be considered together in order to evaluate compliance with the arm's-length principle.
- Outward investment and where such loans are interest free or at a low rate of interest, and what factors may be taken into account in recharacterising such loans as equity.
- Interaction of the transfer pricing rules with the UK's legislation on foreign exchange and financial instruments.
- Treatment of funding transactions between UK charities and their affiliates.
- The use of third-party loan agreements as potentially comparable evidence of arm's-length borrowing.
- The acceptability of independent credit ratings and the use of company-produced credit ratings in pricing debt.

Acting together

Further provisions were introduced by Finance (No. 2) Act 2005, which are incorporated in TIOPA 2010, Part 4 (and formerly ICTA 88, Schedule 28AA), related to the manner through which financing is effected. These provisions are particularly aimed at, but not limited to, private equity financing.

The changes restrict interest deductions to an arm's-length basis, where parties are acting together in relation to the financing of a company. The relevant provisions apply transfer pricing rules where persons who collectively control a company or a partnership have acted together in relation to the financing arrangements of that company or partnership. Given the widely drawn provisions, a third-party bank could be drawn into the rules because it has agreed to provide finance for a deal, although such loans are accepted by HMRC as arm's length. There are clearance procedures for companies to obtain certainty with respect to their particular circumstances.

HMRC issued guidance on what constitutes acting together under TIOPA 2010, Part 4 (and formerly ICTA 88, Schedule 28AA), which indicates that 'acting together' can be construed very widely.

Guarantee fees

TIOPA 2010, Part 4 (and formerly ICTA 1988, Schedule 28AA) applies to a provision effected by one or more transactions. So, when a UK company borrows from a bank and the loan is guaranteed by its parent, there may be a provision between the parent

United Kingdom

and subsidiary. Between independent parties this would usually result in a fee from the borrower to the guarantor.

The rules provide that the borrowing capacity of a UK company must be considered without regard to the guarantee. In such a case (e.g. where the subsidiary is able to borrow more from a third-party bank because of a parental guarantee) there would be no deduction for the guarantee fee related to the excess borrowing, and there would be a potential disallowance of interest in excess of what would have been paid in the absence of the special relationship. This would apply even though the interest is paid to a third-party bank.

Where interest is disallowed for a UK borrower, an affiliated UK guarantor may be able to claim the deduction instead.

The value of a guarantee under the arm's-length principle depends on its terms. The arm's-length fee should be determined based on what would be charged between independent parties under the same or similar circumstances. Where a UK parent provides a guarantee to overseas subsidiaries, in some cases HMRC accepts that a guarantee may be equity in nature, especially where the borrower is thinly capitalised.

Thin Cap GLO

A recent case called into question the compatibility of the pre-2004 UK thin capitalisation legislation with the TFEU. The case, known as the Thin Cap GLO, was heard by the European Court of Justice (ECJ), which decided that the UK thin capitalisation legislation pre-2004 was a restriction on the freedom of establishment provisions of the TFEU. However, the ECJ referred the case back to the UK courts to decide the extent to which the thin capitalisation rules applied and therefore whether these represented a justifiable breach.

In late 2009, the UK court found that the pre-2004 legislation did represent a restriction on the freedom of establishment because the legislation did not include a 'commerciality' test (a separate test to the arm's-length test). It ruled that the pre-2004 legislation should not have applied to thin capitalisation cases where there was a commercial rationale for the transaction and that taxpayers were entitled to restitution for taxes paid as a result of the pre-2004 thin capitalisation legislation.

In February 2011, the UK Court of Appeal has decided that the UK thin capitalisation legislation pre-2004 is European Commission (EC) Treaty compliant. The decision has taken into account two later ECJ judgements *OyAA*, C-231/05 in July 2007 and *Société de Gestion Industrielle* (C-311/08) which the UK Court of Appeal took to mean the UK thin capitalisation legislation did not require an additional 'commercial purpose' test in order to be compliant with the EC Treaty. The decision was appealed to the UK Supreme Court, but this has declined to hear the case, and it must now be considered closed.

Management services

The UK has enacted no specific legislation on management services, and, consequently, where a business in the UK is paying for management services from a related party, the general rules on the deductibility of expenses applies. In general, the payment is tax-deductible where the business receives a benefit for the services provided and where the payment is connected with the business and is at an arm's-length price.

Where a UK business is providing services to related parties, it should be remunerated for those services on an arm's-length basis. This usually means that a profit element should be added to the cost of providing the service and invoiced to those businesses receiving the benefit of the services (i.e. a cost plus basis) to represent a market value for the provision of the services. The arm's-length value of services can also sometimes be less than the cost of providing them. In such a situation the service should still be recharged at the market price (i.e. less than cost), and this principle is recognised in the OECD Guidelines.

Where services are recharged on a cost plus basis, the amount of the mark up is often the subject of negotiation with HMRC. There are no safe harbours in the UK, and no guidelines have been published as to standard acceptable rates of marking up costs in specified situations. HMRC has typically sought cost plus between 5% and 10% for low-value UK-provided services. It may well however look for a higher mark up if it considers the services provided to be particularly valuable.

75.

United States

Introduction

This chapter is devoted to a broad outline of US transfer pricing rules and the accompanying penalty regulations. Also covered are the US Competent Authority procedures, including the Advance Pricing Agreement (APA) programme, and the interaction of the US rules with the Organisation for Economic Co-operation and Development (OECD) Guidelines.

The importance of the US rules on transfer pricing

The US regulatory environment is of great significance for a number of reasons:

- The US is an important market for the majority of multinational enterprises, and therefore compliance with US rules, which remain arguably the toughest and most comprehensive in the world, is a considerable issue in international business.
- Beginning in the 1990s, the US undertook a comprehensive reform of its transfer pricing regulations and has continued to update and expand legislation most recently with changes in the cost-sharing, services, and intangible property transfer areas. These developments tend to influence other countries to subsequently increase the stringency of their own rules. As such an understanding of developments in the US and the controversies surrounding them are good indicators of likely areas of contention in other countries.
- The US' aggressive transfer pricing regime has caused controversy with some of its trading partners, not all of whom have entirely agreed with the US' interpretation of the arm's-length standard. The regulations, together with a greater level of enforcement activity, have resulted in an increasing number of transfer pricing issues being considered through the competent authority process under the mutual agreement article of tax treaties concluded between the US and most of its major trading partners.
- The competent authority process also forms the basis for the APA programme, which has become a progressively more important mechanism for multinational enterprises to obtain prospective reassurance that their transfer pricing policies and procedures meet the requirements of the arm's-length standard as well as an additional mechanism for resolving tax audits involving transfer pricing issues.

Non-US tax authorities and practitioners alike have tended to be critical of the level of detail included in the US regulations and procedures. However, in considering the US regime, it is important to bear in mind that unlike many of its major trading partners, the US corporate tax system is a self-assessment system where the burden of proof is generally placed on the taxpayer – leading to a more adversarial relationship between the government and the taxpayer. This additional compliance burden placed on multinational enterprises by the US is not unique to the field of transfer pricing.

The rationale underlying the US regulations

In 1986, the US Congress ordered a comprehensive study of inter-company pricing and directed the Internal Revenue Service (IRS) to consider whether the regulations should be modified. This focus on transfer pricing reflected a widespread belief that multinational enterprises operating in the US were often setting their transfer prices in an arbitrary manner resulting in misstated taxable income in the US. Additional concerns were raised regarding the difficulty of the IRS to conduct retrospective audits to determine whether the arm's-length standard had been applied in practice due to the lack of documentation supporting the inter-company pricing schemes.

The history of the US reform process

Since 1934, the arm's-length standard has been used to determine whether cross-border, inter-company transfer pricing produces a clear reflection of income for US Federal income tax purposes. The arm's-length standard has become the internationally accepted norm for evaluating inter-company pricing.

In 1968, the IRS issued regulations that provided procedural rules for applying the arm's-length standard and specific pricing methods for testing the arm's-length character of transfer pricing results. These transaction-based methods, the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method, have gained broad international acceptance.

Congress amended § 482 in 1986, by adding the commensurate with income standard for the transfer of intangible property. At the same time, Congress directed the IRS to conduct a comprehensive study of inter-company transfer pricing, the applicable regulations under § 482 of the Code, and the need for new enforcement tools and strategies. The IRS responded to that directive by issuing the White Paper in 1988.

Between 1988 and 1992, Congress added or amended §§ 482, 6038A, 6038C, and 6503(k) to impose on taxpayers new information reporting and record-keeping requirements and to provide IRS Revenue Agents with greater access to that information. In addition, Congress added § 6662(e) and (h) to impose penalties for significant transfer pricing adjustments. In 1992, the IRS issued new proposed regulations under § 482. Those regulations implemented the commensurate with income standard and introduced significant new procedural rules and pricing methods. These proposed regulations also included significant new rules for cost-sharing arrangements.

In 1993, the IRS issued temporary regulations that were effective for taxable years beginning after 21 April 1993, and before 6 October 1994. These regulations emphasised the use of comparable transactions between unrelated parties and a flexible application of pricing methods to reflect specific facts and circumstances. The IRS also issued proposed regulations under § 6662(e) and (h), which conditioned the avoidance of penalties upon the development and maintenance of contemporaneous documentation showing how the pricing methods specified in the § 482 regulations had been applied.

In 1994, the IRS issued temporary and proposed regulations under § 6662(e) and (h), applicable to all tax years beginning after 31 December 1993. The IRS also issued final regulations under § 482, effective for tax years beginning after 6 October 1994 and amended the temporary and proposed § 6662(e) and (h) regulations, retroactive to 1 January 1994.

United States

Also in 1994, final § 482 regulations were issued, which are generally effective for tax years beginning after 6 October 1994. However, taxpayers may elect to apply the final regulations to any open year and to all subsequent years.

In 1995, final regulations on cost-sharing were issued (which were subject to minor modification in 1996). These regulations were effective for taxable years beginning on or after 1 January 1996. Existing cost-sharing arrangements were not grandfathered and had to be amended to conform to the final regulations. If an existing cost-sharing arrangement met all of the requirements of the 1968 cost-sharing regulations, participants had until 31 December 1996 to make the required amendments. Major changes to the rules governing cost-sharing transactions were recommended on 22 August 2005, when the IRS issued proposed cost-sharing regulations. These proposed regulations focus on three new specified methods of valuation for determining the arm's-length buy-in amount and are described later in this chapter. At the writing of this chapter, the proposed regulations have not been finalised.

On 9 February 1996, final transfer pricing penalty regulations under § 6662 were issued with effect from that date subject to a taxpayer's election to apply them to all open tax years beginning after 31 December 1993. Revised procedures for APAs were also issued in 1996. In 1998 the IRS simplified and streamlined procedures for APAs for small-business taxpayers.

In 2003, regulations that were proposed in 2002 dealing with the treatment of costs associated with stock options in the context of qualifying cost-sharing arrangements (*see below*) were finalised, and regulations governing the provision of intragroup services were proposed. The proposed services regulations were replaced by temporary and proposed regulations (temporary regulations) issued on 31 July 2006. Finally, the new services regulations were made final on 31 July 2009.

Global dealing regulations which primarily impact the financial services sector are expected to clarify how to attribute profits consistent with the transfer pricing rules when a permanent establishment exists. At the writing of this chapter, these regulations have not been finalised.

On 13 February 2012 the Treasury released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, also referred to as the 'Green Book'. The proposals include two items that could have a significant impact on outbound transfers of intangible property:

1. Tax Currently 'Excess' Returns Associated with Transfers of Intangibles Offshore.
2. Limit Shifting of Income Through Intangible Property Transfers.

The first proposal is a modified version of the proposal in last year's budget. The proposal would provide that if a US person transfers (directly or indirectly) an intangible from the US to a related controlled foreign corporation (a 'covered intangible'), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10% or less, the proposal would treat all excess income as Subpart F income, and would then ratably phase out for effective tax rates of 10 to 15% percent. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the

costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. For purposes of this proposal, the transfer of an intangible includes sale, lease, license, or any shared risk or development agreement (including any cost-sharing arrangement). This subpart F income will be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under § 904. The second proposal is identical to the version presented in last year's budget. This proposal would clarify the definition of intangible property for purposes of §§ 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

A key factor influencing the future of US Federal corporate income tax policy, and in turn transfer pricing policy, will likely be the outcome of the 2012 US presidential election as the challenger to the current president has a different point of view with respect to corporate taxation than the current administration. The increasing popularity of the fiscal conservative movement among traditionally moderate voters as well as domestic concerns about inflation and unemployment will likely also play a role in electing the next US president and will ultimately influence US Federal corporate income tax policy.

Consistency between the US regulations and the OECD Guidelines

At the same time as the reform process was progressing in the US, the OECD was also revising its guidelines on transfer pricing (*see Chapter 3*). The OECD Guidelines are a significant point of reference for many of the US' major trading partners in dealing with transfer pricing issues. The extent to which the OECD Guidelines are consistent with the US approach is thus a critical issue for all multinational enterprises that wish to be in full compliance with local laws in all the jurisdictions in which they operate and at the same time mitigate the risk of double taxation and penalties. The substantive provisions of the US regulations are compared to the OECD Guidelines in this chapter (*see Comparison with the OECD Transfer Pricing Guidelines section, below*).

Statutory rules

Section 482 of the Internal Revenue Code of 1986 (as amended) provides that the Secretary of the Treasury has the power to make allocations necessary to "prevent evasion of taxes or clearly to reflect the income of...organizations, trades or businesses". It also provides that in respect of intangible property transactions, 'the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible'. Detailed Treasury Regulations promulgated under § 482 are the main source of interpretation of both the arm's-length standard and the commensurate with income standard.

The US transfer pricing regulations

The Best Method Rule

A taxpayer must select one of the pricing methods specified in the regulations to test the arm's-length character of its transfer prices. Under the Best Method Rule, given the facts and circumstances of the transactions under review, the pricing method selected should provide the most reliable measure of an arm's-length result relative

United States

to the reliability of the other potentially applicable methods. In other words, while there may be more than one method which can be applied to a given set of facts and circumstances, the method that yields the most accurate, or best, result should be selected. The relative reliability of the various transaction-based pricing methods depends primarily upon:

- the use of comparable uncontrolled transactions and the degree of comparability between those transactions and the taxpayer's transactions under review, and
- the completeness and accuracy of the underlying data, and the reliability of the assumptions made and the adjustments required to improve comparability.

Adjustments must be made to the uncontrolled comparables if such adjustments will improve the reliability of the results obtained under the selected pricing method. Determination of the degree of comparability will be based on a functional analysis made to identify the economically significant functions performed, assets employed, and risks borne by the controlled and uncontrolled parties involved in the transactions under review.

Industry average returns cannot be used to establish an arm's-length result except in rare instances where it can be demonstrated that the taxpayer establishes its inter-company prices based on such market or industry indices and that other requirements are complied with. Unspecified methods may be used if it can be shown that they produce the most reliable measure of an arm's-length result. A strong preference is given to transactional (as opposed to profits-based) methods that rely on external data and comparable uncontrolled transactions. When using a specified method, a taxpayer is not required to demonstrate the inapplicability of other methods before selecting its preferred method. However, in order to avoid potential penalties, a taxpayer must demonstrate with contemporaneous documentation that it has made a reasonable effort to evaluate the potential applicability of other methods before selecting its best method (*see The US penalty regime section, below*).

The arm's-length range

No adjustment will be made to a taxpayer's transfer pricing results if those results are within an arm's-length range derived from two or more comparable uncontrolled transactions. This concept of a range of acceptable outcomes rather than a single arm's-length answer is the key to understanding the flexible application of the arm's-length standard that underlies the US regulations.

Under the regulations, the arm's-length range will be based on all of the comparables only if each comparable meets a fairly high standard of comparability. If inexact comparables are used, the range ordinarily will be based only on those comparables that are between the 25th and 75th percentile of results. However, other statistical methods may be used to improve the reliability of the range analysis.

If a taxpayer's transfer pricing results are outside the arm's-length range, the IRS may adjust those results to any point within the range. Such an adjustment will ordinarily be to the median of all the results.

The regulations permit comparisons of controlled and uncontrolled transactions based upon average results over an appropriate multiple-year period. If taxpayer's results are not within the arm's-length range calculated using multiple-year data the adjustment

for a year may be based on the arm's-length range calculated using data from only that year.

Collateral adjustments and set-offs

A taxpayer is required to report an arm's-length result on its tax return, even if those results reflect transfer prices that are different from the prices originally set out on invoices and in the taxpayer's books and records, and may be subjected to substantial penalties if they fail to do so. This provision has no direct equivalent in the tax codes of most of the US major trading partners and may result in double taxation of income.

In the event of an income adjustment under § 482 involving transactions between US entities, the IRS is required to take into account any appropriate collateral adjustment. For example, should the income of one member of the controlled group be increased under § 482, other members must recognise a corresponding decrease in income. This should be distinguished from the treatment of both (1) adjustments involving other US domestic taxpayers outside the consolidated group where there is no requirement for the IRS to allow a corresponding deduction, and (2) foreign initiated adjustments where it will be necessary to invoke a Competent Authority process as the only means of obtaining a corresponding adjustment in the US (*see below*).

Taxpayers may also claim set-offs to the extent that it can be established that other transactions were not conducted at arm's length. The regulations limit such set-offs to transactions between the same two taxpayers within the same taxable year.

Impact of foreign legal restrictions

The regulations include provisions that attempt to limit the effect of foreign legal restrictions on the determination of an arm's-length price. In general, such restrictions will be taken into account only if those restrictions are publicly promulgated and affect uncontrolled taxpayers under comparable circumstances. The taxpayer must demonstrate that it has exhausted all remedies prescribed by foreign law, the restrictions expressly prevent the payment or receipt of the arm's-length amount, and the taxpayer (or the related party) did not enter into arrangements with other parties that had the effect of circumventing the restriction. The regulations also attempt to force the use of the deferred income method of accounting where foreign legal restrictions do limit the ability to charge an arm's-length price.

Transfers of tangible property

The regulations governing the transfer of tangible property have not changed substantially since 1992. They continue to focus on comparability of products under the CUP method, and the comparability of functions under the resale price and cost plus methods. Comparability adjustments under the regulations must consider potential differences in quality of the product, contractual terms, level of the market, geographic market, date of the transaction and other issues. In addition, the regulations require consideration of potential differences in business experience and management efficiency.

Transfers of intangible property

The implementation of the commensurate with income standard has been a considerable source of controversy between the US and its trading partners. Some have interpreted the intent of the regulations to be the consideration for the transfer of an intangible asset, which is subject to adjustment long after the transfer takes place. This approach has been viewed as inconsistent with the way unrelated parties would

United States

interact with one another. The primary objective of this provision is to ensure that the IRS has the right to audit the reliability of the assumptions used in setting the transfer price for an intangible asset to determine whether the transfer had been made at arm's length. As such, the regulations provide a detailed description of how the consideration paid for an intangible asset will be evaluated consistent with the statutory requirement that the consideration be commensurate with the income derived from exploitation of the intangible.

In general terms, the need for periodic adjustment to transfer prices for intangible property depends upon whether the transfer pricing method used to set the transfer price relies on projected results (projected profit or cost savings). No periodic adjustments will be required if the actual cumulative benefits realised from exploitation of the intangible are within a range of plus or minus 20% of the forecast. If the actual benefits realised fall outside this range, the assumption is that the transfer price will be re-evaluated unless any of the further extraordinary event exceptions detailed in the regulations are satisfied. The intent behind these regulations is to replicate what would occur in a true third party relationship if, for example, one party to a licence arrangement found that unanticipated business events made the level of royalty payments economically not viable. It also prevents a taxpayer from manipulating a forecast of benefits that would result in a significantly different purchase price for the intangible.

If no adjustment is warranted for each of the five consecutive years following the transfer, the transfer will be considered to be at arm's length and consequently no periodic adjustments will be required in any subsequent year. If an adjustment is warranted, there have been recent debates as to whether a taxpayer can affirmatively invoke the commensurate with income standard. Under the 2003 proposed cost-sharing regulations, the IRS posits that only the commissioner has the right to invoke the commensurate with income standard and not the taxpayer.

All prior regulations (including those issued in 1968, 1992 and 1993, respectively) provided that, for transfer pricing purposes, intangible property generally would be treated as being owned by the taxpayer that bore the greatest share of the costs of development of the intangible. In contrast, the 1994 final regulations provide that if an intangible is legally protected (e.g. patents, trademarks, and copyrights) the legal owner of the right to exploit an intangible ordinarily will be considered the owner for transfer pricing purposes. In the case of intangible property that is not legally protected (e.g. know-how) the owner continues to be the party that bears the greatest share of the costs of development.

The regulations provide that legal ownership of an intangible is determined either by operation of law or by contractual agreements under which the legal owner has transferred all or part of its rights in the intangible to another party. In determining legal ownership of the intangible, the final regulations provide that the IRS may impute an agreement to convey ownership of the intangible if the parties' conduct indicates that, in substance, the parties have already entered into an agreement to convey legal ownership of the intangible.

The temporary regulations issued on 1 July 2006 maintained the 1994 final regulations' treatment for legally protected intangibles (i.e. the legal owner of the rights to exploit an intangible ordinarily will be considered the owner for transfer pricing purposes). However, the temporary regulations redefined the definition of

‘owner’ (for transfer pricing purposes) of intangible property rights that are not legally protected. Unlike the existing regulations which assigns ownership of such intangibles to the party that bears the largest portion of the costs of development, the temporary regulations redefine the owner of such intangibles as the party that has the ‘practical control’ over the intangibles. Therefore, eliminating the old ‘developer-assister’ rule altogether.

Given this position, the possibility still exists that there may be a difference of opinion between the US and other taxing jurisdictions as to whom the primary owner of some categories of intangible assets may be for transfer pricing purposes. For example, taxpayers may find that because proprietary rights strategies can vary from country to country, the treatment of intangibles may not be consistent across countries, even though the economic circumstances are the same. Taxpayers may also find that trademarks are deemed owned by one party, while the underlying product design and specifications are deemed owned by a different party. Multinational corporations should take these potential differences of opinion into account in planning their inter-company pricing policies and procedures.

The IRS has provided rules for determining how the commensurate with income standard should be applied to lump-sum payments. Such payments will be arm’s length and commensurate with income if they are equal to the present value of a stream of royalty payments where those royalty payments can be shown to be both arm’s length and commensurate with income.

In February 2007, the IRS issued an Industry Directive indicating the likely direction that future IRS audits will take with regard to migrations of intangible property. The Industry Directive primarily targets pharmaceutical and other life sciences companies that transferred the operations of former § 936 possessions corporations to controlled foreign corporations, or CFCs. More broadly, the Industry Directive underscores the attention that the IRS has been paying to issues surrounding intangible migration transactions. On 27 September 2007, the IRS issued Coordinated Issue Paper (LMSB-04-0907-62) addressing buy-in payments associated with cost-sharing arrangements. The CIP covers all industries, suggesting that the IRS is preparing to more rigorously analyse and examine the key operations and risks related to the migration of intangible assets going forward. On 19 January 2012, IRS Transfer Pricing Director Samuel Maruca announced that the CIP would be withdrawn. The withdrawal of the CIP is mostly a formality as the final cost-sharing regulations were issued on 16 December 2011 (*see Cost-sharing, below*).

Intangibles embedded in the provision of intragroup services

In July 2006, the Treasury Department and IRS issued temporary and proposed regulations governing the provision of intragroup services. Following a protracted period of public commentary and a transition phase, new services regulations were issued on 31 July 2009.

The new regulations emphasize the interaction between intragroup services and the use of intangible property and provide numerous examples of situations where a provider of intragroup services would earn higher margins, or could be expected to share in the profits of the development of intangible property that is jointly developed by the owner of the property and the service provider. Research and development (R&D), and the development of marketing intangible assets in a local market, are examples of high-value services provided in conjunction with intangible property.

United States

The comparable profits method

The comparable profits method (CPM) may be used to test the arm's-length character of transfers of both tangible and intangible property. The CPM evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability, known as 'profit level indicators', derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Differences in functions performed, resources used, and risks assumed between the tested party and the comparables should be taken into account in applying this method.

Profit split methods

Profit split methods are specified methods for testing the arm's-length character of transfers of both tangible and intangible property. However, the emphasis on comparable transactions throughout the regulations is intended to limit the use of profit split methods to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable uncontrolled comparables under some other method. Profit split methods are appropriate when both parties to a transaction own valuable non-routine intangible assets.

Specified profit split methods are limited to either (1) the comparable profit split method which makes reference to the combined operating profit of two uncontrolled taxpayers dealing with each other and whose transactions are similar to those of the controlled taxpayer, or (2) the residual profit split method, which allocates income first to routine activities using any of the other methods available and then allocates the residual income based upon the relative value of intangible property contributed by the parties. No other profit split methods are treated as specified methods under the final regulations (although other forms of profit splits might be used, if necessary, as unspecified methods). The temporary regulations expanded the potential applications of the residual profit split method. Whereas under the existing regulations the residual profit is split between the parties that contribute valuable non-routine intangibles, the temporary regulations suggest the residual profits can be split between parties that provide non-routine contributions (not necessarily intangibles) to the commercial venture.

Cost-sharing

The US cost-sharing regulations

On 16 December 2011, the Internal Revenue Service (IRS) and the Treasury Department issued final cost-sharing regulations (Final Regulations) that were previously issued as temporary and proposed regulations (2008 Temporary Regulations) on 31 December 2008, providing guidance on the treatment of cost-sharing arrangements (CSAs). The Final Regulations largely continue the guidance contained in the 2008 Temporary Regulations, which were set to expire on 30 December 2011. Subsequently, on 19 December 2011, the IRS and Treasury Department issued additional cost-sharing rules in the form of temporary regulations (2011 Temporary Regulations), which provide further guidance on the evaluation of discount rates in applying the income method. At the same time, the IRS and Treasury Department also issued proposed regulations (2011 Proposed Regulations), which propose to include a new specified application of the income method based on the use of the 'differential income stream'.

The Final Regulations are applicable commencing on 16 December 2011, the date they were filed with the Federal Register, and are generally applicable to all CSAs with a

continuation of the transition rules in the 2008 Temporary Regulations that apply to CSAs in existence on 5 January 2009. The 2011 Temporary Regulations are effective as of 19 December 2011. The comment period for the 2011 Proposed Regulations closed on 21 March 2012, 90 days following their publication in the Federal Register.

Determining platform contribution transactions

The 2008 Temporary Regulations introduced five specified methods for valuing cost-sharing buy-ins, now referred to as Platform Contribution Transactions (PCTs) and provide guidance on the use of the Best Method Rule in determining the value of PCTs. These specified methods include the comparable uncontrolled transaction (CUT) method, income method, acquisition price method, residual profit split method, and market capitalisation method. In addition, the 2008 Temporary Regulations confirmed the use of the arm's-length range in determining the value of PCTs.

The 2008 Temporary Regulations also significantly changed the application of the 'Investor Model', a concept introduced in the proposed regulations issued in August 2005 (August 2005 Proposed Regulations). The Investor Model assesses the reliability of a method based on its consistency with the assumption that the rate of return anticipated at the date of a PCT for both the licensor and licensee must be equal to the appropriate discount rate for the CSA activity. Furthermore, this model indicates that the present value of the income attributable to the CSA for both the licensor and licensee must not exceed the present value of income associated with the best realistic alternative to the CSA. In the case of a CSA, the 2008 Temporary Regulations indicated that such an alternative is likely to be a licensing arrangement with appropriate adjustments for the different levels of risk assumed in such arrangements.

Through the 2008 Temporary Regulations, the IRS recognised that discount rates used in the present value calculation of PCTs can vary among different types of transactions and forms of payment.

While the Final Regulations generally adopt the principals and transfer pricing methods described in the 2008 Temporary Regulations to value a platform contribution, and in particular the reliance on the investor model, the Final Regulations provide further clarification on the parameters used in the application of the specified methods, such as tax rates and discount rates. The Final Regulations clarify that the 'tax rate' for purposes of determining amounts on a pre-tax basis refers to the 'reasonably anticipated effective rate with respect to the pre-tax income to which the tax rate is being applied (PCT Payor or PCT Payee)'.

Definition of intangibles and intangible development area

The scope of the intangible development area under the 2008 Temporary Regulations was meant to include all activities that could reasonably be anticipated to contribute to the development of the cost-shared intangibles. To that end, the 2008 Temporary Regulations stated that the intangible development area must not merely be defined as a broad listing of resources or capabilities to be used and introduced the concept that any 'resource, right or capability' – including resources contributed in the form of services, for example – must be compensated. The Final Regulations ensure that this concept is consistently reflected throughout the regulatory language by referring to 'resource, capability or right' rather than 'intangibles' as in the 2008 Temporary Regulations.

United States

The 2008 Temporary Regulations also broadened the scope of external contributions that must be compensated as PCTs to include the value of services provided by a research team. Such a team would represent a PCT for which a payment is required over and above the team's costs included in the cost-sharing pool. This concept is maintained in the Final Regulations.

Periodic adjustments

A significant change in the 2008 Temporary Regulations, which remains unchanged in the Final Regulations, was the so-called 'periodic adjustment' rule which allows the IRS (but not the taxpayer) to adjust the payment for the PCT based on actual results. Unlike the 'commensurate with income' rules the 2008 Temporary Regulations provided a cap on the licensee's profits (calculated before cost-sharing or PCT payments) equal to 1.5 times its 'investment'. (For this purpose, both the profits and 'investment' are calculated on a present value basis.) That is, if the licensee 'profit' is in excess of 1.5 times its PCT and cost-sharing payments on a present value basis, an adjustment is made using the 2008 Temporary Regulations' version of the residual profit split method. In the example in the 2008 Temporary Regulations, this adjustment leaves the licensee with a 10% markup on its non-cost-sharing (non-R&D) expenses leaving it with only a routine return. Notably, this periodic adjustment is waived if the taxpayer concludes an APA with the IRS on the PCT payment. The Final Regulations also added a third example providing guidance on applying the periodic adjustment when more than two parties are involved in a CSA requiring multiple periodic adjustments each year.

There is also an exception for 'grandfathered' CSAs, whereby the periodic adjustment rule of the 2008 Temporary Regulations is applied only to PCTs occurring on or after the date of a 'material change' in scope of the intangible development area (but *see below for additional commentary*). The 2008 Temporary Regulations also provide exceptions to the periodic adjustment rule in cases where the PCT is valued under a CUT method involving the same intangible and in situations where results exceed the periodic adjustment cap due to extraordinary events beyond control of the parties.

Transition rules

The Temporary Regulations specify that cost-sharing arrangements in place on or before 5 January 2009 must meet certain administrative requirements in order to continue to be treated as CSAs.

The Temporary Regulations indicate that PCT payments made under CSAs in existence on or before 5 January 2009 will not be subject to the periodic adjustment rules described above, but rather will be governed by the commensurate with income adjustment rules. However, there is an exception for PCTs occurring on or after a material change in scope in the CSA which includes 'a material expansion of the activities undertaken beyond the scope of the intangible development area'. A determination of 'material change in scope' is made on a cumulative basis such that a number of smaller changes may give rise to a material change in the aggregate. In addition, grandfathered CSAs are not subject to the requirement of non-overlapping and exclusive divisional interests.

Reasonably Anticipated Benefit Shares

The 2008 Temporary Regulations made an important change to the requirements under which Reasonably Anticipated Benefit (RAB) ratios are calculated for cost-sharing arrangements. There is now an explicit requirement that RAB ratios be computed using the entire period of exploitation of the cost-shared intangibles. The

Final Regulations include new language that explicitly prohibits any retroactive change to RAB shares for prior years based on updated information regarding relative benefits that was not available in the prior year.

Services regulations

The US services regulations

US services regulations were originally issued in 1968, and included the cost safe harbour rule allowing certain services to be charged at cost. On 10 September 2003, the IRS proposed new proposed regulations for the treatment of controlled services transactions, which included a new cost method, the Simplified Cost Based Method (SCBM), introduction of shared services arrangements, and required stock based compensation to be included in the pool of total services costs.

On 4 August 2006, the IRS issued new temporary and proposed services regulations in response to practitioners' feedback from the 2003 proposed regulations. As anticipated, the IRS and Treasury issued final § 482 regulations on 31 July 2009 effective as of that date and applying to taxable years beginning after that date. These regulations provide guidance regarding the treatment of controlled services transactions under § 482 and the allocation of income from intangible property. Additionally, these regulations modify the final regulations under § 861 concerning stewardship expenses to be consistent with the changes made to the regulations under § 482.

Controlled taxpayers may elect to apply retroactively all of the provisions of these regulations to any taxable year beginning after 10 September 2003. Such election will be effective for the year of the election and all subsequent taxable years.

The final service regulations require taxpayers to apply the arm's-length standard in establishing compensation amounts for the provision of inter-company services. Thus, similar to other sections of the transfer pricing regulations, taxpayers involved in the provision of inter-company services must adhere to the best method, comparability, and the arm's-length range requirements of Treas. Reg. § 1.482-1. What is new is that the final service regulations stipulate that taxpayers must apply one of the six specified transfer pricing methods or an unspecified method in evaluating the appropriateness of their inter-company services transactions. The six specified transfer pricing methods include three transactional approaches, two profit-based approaches, and a cost-based safe harbour. The transactional approaches are the comparable uncontrolled services price method (CUSPM), the gross services margin method (GSMM) and the cost of services plus method (CSPM). The two profit-based approaches are the existing comparable profits method (CPM) and the profit split method (PSM). The cost-based safe harbour is the services cost method (SCM).

Services cost method (SCM)

The new services regulations, consistent with the 2006 regulations, include the SCM which replaced the previously proposed SCBM. Taxpayers employing the SCM must state their intention to apply this method to their services in detailed records that are maintained during the entire duration that costs relating to such services are incurred. The records must include all parties involved (i.e. renderer and recipient) and the methods used to allocate costs.

The new regulations make certain clarifying changes to the provisions dealing with the SCM. The final regulations incorporate the clarifications and changes previously issued

United States

in Notice 2007-5, 2007-1 CB 269. Aside from these changes and certain other minor, non-substantive modifications, the provisions in the final regulations relating to the SCM and other transfer pricing methods applicable to controlled services transactions are essentially the same as those in the temporary regulations.

In addition to the good list and the low-margin services, a taxpayer must also comply with the Business Judgment Rule, which was effective for taxable years beginning after 31 December 2006 under the proposed and temporary services regulations. This rule requires taxpayers to conclude that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or business of the renderer, the recipient, or both.

Consequently, like the temporary regulations, the final regulations provide that services may qualify for the SCM only if they are either 'specified covered services' as described in Revenue Procedure 2007-13, 2007-1 C.B. 295, or are services for which the median arm's-length markup is 7% or less. In addition, the services must continue to satisfy the Business Judgment Rule, which in the final regulations is consistent with the temporary regulations as clarified by Notice 2007-5. With respect to 'specified covered services' that may be eligible for SCM, the IRS and Treasury believe that the list of specified covered services issued in Revenue Procedure 2007-13 is generally appropriate, although they will consider recommendations for additional services to be added to the list in the future.

The regulations also specifically mention services where the SCM cannot be employed, these services include:

- Manufacturing.
- Production.
- Extraction, exploration or processing of natural resources.
- Construction.
- Reselling, distribution, acting as sales or purchasing agent, or acting under a commission or similar arrangement R&D or experimentation.
- Financial transactions, including guarantees.
- Insurance or reinsurance.

The comparable uncontrolled services price method (CUSPM)

The CUSPM is analogous to the comparable uncontrolled price (CUP) and the comparable uncontrolled transaction (CUT). Under the CUSPM, the price charged in a comparable uncontrolled services transactions form the basis of evaluating the appropriateness of the controlled services transaction. Generally, the CUSPM is applicable in situations where the related party services are similar (or have a high degree of similarity) to the comparable uncontrolled services transactions.

The gross services margin method (GSMM)

The GSMM is comparable to the resale price method (RPM) of the tangible property transfer pricing regulations. Under this method, evaluating the appropriateness of inter-company services pricing arrangements relies on the gross profit margins earned in comparable uncontrolled services transactions as benchmarks. The GSMM is appropriate in situations where a controlled taxpayer provides services (e.g. agency or intermediary services) in connection with a related uncontrolled transaction involving a member of the controlled group and a third party.

The cost of services plus method (CSPM)

The CSPM is analogous to the cost plus (CP) method of the tangible property transfer pricing regulations. Like the CP method, the CSPM evaluates the appropriateness of inter-company services transfer pricing arrangements by reference to the gross services profit markup earned in comparable uncontrolled services transactions. The CSPM is appropriate when the service providing entity provides the same or similar services to both related and third parties.

Contractual arrangements and embedded intangibles

In analysing transactions involving intangible property, the new services regulations have retained the emphasis on the importance of legal ownership. When intangible property is embedded in controlled services transactions, the economic substance must coincide with the contractual terms and must be in accord with the arm's-length standard.

Ownership of intangibles

The new services regulations have issued new guidance surrounding the ownership of intangibles. For transfer pricing purposes, the owner for legally-protected intangibles is the legal owner. However, in the case of non-legally protected intangibles, the owner is the party with 'practical control' over the intangible. When the legal ownership standard is inconsistent with 'economic substance,' these rules may be dismissed. The new services regulations eliminate the possibility of multiple ownership of a single intangible as was the case under the 'developer-assister' rule in the prior regulations.

The final regulations continue without significant change in the provisions of the temporary regulations for identifying the owner of an intangible for transfer pricing purposes, and for determining the arm's-length compensation owing to a party that contributes to the value of an intangible owned by another controlled party. Thus, the final regulations reflect the continuing view of the IRS and Treasury that legal ownership provides the appropriate framework for determining ownership of intangibles. The legal owner is the controlled party that possesses legal ownership under intellectual property law or that holds rights constituting an intangible pursuant to contractual terms (such as a license), unless such ownership is inconsistent with the economic substance of the underlying transactions.

Benefit test

An activity provides a benefit if it directly results in a reasonably identifiable increment of economic or commercial value to the service recipient. The final services regulations look at benefit primarily from the service recipient's perspective.

The final service regulations permit the sharing or allocation of centralised service activities or corporate headquarters costs only in situations in which there is an identifiable benefit to the recipients attributed to the charged-out costs. The final services regulations states that activities that provide only an indirect or remote benefit, duplicative activities, shareholder activities, and passive association are not beneficial services for recipients. Thus, recipients are not liable for such costs under the service regulations.

Pass-through costs

The new regulations further clarify the rules for 'pass-through' of external costs without a markup. This generally applies to situations in which the costs of a controlled service provider include significant charges from uncontrolled parties. Rather than

United States

have these costs permitted to ‘pass-through’ and not be subject to a markup under the transfer pricing method used to analyse the controlled services transaction, the new regulations allow for the evaluation of the third party costs (if material) to be evaluated on a disaggregated basis from the covered service transaction.

Passive association benefits

A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer’s status as a member of a controlled group. A controlled taxpayer’s status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

Stewardship and shareholder activities

The final regulations continue without significant change the provisions of the temporary regulations dealing with ‘stewardship expenses’. These provisions include the provisions under the § 482 regulations for determining whether an activity constitutes a service to a related party for which arm’s-length compensation is due, or instead constitutes solely a stewardship activity. They also include the related regulatory provisions under § 861 dealing with the allocation and apportionment of expenses. As noted above, like the temporary regulations, the final regulations under Treas. Reg. § 1.861-8(e)(4) concerning stewardship expenses have been modified to be consistent with the language relating to controlled services transactions in Treas. Reg. § 1.482-9(l). Stewardship expenses, which are defined in the final regulations as resulting from ‘duplicative activities’ or ‘shareholder activities’ (as defined in Treas. Reg. § 1.482-9(l)), are allocable to dividends received from the related corporation. The final regulations maintain the narrowed definition of ‘shareholder activities’ that includes only those activities whose ‘sole effect’ (rather than ‘primary effect’) is to benefit the shareholder. Examples:

- Preparation and filing of public financial statements.
- Internal Audit activities.

Stewardship activities are defined as an activity by one member of a group of controlled taxpayers that results in a benefit to a related member. These services would be allocated and charged out to the group members. Examples:

- Expenses relating to a corporate reorganisation (including payments to outside law firms and investment bankers) could require a charge depending on the application of the benefit test.
- Under the temporary regulations, the IRS may require US multinationals to charge for many centralised group services provided to foreign affiliates.
- Activities in the nature of day-to-day management of a controlled group are explicitly excluded from the category of shareholder expenses because the temporary regulations do not view such expenses as protecting the renderer’s capital investment.

Stock-based compensation

The IRS received a number of comments on the regulatory provision that requires stock-based compensation to be included in ‘total services costs’ for purposes of the SCM. Some commentators requested further guidance on valuation, comparability, and reliability considerations for stock-based compensation, while others objected to the statement that stock-based compensation can be a services cost. On this somewhat

controversial issue, the IRS and Treasury deferred consideration of the comments. The Preamble to the final regulations states: “These final regulations do not provide further guidance regarding stock-based compensation. The Treasury Department and the IRS continue to consider technical issues involving stock-based compensation in the services and other contexts and intend to address those issues in a subsequent guidance project”.

Shared services arrangements

The new regulations provide guidance on the Shared Services Arrangements (SSAs), which applies to services that otherwise qualify for the SCM, i.e. are not subject to a markup. Costs are allocated based on each participant's share of the reasonably anticipated benefits from the services with the actual realisation of benefit bearing no influence on the allocation. The taxpayer is required to maintain documentation stating the intent to apply the SCM for services under an SSA.

Financial guarantees

Financial guarantees are excluded as eligible services for application of the SCM because the provision of financial transactions including guarantees requires compensation at arm's length under the temporary regulations.

Economic substance, realistic alternatives, and contingent payment services

The final regulations are consistent with the temporary regulations regarding the IRS's authority to impute contractual terms to be consistent with the economic substance of a related-party transaction, including the provisions addressing contingent payment services transactions. Provisions authorising the IRS to consider realistic alternatives in evaluating the pricing of controlled services transactions also remain unchanged. The Preamble to the final regulations, and certain clarifying changes to the regulatory language, emphasise that the evaluation of economic substance must be based on the transaction and risk allocation actually adopted by the related parties and based on the actual conduct of the parties, and that IRS is not authorised to impute a different agreement solely because there is a dispute regarding the transfer pricing of the transaction. In addition, the Preamble emphasises that the ‘realistic alternatives’ principle does not permit the IRS to recast a controlled transaction as if the alternative transaction had been adopted, but rather permits the IRS only to consider alternatives in evaluating what price would have been acceptable to a controlled party.

Documentation requirements

The new regulations do not require documentation to be in place prior to the taxpayer filing the tax return. However, documentation prepared after the tax return is filed would not provide for penalty protection in the event the IRS disagrees with the application of the method used.

Legal cases

There are a number of significant settled, decided and pending litigation matters involving transfer pricing issues in the US. In the last decade the following three cases have attracted particular attention.

- *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, 117 T.C. No. 1 (2001). The issue of development of marketing intangibles is at the core of the GlaxoSmithKline plc (Glaxo) Tax Court case. In September 2006, the IRS

United States

announced the resolution of the case, the largest tax dispute in the agency's history. The parties reached a settlement under which Glaxo agreed to pay the IRS approximately 3.4 billion United States dollars (USD). According to the IRS claims, drugs marketed by the UK multinational Glaxo through a US affiliate derived their primary value from marketing efforts in the US rather than from R&D owned in the UK. The IRS's position is that the unique nature of the R&D may explain the success of the first drug of its kind; however, subsequent market entrants are successful primarily because of the marketing acumen of the US affiliate. Consequently, the IRS asserted that the rate Glaxo's US affiliate charged to its UK parent for marketing services was too low. Furthermore, it argues that the 'embedded' marketing intangibles, trademarks, and trade names existed and were economically owned by the US affiliate. The IRS adjusted the transfer prices paid by the US affiliate to its parent to a contract manufacturing markup on costs and reduced the royalties paid by the US affiliate for the right to sell the product. Emphasising the US affiliate's contribution to enhancing the value of the intangibles, the IRS applied the residual profit split method, resulting in a majority of the US affiliate's profits being allocated to the US. Some tentative observations may be made as to what the implications of both the Glaxo case and the temporary regulations may be in the analysis of the use of marketing intangibles for transfer pricing purposes. The approach proposed by the IRS under the temporary regulations (and the new services regulations), as well as in the Glaxo case, might in the future suggest greater reliance by the IRS on profit split methods where a high value could arguably be attached to marketing services. With the heightened importance of these issues arising from a US perspective, tax authorities from other countries may also seek to employ a similar approach in determining the appropriate return for marketing and distribution functions performed by affiliates of foreign companies, especially where these issues are not contractually addressed by the parties.

- *Veritas Software Corporation v. Commissioner*, 133 T.C. No. 14 (2009). In *Veritas*, the IRS asserted taxpayer's calculation of the lump-sum buy-in payment for the transfer of intangibles between taxpayer's US entity and its Irish entity was incorrect and determined tax deficiencies of USD 704 million and USD 54 million, and § 6662 penalties of USD 281 million and USD 22 million, relating to 2000 and 2001, respectively. In taking its very aggressive position with respect to the valuation of the transferred intangibles, the IRS relied extensively on the report and trial testimony of its expert economist. However, the report and trial testimony demonstrated a lack of understanding of the applicable law and cited regulations not in effect at the time of the transactions under review. The Tax Court found in favour of the taxpayer. The key lesson to be learned from this case is the importance of identifying and applying the relevant rules and regulations to the facts and circumstances at hand given the IRS' targeting transactions involving the transfer of intangible property.
- *Xilinx v. Commissioner*, No. 06-74246 (9th Cir. Mar. 22, 2010). This extensively litigated case deals with the treatment of stock option costs in cost-sharing arrangements before the Temporary Regulations explicitly required the inclusion of these costs. In 2005, the US Tax Court rejected the IRS's assertion that taxpayer had to include employee stock option deductions in the cost base of its cost-sharing arrangement despite the fact that unrelated parties acting at arm's length would not bear such costs. In May 2009 a 3-judge panel of the 9th Circuit reversed the Tax Court. In January 2010 the 9th Circuit's ruling was withdrawn, apparently following a request for rehearing by the taxpayer. On rehearing the case, the same 3-judge panel of the 9th Circuit reversed their earlier decision and sided with taxpayer. The *Xilinx* case highlights the continued focus of the IRS on cost-sharing

arrangements and the importance of documentation and calculation support by taxpayers.

Burden of proof

The administration of matters related to transfer pricing in the US is based on the principle that the corporate income tax system relies on self-assessment and that consequently the burden of proof is on the taxpayer.

Tax audits

The IRS has extensive resources available to pursue field audits, at the appellate level and in competent authority procedures, including agents specially trained in economic analysis. Transfer pricing audits are not limited to cases where avoidance is suspected.

Multinational entities should expect to be called upon to affirmatively demonstrate how they set their inter-company prices and why the result is arm's length as part of the standard review of their US tax returns. Requests to produce supporting documentation within 30 days have become a standard feature of the commencement of such examinations.

The US penalty regime

The final penalty regulations

The IRS has stated that the objective of the penalty regime is to encourage taxpayers to make reasonable efforts to determine and document the arm's-length character of their inter-company transfer prices. The regulations provide guidance on the interpretation of 'reasonable efforts'.

With respect to transfer pricing, the transactional penalty applies to individual transactions in which the transfer price is determined not to be arm's length by the IRS. The regulations impose a 20% non-deductible transactional penalty on a tax underpayment attributable to a transfer price claimed on a tax return that is 200% or more, or 50% or less than the arm's-length price. The penalty is increased to 40% if the reported transfer price is 400% or more, or 25% or less than the arm's-length price. Where these thresholds are met, the transfer pricing penalty will be imposed unless the taxpayer can demonstrate reasonable cause and good faith in the determination of the reported transfer price.

In certain instances, based on the sum of all increases and decreases in taxable income which results from a series of transactions in which the transfer price is determined by the IRS to not be arm's length a net adjustment penalty may apply. A 20% net adjustment penalty is imposed on a tax underpayment attributable to a net increase in taxable income caused by a net transfer pricing adjustment that exceeds the lesser of USD 5 million or 10% of gross receipts. The penalty is increased to 40% if the net transfer pricing adjustment exceeds USD 20 million or 20% of gross receipts. Where these thresholds are met, the transfer pricing penalty can be avoided only if a taxpayer can demonstrate that it had a reasonable basis for believing that its transfer pricing would produce arm's-length results, and that appropriate documentation of the analysis upon which that belief was based existed at the time the relevant tax return was filed and is turned over to the IRS within 30 days of a request. The principal focus of the transfer pricing regulations is on these documentation requirements that must be met if a taxpayer is to avoid the assessment of a net adjustment penalty.

United States

Under this penalty regime, it is entirely possible that a taxpayer could be assessed a transactional penalty but no net adjustment penalty at one end of the spectrum, or could be assessed a net adjustment penalty but no transaction penalty at the other. However, only one penalty, at the highest applicable rate, will be applied. The same underpayment in taxes will not be penalised twice. Regardless of the penalty, whether an underpayment of tax is attributable to non-arm's-length transfer pricing is determined from the results reported on an income tax return without consideration as to whether those reported results differ from the transaction prices initially reflected in a taxpayer's books and records. An amended tax return will be used for this purpose if it is filed before the IRS has contacted the taxpayer regarding an examination of the original return. A US transfer pricing penalty is not a no fault penalty. Even if it is ultimately determined that a taxpayer's transfer prices were not arm's length and the thresholds for either the transactional penalty or net adjustment penalty are met, a penalty will not be imposed if the taxpayer can demonstrate that based upon reasonably available data, it had a reasonable basis for concluding that its analysis of the arm's-length character of its transfer pricing was the most reliable, and that it satisfied the documentation requirements set out in the new final regulations.

The US Competent Authority has stated that transfer pricing penalties will not be subject to negotiation with tax treaty partners in connection with efforts to avoid double taxation.

The reasonableness test

A taxpayer's analysis of the arm's-length character of its transfer pricing will be considered reasonable if the taxpayer selects and applies in a reasonable manner a transfer pricing method specified in the transfer pricing regulations. To demonstrate that the selection and application of a method was reasonable, a taxpayer must apply the Best Method Rule and make a reasonable effort to evaluate the potential application of other specified pricing methods. If a taxpayer selects a transfer pricing method that is not specified in the regulations, the taxpayer must demonstrate a reasonable belief that none of the specified methods was likely to provide a reliable measure of an arm's-length result, and that the selection and application of the unspecified method would provide a reliable measure of an arm's-length result.

In applying the Best Method Rule, the final regulations make it clear that ordinarily it will not be necessary to undertake a thorough analysis under every potentially applicable method. The final regulations contemplate that in many cases the nature of the available data will readily indicate that a particular method will or will not likely provide a reliable measure of an arm's-length result. Thus, a detailed analysis of multiple transfer pricing methods should not be necessary except in unusual and complex cases.

The regulations specify that the following seven factors should be considered in determining whether a taxpayer's selection and application of a transfer pricing method has been reasonable:

1. The experience and knowledge of the taxpayer and its affiliates.
2. The availability of accurate data and the thoroughness of the taxpayer's search for data.
3. The extent to which the taxpayer followed the requirements of the transfer pricing regulations.

4. The extent to which the taxpayer relied upon an analysis or study prepared by a qualified professional.
5. Whether the taxpayer arbitrarily sought to produce transfer pricing results at the extreme point of the arm's-length range.
6. The extent to which the taxpayer relied on an advance pricing agreement applicable to a prior tax year, or a pricing methodology specifically approved by the IRS during an examination of the same transactions in a prior year.
7. The size of a transfer pricing adjustment in relation to the magnitude of the inter-company transactions out of which the adjustment arose.

In determining what level of effort should be put into obtaining data on which to base a transfer pricing analysis, a taxpayer may weigh the expense of additional research against the likelihood of finding new data that would improve the reliability of the analysis. Taxpayers are not required to search for relevant data after the end of the tax year but are required to retain any relevant data that is in fact acquired after the year-end but before the tax return is filed.

The contemporaneous documentation requirement

To avoid a transfer pricing penalty, a taxpayer must maintain sufficient documentation to establish that it reasonably concluded that, given the available data, its selection and application of a pricing method provided the most reliable measure of an arm's-length result and must provide that documentation to the IRS within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates.

The announcement by the commissioner of the IRS Large Business and International (formerly Large and Midsize Business) Division (on 23 January 2003) indicates that the IRS is stepping up enforcement of the 30-day rule and adopting a standard practice of requiring field examiners to request a taxpayer's contemporaneous documentation within 30 days at the commencement of every examination of a taxpayer with significant inter-company transactions.

There is no requirement to provide any documentation to the IRS in advance of such a request and the tax return disclosure requirements relating to the use of unspecified methods, the profit split method and lump-sum payments for intangibles originally included in the 1993 temporary regulations were not retained in the final regulations. In this respect, the US regime is less onerous than some other jurisdictions (e.g. Canada, Australia, and India). However, in contrast, it should be noted that the IRS apparently is enforcing tax return disclosure requirements relating to the existence of cost-sharing arrangements (*see above*).

Principal documents

To meet this documentation requirement the following principal documents which must exist when the relevant tax return is filed should accurately and completely describe the basic transfer pricing analysis conducted by a taxpayer:

- An overview of the taxpayer's business, including an analysis of economic and legal factors that affect transfer pricing.
- A description of the taxpayer's organisational structure, including an organisational chart, covering all related parties engaged in potentially relevant transactions.
- Any documentation specifically required by the transfer pricing regulations.

United States

- A description of the selected pricing method and an explanation of why that method was selected.
- A description of alternative methods that were considered and an explanation of why they were not selected.
- A description of the controlled transactions, including the terms of sale, and any internal data used to analyse those transactions.
- A description of the comparable uncontrolled transactions or parties that were used with the transfer pricing method, how comparability was evaluated, and what comparability adjustments were made, if any.
- An explanation of the economic analysis and projections relied upon in applying the selected transfer pricing method.

The following additional principal documents must also be maintained by a taxpayer and must be turned over to the IRS within the 30-day period but do not have to exist at the time the relevant tax return is filed:

- A description of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return that would be useful in determining whether the taxpayer's selection and application of its transfer pricing method was reasonable.
- A general index of the principal and background documents related to its transfer pricing analysis and a description of the record keeping system used for cataloguing and accessing these documents.

Background documents

Background documents include anything necessary to support the principal documents, including documents listed in the § 6038A regulations, which cover information that must be maintained by foreign-owned corporations. Background documents do not need to be provided to the IRS in connection with a request for principal documents but if the IRS makes a separate request for background documents, they must be provided within 30 days.

The regulations provide that the 30-day requirement for providing documentation to the IRS applies only to a request issued in connection with an examination of the tax year to which the documentation relates. The IRS has stated that it may also seek to obtain transfer pricing documentation related to subsequent tax years as well. A taxpayer is not required to comply with that request within 30 days in order to avoid potential transfer pricing penalties.

ASC 740-10/FIN 48

Accounting Standards Codification 740-10 (ASC 740-10), formerly referred to as Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), specifies a comprehensive model for how companies should determine and disclose in their financial statements uncertain tax positions that they have taken or expect to take on their tax returns. Existing guidance on the application of income tax law is complicated and at times ambiguous; thus it is often unclear whether a particular position adopted on a tax return will ultimately be sustained or whether additional future payments will be required. As a result of limited specific authoritative literature on accounting for uncertain tax positions, significant diversity in practice has developed. This diversity in accounting raised concerns that tax contingency reserves had become susceptible to earnings manipulations, and that

companies' reserves could not reasonably be compared until standards for recording tax benefits were strengthened and standardised.

Under ASC 740-10, a company's financial statements will reflect expected future tax consequences of all uncertain tax positions. ASC 740-10 was effective as of the beginning of fiscal years that start after 15 December 2006. The estimation of tax exposure is to be retrospective as well as prospective. Tax reserves should be assessed under the assumption that taxing authorities have full knowledge of the position and all relevant facts. Each tax position must be evaluated on its own merits, without consideration of offsets or aggregations, and in light of multiple authoritative sources including legislation and intent, regulations, rulings, and case law, as well as past administrative practices and precedents.

Two principles central to ASC 740-10 are recognition and measurement. The principle of 'recognition' means that a tax benefit from an uncertain position may be recognised only if it is 'more likely than not' that the position is sustainable under challenge from a taxing authority based on its technical merits, and without consideration of the likelihood of detection. With regard to 'measurement,' ASC 740-10 instructs that the tax benefit of an uncertain tax position be quantified using a methodology based on 'cumulative probability'. That is, a company is to book the largest amount of tax benefit which has a greater than 50% likelihood of being realised upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

Because transfer pricing is a significant source of tax uncertainty, it must be considered in developing a tax provision. The existence of contemporaneous documentation covering a company's inter-company transactions is not sufficient to eliminate tax exposure uncertainty associated with those transactions. Often, the uncertainty associated with transfer pricing relates not to whether a taxpayer is entitled to a position but, rather, the amount of benefit the taxpayer can claim. The form and detail of documentation required to support a company's determination of its uncertain tax positions associated with transfer pricing will depend on many factors including the nature of the uncertain tax positions, the complexity of the issues under consideration and the materiality of the dollar amounts involved.

Coordination with Schedule UTP

The IRS has finalised Schedule UTP and instructions that certain corporations will use starting with 2010 tax years to report uncertain tax positions as part of their US Federal income tax filings. Additionally, with Announcement 2010-76, IRS is expanding its policy of restraint in connection with its decision to require certain corporations to file Schedule UTP. A directive to LB&I personnel has also been issued setting forth the IRS's planned treatment of these UTPs by examiners and other personnel.

SEC Roadmap: Conversion of US GAAP to IFRS

In November 2008, the US Securities and Exchange Commission (SEC) released its proposed roadmap for the mandatory adoption of International Financial Reporting Standard (IFRS) in the US. The proposed roadmap currently provides that US issuers adopt IFRS for financial reporting purposes as early as 2014, with the potential for voluntary adoption as early as 2009. Although the mandatory conversion date is 1 January 2014, US issuers will be required to issue their financial reports with three-year comparative financials, which means that these companies' financials for 2012 and 2013 must also be reported under IFRS.

United States

For many US-based multinational enterprises the conversion to IFRS presents opportunities to harmonise their internal transfer pricing policies, typically based on US Generally Accepted Accounting Principles (US GAAP), to IFRS, the new accounting standard of choice for many of the jurisdictions in which their affiliates operate. However, considering the significant differences in the accounting for revenue and expense items between US GAAP and IFRS (e.g. as many as four hundred potential differences impacting the pre-tax income), the adoption of IFRS also presents many implementation and risk management challenges that need to be considered well in advance of the conversion date.

The accounting policies adopted by the multinational enterprises' accounting/finance departments will have profound impacts on the multinational enterprises transfer pricing footprint, including the planning and setting of prices, documentation, defence of the group's inter-company policies in the event of an examination by a taxing authority, and in negotiating tax rulings advance pricing agreements, and the like. Considering the significant impacts IFRS conversion will have on the multinational enterprises transfer pricing landscape, it is vital that the tax department be involved, and if not, at the very least, be aware of the implications each of these policies will have on the transfer pricing aspect of the group's tax profile.

Competent authority

The 2006 revenue procedure

The competent authority process may be invoked by taxpayers when they believe that the actions of the US or another country with which the US has concluded a tax treaty, or both parties, result or will result in taxation that is contrary to the provisions of a treaty (i.e. double taxation).

Taxpayers have the option of requesting competent authority assistance without first seeking a review of issues not agreed in the US by the IRS Appeals Division. Issues may also be simultaneously considered by the US Competent Authority and the IRS Appeals Division. Competent authority agreements may be extended to resolve similar issues in subsequent tax years.

Under section 12 of the Revenue Procedure, the limited circumstances in which the US Competent Authority may decline to take up the taxpayer's case with a treaty partner are enumerated. One such circumstance is if the taxpayer does not agree that competent authority negotiations are a government to government activity and they do not include the taxpayer's participation in the negotiation proceedings. Another is if the transaction giving rise to the request for competent authority assistance is a listed transaction under the US regulations as a tax avoidance transaction.

The scope of competent authority assistance

With the exception of the treaty with Bermuda, all US income tax treaties contain a Mutual Agreement Article that requires the competent authorities of the two treaty countries to consult with one another in an attempt to reduce or eliminate double taxation that would otherwise occur when the two countries claim simultaneous jurisdiction to tax the same income of a multinational enterprises or an affiliated group.

The Mutual Agreement Article contained in US tax treaties does not require the competent authorities to reach an agreement eliminating double taxation in a

particular case. Rather, the treaties require only that the competent authorities make a good faith effort to reach such an agreement. Thus, there is no guarantee that competent authority assistance will result in the elimination of double taxation in every case; however, in practice the vast majority of cases are concluded with an agreement that avoids double taxation. Latest statistics from the US Competent Authority office (for the IRS's fiscal 2010) indicate that the US Competent Authority completed more cases in its inventory than in any of the five prior fiscal years. The overall processing time for cases has also increased. In fiscal year 2010, the U.S Competent Authority disposed of 271 cases. (This total includes allocation cases (i.e., transfer pricing cases), non-allocation cases (e.g. withholding tax cases), permanent establishment (PE) cases, Limitation on Benefits (LOB) cases (i.e. discretionary relief cases) and Advance Pricing Agreements (APAs)). The fiscal year 2010 ending inventory was slightly down from the prior fiscal year, but the processing time for the closed cases has increased.

Competent authority negotiations are a government-to-government process. Direct taxpayer participation in the negotiations is not permitted. However, a taxpayer may take a very proactive approach to competent authority proceedings, presenting directly to each government its view of the facts, arguments and supporting evidence in a particular case. The taxpayer can facilitate the negotiation process between the two governments by developing alternatives and responses to their problems and concerns.

Competent authority relief is most commonly sought in the context of transfer pricing cases, where one country reallocates income among related entities in a manner inconsistent with the treatment of the same transactions in the other country. In such cases, competent authority relief is intended to avoid double taxation by either eliminating or reducing the adjustment or by making a correlative reduction of taxable income in the country from which income has been allocated. In transfer pricing cases, the US Competent Authority is guided by the § 482 regulations but is not strictly bound by the regulations and may take into account all the facts and circumstances, including the purpose of the treaty to avoid double taxation.

Other types of issues for which competent authority assistance may be sought include, *inter alia*, withholding tax issues, qualifications for treaty benefits and zero rate withholding for dividends and certain treaty interpretative issues.

When to request competent authority assistance

In the case of a US-initiated adjustment, a written request for competent authority relief may be submitted as soon as practical after the amount of the proposed IRS adjustment is communicated in writing to the taxpayer. For a foreign-initiated adjustment, competent authority assistance may be requested as soon as the possibility of double taxation arises. Once competent authority has been requested, the applicable treaty may provide general guidance with respect to the types of issues the competent authorities may address. These issues could be allocation of income, deductions, credits, or allowances between related persons, determination of the source and characterisation of particular items of income, and the common meaning or interpretation of terms used in the treaty.

Pre-filing and post-agreement conferences

The Revenue Procedure provides for a pre-filing conference at which the taxpayer may discuss the practical aspects of obtaining the assistance of the US Competent Authority and the actions necessary to facilitate the negotiations with the foreign treaty partner. The Revenue Procedure also provides for a post-agreement conference after an

United States

agreement has been reached by the competent authorities to discuss the resolution of the issues considered. There is no explicit provision for conferences while the issues are being considered by the competent authorities of both countries but the US Competent Authority has a practice of meeting and/or otherwise communicating with the taxpayer throughout the period of negotiations with the foreign treaty partner.

Small case procedures

To be eligible for the small case procedure, the total proposed adjustments assessments must fall below certain specified amounts. Corporations would qualify for this small case procedure if the proposed adjustments were not more than USD 1 million.

Statute of limitation protective measures

The statute of limitations or other procedural barriers under US or non-US law may preclude or limit the extent of the assistance available from the competent authorities. The US Competent Authority has generally sought to read into treaties a waiver of procedural barriers that may exist under US domestic law, even in the absence of specific language to that effect in the treaty. The same policy is not always followed by the US's treaty partners. Therefore, a taxpayer seeking the assistance of the US Competent Authority must take whatever protective measures are necessary to ensure that implementation of a competent authority agreement will not be barred by administrative, legal, or procedural barriers that exist under domestic law in either country.

In particular, the taxpayer must take steps to prevent the applicable statute of limitations from expiring in the other country. If a treaty partner declines to enter into competent authority negotiations, or if a competent authority agreement cannot be implemented because the non-US statute of limitations has expired, a taxpayer's failure to take protective measures in a timely fashion may cause the US Competent Authority to conclude that the taxpayer failed to exhaust its competent authority remedies for foreign tax credit purposes.

Some US treaties contain provisions that are intended to waive or otherwise remove procedural barriers to the credit or refund of tax pursuant to a competent authority agreement, even though the otherwise applicable statute of limitations has expired. The 2006 Revenue Procedure warns taxpayers not to rely on these provisions because of differences among treaty partners in interpreting these waiver provisions. The limits a treaty may impose on the issues the competent authority may address are also another reason for a taxpayer to take protective measures to ensure that implementation of a competent authority agreement will not be barred.

Most US treaties also contain specific time limitations in which a case may be brought before the applicable competent authorities. These time limitations are separate from the domestic statute limitations. For example, the treaty with Canada requires that the other country be notified of a proposed adjustment within six years from the end of the taxable year to which the case relates. This notification under the treaty can be accomplished, from a US perspective, by filing either a competent authority request pertaining to the proposed adjustments or a letter requesting the preservation of the taxpayer's right to seek competent authority assistance at a later date, after administrative remedies in the other country have been pursued. If the latter course is followed, this letter must be updated annually until such time as the actual competent authority submission is filed or the taxpayer determines it no longer needs to protect its rights to go to competent authority.

Unilateral withdrawal or reduction of US-initiated adjustments

Where the IRS has made a transfer pricing allocation, the primary goal of the US Competent Authority is to obtain a correlative adjustment from the foreign treaty country. Unilateral withdrawal or reduction of US-initiated adjustments, therefore, generally will not be considered. Only in extraordinary circumstances will the US Competent Authority consider unilateral relief to avoid double taxation.

Repatriation of funds following a transfer pricing adjustment

In 1999, the US issued Revenue Procedure 99-32 that provided for the tax-free repatriation of certain amounts following a transfer pricing allocation to a US taxpayer, broadly with the intention of allowing the taxpayer to move funds to reflect the agreed allocation of income following the transfer pricing adjustment. In cases involving a treaty country, coordination with the US Competent Authority is required before concluding a closing agreement with the taxpayer.

The Revenue Procedure requires the taxpayer to establish an account receivable, which may be paid without any tax consequence, provided it is paid within 90 days of the closing agreement or tax return filing for the year in which the adjustment was reported. The following should be taken into account when establishing an account receivable:

- Absent payment of the account receivable within 90 days, the amount is treated as a dividend or capital contribution.
- The account receivable bears interest at an arm's-length rate.
- The receivable is deemed to have been created on the last day of the year subject to the transfer pricing allocation, with the interest accrued being included in the income of the appropriate corporation each year the account receivable is deemed outstanding.

The Revenue Procedure the IRS previously issued in this area provided that previously paid dividends could be offset by the cash payment made in response to the primary transfer pricing adjustment. Under the 1999 Revenue Procedure, a taxpayer may only offset (1) dividends paid in a year in which a taxpayer-initiated adjustment relates if offset treatment is claimed on a timely income tax return (or an amended tax return), or (2) in the same year that a closing agreement is entered into in connection with an IRS-initiated adjustment. In the former case, the dividend is treated as a prepayment of interest and principle on the deemed account receivable.

Under the 1999 Revenue Procedure, relief is not available, however, with respect to transactions where a transfer pricing penalty is sustained. Effectively, this requirement imposes an additional tax for failure to maintain contemporaneous documentation to substantiate arm's-length transfer pricing.

Interest and penalties

The US Competent Authority generally has no authority to negotiate or provide relief with respect to interest and penalties.

Advance pricing agreements (APA)

US procedures

The US was the first country to issue a formal, comprehensive set of procedures relating to the issue of binding advance agreements dealing with the application of

United States

the arm's-length standard to inter-company transfer prices. Under the procedure, the taxpayer proposes a transfer pricing method (TPM) and provides data intended to show that the TPM is the appropriate application of the best method within the meaning of the regulations for determining arm's-length results between the taxpayer and specified affiliates with respect to specified inter-company transactions. The IRS evaluates the APA request by analysing the data submitted and any other relevant information. After discussion, if the taxpayer's proposal is acceptable, a written agreement is signed by the taxpayer and the IRS.

The procedures specify a detailed list of data that must be provided to the IRS with the application. There is also a user fee for participation in the programme, which currently ranges between USD 10,000 and USD 50,000, based on the size of the taxpayer and the nature of the request.

In the application, the taxpayer must propose and describe a set of critical assumptions. A critical assumption is described as any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business or economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume.

The taxpayer must file an annual report for the duration of the agreement, which will normally include:

- The application of the TPM to the actual operations for the year.
- A description of any material lack of conformity with the critical assumptions.
- An analysis of any compensating adjustments to be paid by one entity to another and the manner in which the payments are to be made.

The taxpayer must propose an initial term for the APA appropriate to the industry, product or transaction involved, and must specify for which taxable year the agreement will be effective. The APA request must be filed no later than the extended filing date for the Federal income tax return for the first taxable year to be covered by the APA.

The effect of an APA is to guarantee that the IRS will regard the results of the TPM as satisfying the arm's-length standard if the taxpayer complies with the terms and conditions of the APA. The APA may be retroactively revoked in the case of fraud or malfeasance, cancelled in the event of misrepresentation, mistake/omission of fact, or lack of good faith compliance, or revised if the critical assumptions change. Adherence to the terms and conditions may be subject to audit – this will not include re-evaluation of the TPM.

Traditionally, the IRS APA procedures were limited to issues concerning transfer pricing matters in the context of section 482 of the Internal Revenue Code. However, effective 9 June 2008 the APA procedures (through Rev. Proc. 2008-31) were modified to expand the scope of the APA Programme's purview to include other issues for which transfer pricing principles may be relevant, including: 'attribution of profits to permanent establishment under an income tax treaty, determining the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the US, and determining the amounts of income derived from sources partly within and partly without the US, as well as related subsidiary issues.' The expansion

of the programme's scope may not necessarily translate into an immediate increase in the number of non-section 482 cases within the programme as the IRS has publicly indicated that it will be selective in the cases admitted into the programme. Nevertheless, the expansion of the programme's scope of review, providing for other non-section 482 issues that may be resolved through the APA process, is a welcomed development.

Rollbacks

APAs may, at the taxpayer's request at any point prior to the conclusion of an agreement, and with agreement of the responsible IRS District, be rolled back to cover earlier taxable years. This may be an effective mechanism for taxpayers to resolve existing audit issues.

Bilateral and unilateral APAs – impact on competent authority

When a taxpayer and the IRS enter into an APA, the US Competent Authority will, upon a request by the taxpayer, attempt to negotiate a bilateral APA with the competent authority of the treaty country that would be affected by the transfer pricing methodology. The IRS has encouraged taxpayers to seek such bilateral APAs through the US Competent Authority.

If a taxpayer and the IRS enter into a unilateral APA, treaty partners may be notified of the taxpayer's request for the unilateral APA involving transactions with that country. Additionally, the regular competent authority procedures will apply if double taxation subsequently develops as a result of the taxpayer's compliance with the unilateral APA. Importantly, the US Competent Authority may deviate from the terms and conditions of the APA in an attempt to negotiate a settlement with the foreign competent authority. However, the 2006 Revenue Procedure includes a strongly worded warning that a unilateral APA may hinder the ability of the US Competent Authority to reach a mutual agreement, which will provide relief from double taxation, particularly when a contemporaneous bilateral or multilateral APA request would have been both effective and practical to obtain consistent treatment of the APA matters in a treaty country.

APAs for small business taxpayers and IRS-initiated APAs

In an effort to make the APA programme more accessible to all taxpayers, the IRS released a notice in early 1998 proposing special, simplified APA procedures for small business taxpayers (SBT). The notice provides that a SBT is any US taxpayer with total gross income less than USD 200 million. Under the simplified APA procedures, the entire APA process is accelerated and streamlined, and the IRS will provide the SBT with more assistance than it does in a standard APA.

In an effort to streamline the APA process, the IRS may agree to apply streamlined procedures to a particular APA request, even if it does not conform fully to the requirements for 'small business' treatment.

The IRS has announced a programme under which district examiners are encouraged to suggest to taxpayers that they seek APAs, if the examiners believe that APAs might speed issue resolution.

Developments in the APA programme

There is increased specialisation and coordination in the APA office, with teams designated to specific industries/issues, such as automotive, pharmaceutical and medical devices, cost-sharing, financial products and semiconductors.

United States

The APA programme is also getting stricter with its deadlines. From now on, if the date on which the IRS and the taxpayer have agreed to complete an APA passes and the case goes unresolved, both parties will have to submit a joint status report explaining the reason for the delay and mapping out a new plan to close the case within three to six months. If the IRS and the taxpayer fail to meet the second target date, the new procedures call for an automatic all hands meeting of key officials from both sides. For an APA that has been executed, the taxpayer is required to submit an annual report showing its compliance with the terms of the agreement. Taxpayers now must also submit an APA Annual Report Summary, which is a standardised form reflecting key data, as part of the APA annual report.

Compliance assurance process (CAP) programme and transfer pricing

In May 2011, the IRS expanded and made permanent its six-year-old compliance assurance process (CAP) pilot programme for large corporate taxpayers. Under CAP, participating taxpayers work collaboratively with an IRS team to identify and resolve potential tax issues before the tax return is filed each year. With the major potential tax issues largely settled before filing, taxpayers are generally subject to shorter and narrower post-filing examinations. With the CAP programme growing in popularity, it is being expanded to include two additional components. A new pre-CAP programme will provide interested taxpayers with a clear roadmap of the steps required for gaining entry into CAP. A new CAP maintenance programme is intended for taxpayers who have been in CAP, have fewer complex issues, and have established a track record of working cooperatively and transparently with the IRS. The CAP pilot began in 2005 with 17 taxpayers and in FY 2011 there are 140 taxpayers participating. Only taxpayers with assets of USD 10 million or more are eligible to participate. While participation in the CAP programme does not provide taxpayers with the same level of assurance as an agreed APA, it may be a means for large taxpayers to agree on transfer pricing matters ahead of the filing of the return and potentially minimise post-filing transfer pricing examinations.

Comparison with the OECD Transfer Pricing Guidelines

The best method rule

As noted in *The US transfer pricing regulations section, above*, the US regulations require application of the Best Method Rule in the selection of a pricing method. The OECD Guidelines now refer to use of the ‘most appropriate method’ which in principle is very similar to the ‘best method’ described in the US regulations. A taxpayer does not necessarily have to examine each method in detail, but must take into account:

- the facts and circumstances of the case
- the evidence available, particularly in relation to the availability of comparable data, and
- the relative reliability of the various methods under consideration, which arguably continues to demonstrate some level of bias towards the use of transactional methods.

Comparability analysis

Both the US regulations and the OECD Guidelines provide that the arm’s-length character of an inter-company transaction is ordinarily determined by comparing the results under the regulations or the conditions under the Guidelines (i.e. in both cases meaning either prices or profits) of that controlled transaction to the results realised or conditions present in comparable uncontrolled transactions. Comparability

factors that must be taken into account include functions performed, risks assumed, contractual terms and economic conditions present, and the characteristics of the property transferred or the services provided. Determination of the degree of comparability must be based on a functional analysis made to identify the economically significant functions performed, assets used, and risks assumed by the controlled and uncontrolled parties involved in the transactions under review.

Both the US regulations and the OECD Guidelines permit the use of inexact comparables that are similar to the controlled transaction under review. Reasonably accurate adjustments must be made to the uncontrolled comparables, however, to take into account material differences between the controlled and uncontrolled transactions if such adjustments will improve the reliability of the results obtained under the selected pricing method. Both the US regulations and the OECD Guidelines expressly prohibit the use of unadjusted industry average returns to establish an arm's-length result.

An important comparability factor under both the US regulations and the OECD Guidelines is the allocation of risk within the controlled group. The types of risks that must be taken into account under both sets of rules include: market risks; risk of loss associated with the investment in and use of property, plant, and equipment; risks associated with the success or failure of R&D activities; and financial risks such as those caused by currency exchange rate and interest rate variability. In addition, under both sets of rules the determination of which party actually bears a risk depends, in part, on the actual conduct of the parties and the degree to which a party exercises control over the business activities associated with the risk.

Market penetration strategies

Consistent with the US regulations, the OECD Guidelines recognise that market penetration strategies may affect transfer prices. Both the Regulations and the Guidelines require that where a taxpayer has undertaken such business strategies, it must be shown that:

- there is a reasonable expectation that future profits will provide a reasonable return in relation to the costs incurred to implement the strategy, and
- the strategy is pursued for a reasonable period of time given the industry and product in question.

The OECD Guidelines are generally less restrictive concerning market penetration strategies than the US regulations, which require a very extensive factual showing and documentation.

Arm's-length range

Similar to the US regulations, the OECD Guidelines provide that no adjustment should be made to a taxpayer's transfer pricing results if those results are within an arm's-length range. The Guidelines do not include specific rules for establishing the arm's-length range but do recognise that the existence of substantial deviation among the results of the comparables suggests that some of the comparables may not be as reliable as others, or that significant adjustments to the results of the comparables may be necessary.

United States

What has to be at arm's length? Setting prices versus evaluating the result

The primary focus of the US regulations is on whether a taxpayer has reflected arm's-length results on its US income tax return; the actual methods and procedures used by taxpayers to set transfer prices are not relevant. The OECD Guidelines, however, tend to focus less on the results of transfer pricing and more on whether the transfer prices were established in an arm's-length manner substantially similar to the manner in which uncontrolled parties would negotiate prices. Thus, the Guidelines put significant emphasis on factors known by the taxpayer at the time transfer prices were established.

Traditional transactional methods

As noted above the OECD Guidelines express some level of preference for the use of traditional transaction methods for testing the arm's-length character of transfer prices for transfers of tangible property. These methods include the CUP method, the resale price method, and the cost plus method. These same methods are 'specified methods' under the US regulations.

Under both the US regulations and the OECD Guidelines, the focus is on the comparability of products under the CUP method, and the comparability of functions under the resale price and cost plus methods. Under all three methods and under both sets of rules, comparability adjustments must take into account material differences in operating expenses, accounting conventions, geographic markets, and business experience and management efficiency.

There are no material substantive differences between the US regulations and the OECD Guidelines in the theoretical concepts underlying these methods, the manner in which these methods are to be applied, or the conditions under which these methods would likely be the best method.

Other methods

Both the US regulations and the OECD Guidelines provide for the use of other methods when the traditional transaction methods cannot be used. Under the US regulations, a taxpayer may use the CPM or the profit split method. Under the Guidelines, a taxpayer may use the profit split method or the transactional net margin method (TNMM). In most cases, as explained below, the CPM and the TNMM are virtually indistinguishable. The emphasis on comparability throughout the US regulations, however, is intended to limit the use of profit split methods to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable comparables under some other method. The Guidelines, on the other hand, express a strong preference for the use of the profit split over the TNMM.

Transactional net margin method (TNMM)

TNMM compares the operating profit relative to an appropriate base (i.e. a profit level indicator) of the controlled enterprise that is the least complex and owns no valuable intangibles (i.e. the tested party) to a similar measure of operating profit realised by comparable uncontrolled parties in a manner consistent with the manner in which the resale price or cost plus methods are applied. The operating rules for TNMM are thus substantially the same as those for CPM. Both methods require that the analysis be applied to an appropriate business segment and use consistent measures of profitability and consistent accounting conventions.

The OECD Guidelines do require that TNMM be applied on a transactional basis. The precise meaning of this requirement is not clear. It will ordinarily not be possible to identify net profit margins of comparables on a truly transactional basis, and in many cases, taxpayers will have difficulty identifying their own net profits on a transactional basis. In any event, it appears that TNMM is intended to be applied in the same manner as the resale price and cost plus methods, which ordinarily look to overall gross margins for an entire business segment for the full taxable year. Presumably, TNMM should be applied in the same manner.

The OECD Guidelines thus do not prohibit the use of CPM. They do provide, however, that the only profit-based methods such as CPM and so-called modified resale price/cost plus methods that satisfy the arm's-length standard are those that are consistent with TNMM.

Intangible property

In respect to the treatment of intangible property, the OECD issued a chapter discussing the special considerations arising under the arm's-length principle for establishing transfer pricing for transactions involving intangible property which will be revised in the near future. The OECD places emphasis on the actions that would have been taken by unrelated third parties at the time the transaction occurred. The Guidelines focus on the relative economic contribution made by various group members towards the development of the value of the intangible and on the exploitation rights that have been transferred in an inter-company transaction. This is particularly true in the case of the pricing of marketing intangibles. The Guidelines thus focus on economic ownership of the intangible as opposed to legal ownership.

The OECD Guidelines do not provide significant new guidance for the pricing of intangibles by providing specific standards of comparability. The Guidelines, similar to the US regulations provide that prices for intangibles should be based on:

- the anticipated benefits to each party
- prior agreement on price adjustments, or short term contracts, or
- the allocation of the cost or benefit of uncertainty to one party in the transaction, with the possibility of renegotiation in the event of extreme or unforeseen circumstances.

The only pricing method that is specifically approved is the CUP method, which is equivalent to the comparable uncontrolled transaction (CUT) method in the US regulations. The Guidelines give a cautious endorsement to the use of profit split methods or the TNMM when it is difficult to apply a transactional method. This is not inconsistent with the outcome that would be expected if the US Best Method Rule were applied in the same circumstances except for the preference of profit split over the TNMM.

The redefining of the IP ownership rules for non-legally protected intangibles under the proposed regulations will likely attract much debate between the US and its treaty partners who have adopted the OECD Guidelines on this matter. Uncertainties in the definition of 'practical control' and 'economic substance' will be the main drivers of such potential disputes.

United States

Periodic adjustments under the OECD Guidelines

The main area of potential difficulty arises from the focus in the US regulations on achieving an arm's-length result. There is a very evident potential for dispute as to whether the concept of periodic adjustments under the US regulations (*described above*) is at odds with the statements in the Guidelines concerning the use of hindsight. However, the OECD clearly affirms the right of tax authorities to audit the accuracy of the forecasts that were used to establish transfer pricing arrangements, and to make adjustments if the projections on which the pricing was based prove to be inadequate or unreasonable.

Services

Both the US regulations and the OECD Guidelines focus on satisfying the arm's-length standard by the recharge of costs specifically incurred by one group member to provide a service to another group member. Under both the US regulations and the Guidelines, costs incurred include a reasonable allocation of indirect costs.

As to whether the arm's-length charge for services also includes a profit to the service provider, the Guidelines state that the inclusion of a profit margin is normally part of the cost of the services. In an arm's-length transaction, an independent enterprise would normally seek to charge for services in such a way as to generate a profit. There might be circumstances, however, in which an independent enterprise may not realise a profit from the performance of service activities alone. For example, the services provider might offer its services to increase profitability by complementing its range of activities.

The proposed regulations (on Services) are intended to conform the US regulations to the OECD Guidelines by eliminating the cost safe harbour method for non-integral activities. However, this intention is partially negated with proposal of the elective services cost method for certain types of activities deemed 'low margin' services.

Documentation and penalties

The OECD Guidelines recommend that taxpayers make reasonable efforts at the time transfer pricing is established to determine whether their transfer pricing results meet the arm's-length standard, and they advise taxpayers that it would be prudent to document those efforts on a contemporaneous basis. The Guidelines also admonish tax authorities to balance their needs for taxpayer documentation with the cost and administrative burden imposed on taxpayers in the preparation of that documentation. The Guidelines also note that adequate record keeping and voluntary production of documents facilitates examinations and the resolution of transfer pricing issues that arise.

The OECD Guidelines include a cautious acknowledgement that penalties may play a legitimate role in improving tax compliance in the transfer pricing area. The Guidelines encourage member countries to administer any such penalty system in a manner that is fair and not unduly onerous for taxpayers.

76.

Uruguay

Introduction

In 2007, Uruguay implemented a significant and historical tax reform pursuant to approval of Law 18,083, which incorporates, among other concepts, the personal income tax that had been repealed in the early 1970s, the figure of permanent establishment and the concepts of residence and transfer pricing. Notwithstanding, the source principle is maintained as the basic taxability empowerment criteria.

This law was enacted by the Executive Power on 27 December 2006, and was published in the Official Gazette on 18 January 2007.

Until 2007, Uruguayan tax legislation had not given a general legal solution for the issue of transfer pricing, except for certain provisions included in the regulations of business income tax relating to export or import transactions involving merchandise and some other specific rulings. Regarding export and import transactions, Article 21 of Title 4 of the 1996 Coordinated Tax Compilation (CTC) and related detailed regulations contained in Article 19 of Decree 840/988 prescribe consideration of the wholesaler's price plus certain other connected charges for determining the net income of a local source related to all export and import transactions made by an enterprise (without differentiating between a related party or a third party). This ruling is extensive to transactions made between Uruguayan free zones and non-free zone territory, as stated in Article 8 of Decree 733/991.

Law 18,083 incorporates for the first time a specific chapter (Chapter VII of Title 4 of the 1996 CTC) on transfer pricing under the regulations of Income Tax on Economic Activities (ITEA or IRAE as per Uruguayan abbreviation in Spanish), which are in force for fiscal years starting from 1 July 2007, and onwards.

On 26 January 2009, the regulatory decree was issued (Decree 56/009), containing detailed regulations on transfer pricing regime. Later, on 24 August 2009, a second decree (Decree 392/009) was issued clarifying some of those regulations. The regulations of this decree establishing obligations or burdens for the taxpayer will become in force for operations made in fiscal years starting from 1 January 2009.

In December 2009, the Uruguayan General Tax Bureau (GTB), in agreement with the Finance Ministry, issued Resolutions 2084/009 and 2269/009, providing further details about certain aspects of the existing transfer pricing regulations.

In February 2010, the first binding consultation regarding transfer pricing was published by the GTB. The subject of such consultation is the price to be applied in exports and imports of commodities.

Uruguay

Statutory rules

As a general principle, the regulations on transfer pricing are applicable to international transactions made between related parties. However, Uruguayan legislation has extended the scope of these regulations to transactions carried out with low-tax or nil-tax jurisdictions or regimes (either international or domestic) and certain operations through third intermediaries.

Transactions between related parties

Law 18,083 states that transactions between IRAE taxpayers and related parties or individuals will be deemed arm's length for all purposes when the terms and conditions provided therein are in conformity with normal market practices between independent parties, without prejudice to the cases of existing limitations for expense deductions upon computing net taxable income.

In principle, according to the law, the burden of proving that the aforementioned terms and conditions are not in conformity with market values falls on the GTB, except in the case of transactions by the IRAE taxpayer with companies in low-tax or nil-tax jurisdictions or regimes that are absolutely presumed not to be arm's length.

However, the documentation requirements imposed by the GTB have, in fact, transferred such burden to the taxpayers.

Related parties

The definition adopted by the law for related-party status is quite broad. Such a relationship is configured when both parties are subject, directly or indirectly, to the management or control of the same individuals or legal entities, or when they have power of decision to direct or define the taxpayer's activities due either to their participation in capital interest, the level of their credit rights, their functional or any other type of influence (whether contractual or not).

The law expressly states that operations undertaken by taxpayers with foreign affiliates, branches, permanent establishments or any other kind of foreign nonresident entities related thereto will be subject to the same principle.

Resolution 2084/009 provides an in-depth description of the circumstances under which a company will be deemed a related party. For the GTB, and without prejudice to other situations, the related-party status will be deemed configured when transactions are made between the parties and one of the assumptions detailed below is in existence:

- An entity has an equity interest of 10% or more in the capital of another entity.
- An entity exercises its functional influence on the other entity.
- Two or more entities have, indistinctly:
 - another common entity jointly possessing an equity interest of 10% or more in the capital of each of the above
 - another common entity jointly possessing an equity interest of 10% or more in the capital of one or more entities together with functional influence on one or more of the other entities above, and
 - another common entity possessing functional influence simultaneously on each of the other entities above

- An entity holding the voting rights as necessary to determine the decision-making of the other entity or to prevail on the competent decision-making body of the other entity.
- Two or more entities having an entity in common that holds the voting rights as necessary to determine the decision-making of the other entity or to prevail on the competent decision-making body of those two or more entities.
- When the main business activity of an entity is derived from exclusivity contracts as agent, distributor, concessionaire or supplier of goods, services or rights, subscribed with another entity (To these effects, it will be considered that a business activity will qualify as the principal activity, when the level of income generated by the same represents at least 50% of the total revenue obtained by the entity during the corresponding financial year.).
- An entity enjoying exclusive right as agent, distributor, concessionaire or supplier of goods, services or rights of the other entity.
- An entity participating in fixing policies in the areas of business, procurement of raw materials, production or marketing and trading of the other entity.
- Two or more entities having a common entity jointly participating in fixing policies in the areas of business, procurement of raw materials, production or marketing and trading of those two or more entities
- An entity taking charge of the losses or expenses of another entity.

The GTB also describes some situations in which the ‘functional influence’ is deemed to be in place, whenever:

- two or more entities have common directors, managers or other staff members holding decision powers to provide guidance or to define the activities of the entities
- an entity provides to the other entity proprietary technology or technical knowledge that constitutes the basis for the activities of the latter
- two or more entities agree to contractual clauses that assume a preferential nature in comparison with those granted to third parties under similar circumstances, such as volume discount arrangements, financing for transactions or delivery on consignment
- an entity develops significant activities only in relation to the other entity, or its existence is justified only in relation to the other entity, giving rise to situations such as being the sole supplier or sole client
- an entity provides substantially the funding required for the business activities of the other, by means of granting loans and submitting guarantees of whatever type in the case of financing provided by a third party
- the directors, managers, or other staff holding decision powers in an entity receive instructions from the other entity or act in the interest of the latter, and
- there are agreements, circumstances or situations whereby the management of an entity is entrusted to an entity holding a minority capital interest in the first entity.

Countries or regimes with low taxation or nil taxation

The operations undertaken by taxpayers with countries or regimes with low or nil taxation will be perceptively treated as related parties (without admitting proof to the contrary) and will be considered as not being in conformity with normal market practices or values between independent parties.

The following operations are included in this category:

Uruguay

1. Transactions with non-residents who are domiciled, organised or located in countries of low or nil taxation.
2. Transactions with non-residents who are beneficiaries under a special regime of low or nil taxation.
3. Transactions carried out with entities operating in customs areas (including those within Uruguayan territory) and benefitting from a regime of low or nil taxation; consequently, transactions with entities operating in such areas (e.g. Uruguayan or foreign free zones) would fall under this category.

The countries and regimes referred to in cases (1) and (2) above were enumerated specifically in the Decree 56/009 (33 countries or jurisdictions were listed). Regarding operations referred to in case (3), the Decree 392/009 defined the concept of 'customs areas' that benefit from a 'regime of low or nil taxation'. Customs areas comprise the free zones, free ports and other geographic areas where customs regulations are not applicable, located either in Uruguay or abroad. Regimes of low or nil taxation are defined as those having an effective income tax rate lower than 40% of the IRAE rate (i.e. when such effective income tax rate is lower than 10%, equivalent to 40% of 25%). It must be noted that some of these operations are excluded from the transfer pricing regime when they comply with certain requirements.

Operations through intermediaries

Imports and exports transactions under the intervention of an international intermediary other than the final recipient of the goods are subject to transfer pricing rules when:

- there is a related-party connection between the local operator and the international intermediary, either by virtue of the general related-party assumptions established by law or of noncompliance with the certain requirements stated by law (If these requirements are not met, the intermediary would be considered a related party), and
- there is a related-party connection between the local operator and the effective recipient of the goods (whether or not the intermediary complies with such requirements).

In principle, these rules are applicable to commodities transactions. However, the GTB may extend these particular rules to other goods.

Methodology

Law 18,083 adopts the best accepted international methodologies and requires use of the most appropriate method according to the type of transaction performed.

The law foresees the application of five methods, apart from others that may be established in the detailed regulations:

- Comparable uncontrolled price method (CUP).
- Resale price method (RPM).
- Cost plus (CP) method.
- Profit split method (PSM).
- Transactional net margin method (TNMM).

Decree 56/009 adopts such methods and defines them.

Tested party

When applying the methods, the analysis of comparability and justification of the transfer prices can be made indistinctly on the situation of the local entity or of the foreign entity. Should the option adopted be to analyse the position of the foreign subject, due documentary proof will be required, which should be certified in the foreign subject's host country by an independent auditor of recognised reputation, duly translated into Spanish and legalised.

Comparability factors

In accordance with the Decree 56/009, the comparability factors include, among others:

- Characteristics of the transactions.
- Functions or activities, including assets engaged and risks assumed in the transactions of each of the parties involved.
- Contractual terms.
- Economic circumstances.

The regulatory decree does not mention the 'business strategies' as one of the factors determining comparability. However, the elements and circumstances referred to in the decree are not stated in a restricted sense. In this case, an in-depth analysis is recommended.

Exception to the best method rule

The law prescribes perceptive application of the CUP method in the following cases:

- Imports and exports of goods with related parties for which a public and notorious international price known in transparent markets can be determined (commodities), in which case such prices should be used, unless there is proof to the contrary.
- Imports and exports of goods through a foreign intermediary other than the final recipient of the goods.

These represent transactions between related parties involving primary farming products, and, in general, goods knowingly quoted in transparent markets (commodities); in this case the price applied should be the value quoted in such market at the date the goods are laden, regardless of means of transportation or the price agreed upon with the intermediary. According to the law, this method will not be enforced when the taxpayer is able to provide trustworthy evidence that the intermediary fully complies with the following requisites:

- It has a residence abroad and actual presence in the foreign territory, having a commercial establishment in such location for managing its business activities and complying with the legal requisites of constitution, registration and filing of financial statements. The assets, risks and functions assumed by the intermediary should be appropriate to the volume of business transactions made
- Its main activity should be different from generating passive revenue or intermediation in the trading of goods out of or into Uruguay, or with other members of the group economically related to the intermediary
- Its international trade transactions with other subjects related to the importer, or exporter in the case, should not exceed 30% of the annual revenue from transactions made under its intervention

Uruguay

However, as it was mentioned above, Decree 392/009 states that the operations included in case (2) comprise all imports and exports transactions made under the intervention of an international intermediary, provided any of the following situations take place:

- Existence of a related-party connection between the local operator and the international intermediary, either by virtue of the general related-party assumptions established by law or of noncompliance with the three requirements mentioned above.
- Existence of a related connection between the local operator and the effective recipient of the goods as established by law, even when the intermediary complies with the three requirements mentioned above.

The GTB may extend the application of this method to comprise other international transactions with the participation of an intermediary other than the final recipient of the goods, provided the GTB is able to produce trustworthy evidence proving that the intermediary is not in compliance with the aforementioned requisites. For this purpose, in the case of import transactions, the price will be the higher of the prices quoted in a transparent market of recognised international prestige, if the price agreed upon with the related party is still higher. In the case of export transactions, the lower quoted price will be applied if the agreed-upon price is lower. The quoted price may be reasonably adjusted to the value of the merchandise to the point of local market, in respect of the insurance and freight costs involved.

According to Decree 392/009, in either case (1) or (2) above, if the contract has been registered, the price applied should be the quoted price prevailing as of the date of the contract. If the contract has not been registered, such quoted price will be applied as of the date of the corresponding bill of lading.

The Uruguayan Products Mercantile Chamber is the institution appointed as the registry office of such contracts. This registration will be optional for the taxpayers and will be opposable to the GTB when such registration is made within five working days of the month following execution of the contract.

Arm's-length range

When two or more comparable transactions are identified, the median and the interquartile price ranges should be determined for the amount of the consideration or the profit margins involved.

Should the price or profit margin fixed by the taxpayer fall within the interquartile range, such price and profit margin will be deemed as having been agreed upon between independent parties.

Otherwise, it will be deemed that the price, amount of the consideration or profit margin that would have been applied by independent parties is the one that corresponds to the median reduced (or plus) 5%, depending on the transactions under analysis.

Information required

Although the law per se does not require mandatory preparation of formal transfer pricing documentation, it does provide that both the administration and the detailed regulations may require additional information for purposes of control and tax audit.

The regulatory decree states that the taxpayers determined by the GTB must file special tax returns in the form established by this authority. The GTB may require them to file the vouchers and other documentary evidence supporting the transfer prices as well as the comparison criteria used to analyse due application of the prices, amounts of the considerations or profit margins reported in such special tax return.

According to Resolution 2084/009, taxpayers will be required to file annual information if they meet any of the following conditions:

- Their transactions subject to transfer pricing rules are in excess of 50 million indexed units (equivalent to approximately 6 million United States dollars [USD]).
- They have been notified for filing by the GTB.

The information referred to above will have the following contents:

- Informative tax return stating the details and amounts of transactions of the period subject to the transfer pricing regime.
- Copy of the financial statements for the fiscal period, if not submitted previously in compliance with other regulations.
- Transfer pricing study (with a minimum content).

The filing deadline for this documentation will be nine months after the closing date of the fiscal year.

Resolution 2084/009 states that taxpayers who are not required to file the annual information referred to above must still keep on file the vouchers and other supporting evidence justifying the transfer prices used and the comparison criteria applied during the period of limitations of taxation in order to duly demonstrate and justify the correct determination of those prices and the amounts of the considerations fixed or the profits margin declared.

Other regulations

Optional regimes of notional profit assumptions

Law 18,083 empowers the Executive Power to establish special notional profit regimes (safe harbours) considering the *modus operandi* of the transactions and of the type of business activity or exploitation. Such regimes will be optional and for the purpose of determining the income source of those transactions subject to regulations on transfer pricing.

The GTB may establish a special regime for determining notional profits derived from import or export operations concerning goods for which a notorious international price in a transparent market can be determined. This regime will be optional and applicable during a period of no more than three years (counted for fiscal years closing after the date the regime becomes in force).

The rule of wholesaler's price as residual criterion

In the case of import and export operations not contemplated in Chapter VII of Title 4 of the 1996 CTC in connection with transfer pricing, the Uruguayan source income will be determined considering the FOB or CIF value of the goods being imported or exported.

Uruguay

However, when no price has been fixed or when the price stated does not conform to prices prevailing in the international market, such income will be determined in the form to be established in the detailed regulations.

Such detailed regulations adopted the criteria followed to date in connection with the wholesaler's price rule. Such price will be the wholesaler's price prevailing in the place of origin of the goods (in the case of imports) or in the place of destination (in the case of exports), plus certain comparability adjustments. Should this price not be known to the public, or should there be doubts about its applicability to the same or to similar goods being imported or exported, or some other reason hindering comparison, the Uruguayan source income will be calculated taking into account profit ratios obtained from independent enterprises engaged in identical or similar activities.

Operations between head offices and permanent establishments

Decree 572/009 regulates transactions executed between head offices regarding different aspects, such as expenses incurred abroad, the determination of income distribution between head offices and permanent establishments and the tax withholding regime.

- Expenses incurred abroad

Expenses incurred abroad by non-resident entities in order to generate and preserve the income obtained by a Uruguayan source of a permanent establishment will be admitted as long as they are necessary for those purposes and provided that reliable proof can be produced in order to justify their origin and nature. The same treatment will apply to such expenses made by a permanent establishment located abroad in favour of the head office located in Uruguayan territory and between permanent establishments of the same head office located abroad or in Uruguayan territory.

- Attribution of Income between head offices and permanent establishments

The net income generated by permanent establishments of entities not residing in Uruguay will be determined on the basis of the separate accounting records. It might be necessary to make some adjustments in order to assess the real profits of these establishments. The same criteria would be applied in the cases in which the head office resides in Uruguay and the entity's permanent establishment resides abroad. If the accounting records fail to accurately reflect the income generated by the Uruguayan source, the GTB will perform an administrative assessment of such net income for tax purposes. The business turnover and other appropriate indicators may be used to perform such task.

To these effects the head office or permanent establishment will be attributed the income it might have derived had it been a distinct and separate enterprise engaged in identical or similar activities in the same or analogous conditions and operating with total independence from the enterprise of which it is a permanent establishment or head office (confirming the arm's-length principle).

It must be taken into consideration that permanent establishments of non-resident entities must compute (from a tax point of view) all income obtained in the country by the foreign entity (except certain cases).

- Ratification of the arm's-length principle

Transactions made by a permanent establishment with its head office are deemed to be made between parties that are economically and judicially independent, provided their considerations and conditions are in line with normal market practices between independent entities. The same treatment will be applied for transactions made between permanent establishments of a same head office, which are located in a Uruguayan territory and abroad.

- Tax withholding regime

The transactions between a permanent establishment and its head office or with other foreign permanent establishments will be subject to the general tax withholding regime.

Legal cases

There have been practically no transfer pricing issues submitted to administrative or legal jurisdictions. This trend is expected to change once the transfer pricing regime is put into practice.

To date, few verdicts of the Court on Administration Matters (CAM) concern transfer pricing issues.

Verdict 8/982 issued in February 1982:

This verdict defines 'economic group' and determines the tax effects regarding this figure. The court refers to the concept of 'economic group' as the union of several legal entities dominated by one of those entities or by the same group of individuals, which under private law will be independent taxpayers. As such group has the purpose of transferring profits, or at least leads to this result in most cases, so as to cause the related loss of tax revenue to the GTB, tax law regards them as one single group for tax assessment purposes, assigning the total tax debt to any of its components or redistributing the profits to adjust them to what each of the group members would have obtained if they were independent entities. In Verdict 149/997 of 17 March 1997, the court ratified the concept of 'economic group' in terms of the 1982 verdict.

Case: Philips Uruguay S.A. (Verdict issued on 19 February 2005):

The Uruguayan subsidiary had entered into a general services agreement with its shareholder in The Netherlands, comprising the following services: commercial advisory; accounting advisory; and audits regarding financial, fiscal and social matters for a consideration computed at 1.75% on the local sales revenue. The amounts paid for this concept had been deducted by the taxpayer in its business income tax return. The GTB questioned such tax deduction for years 1997 and 1998, alleging that the services lacked adequate documentation support and that they were neither indispensable nor reasonable for generating taxable income. The CAM, however, decided in favour of the taxpayer for various reasons. Regarding the reasonableness of the amount deducted by the taxpayer, the court explicitly recognised the Organisation for Economic Co-operation and Development (OECD) Guidelines as valid criteria for fixing the transfer prices between related parties, in the context of regulations not providing any specific rules on this issue.

Uruguay

Case: Milagro S.A. (Verdict 688 issued in October 2006):

In this case the GTB questioned the selling price of certain export transactions made by the taxpayer during 1996 and 1997, on the basis of the wholesaler's price rule – among other rules – established in the aforementioned Article 19 of Decree 840/988. Applying this rule, the GTB determined the income of the Uruguayan source on the basis of the wholesaler's price at destination (The Netherlands, in this case), overtaking the prices stated in the custom clearance documentation by prices indicated in the listings submitted by the Uruguayan Embassy in The Netherlands. Again, the CAM favoured the taxpayer in its verdict. While the arguments used as a basis for the decision are not clearly stated, the verdict is the first local jurisdictional precedent of the wholesaler's price rule. During 2010 some specific transfer pricing consultations were filed to the GTB, regarding the following topics:

- Consultation 5367: A non-binding consultation was submitted concerning the determination of the net income of Uruguayan source in the case of exports or imports of commodities under future contract (included in Article 42, Title 4 of the 1996 CTC) on whether the price quotations to be considered are those prevailing as of the date of the contract for future transactions in a specific transparent market (the future price) or whether the price quotations should be those prevailing for transactions made at the date of the contract (the spot price). The GTB understood that in the case of the transactions referred to, the price of the goods to be considered is the price quoted for transactions prevailing on the date of the bill of lading, unless the contract was registered, in which case the price quoted for the goods should be the price quotation prevailing on the date of signature of the contract (the spot price), regardless of the future conditions agreed upon between the parties.
- Consultation 5432: A Uruguayan free zone user, which performs offshore trading activities between non-residents, would sell goods to an IRAE taxpayer (a non-free zone user). The said goods would be delivered abroad (in the manufacturer domicile) on FOB conditions, being directly imported by the IRAE taxpayer without passing through the free zone territory. In such a case, the GTB states this would be a transaction between a Uruguayan free zone user, with an IRAE taxpayer being subject to the transfer pricing regimen, regardless of the delivery conditions of the goods.

Burden of proof

As a rule, the burden of proof lies with the tax authority (GTB) unless the operations involve countries or regimes of low or nil taxation.

The law presumes that transactions with related parties are made at market values, unless the GTB can provide trustworthy proof that the transactions have not been priced at such values. Conversely, in the case of transactions with countries or regimes of low or nil taxation (either domestic or international), the law presumes that such transactions do not comply with the arm's-length principle and therefore should be adjusted.

However, taking into account the transfer pricing documentation requirements, taxpayers should endeavour to show that their determinations of transfer pricing are consistent with the arm's-length principle, regardless of where the burden of proof lies. In fact, the burden of proof would be transferred to taxpayers.

Tax audit procedures

The GTB launched intense tax audit proceedings, focused within the large taxpayers division.

Although the new regulations on transfer pricing were not applicable until 2007, before that date there were cases in which the GTB set forth its allegations questioning the structures adopted by the taxpayers, on the basis of current regulations on ‘economic substance’. Many of these cases were closed under mutual agreement with the GTB, with the corresponding tax amounts being restored along with related fines and interest charges. In some of the cases, the administration had accepted presentation of the documentation on transfer pricing studies as a form of justifying the pricing policy adopted by the taxpayer in the structures used.

During 2010, the GTB formed a specialist transfer pricing team, which has performed some transfer pricing inspections. The first sectors audited were laboratories and telecommunication enterprises.

Tax audits are carried out by the audit department of the GTB after tax returns are filed. Tax audits are carried out on a sampling basis; therefore, from the taxpayer’s perspective, they are unpredictable. Tax audits start with a formal communication of the inspection. A request for information setting forth a series of questions is delivered to the taxpayer.

As a general rule, the taxes are self-assessed by the taxpayer, but the GTB has far-reaching authority for fiscal investigation and verification. For example, the GTB may require taxpayers to show their books and records, including documentation files and business correspondence, either of their own or kept for third parties; require the taxpayer’s appearance at the administration’s authority to provide information; or perform tax audits of real estate and chattel properties held or occupied by the taxpayer.

The proceedings are in writing, both for the presentations made by the taxpayer and the tax auditor. These are documented in minutes, which should be signed by both parties.

Regarding transfer pricing, it must be noted that the GTB may use the information obtained in its audit as ‘secret comparables’. Expressly, the law states that the tax secrecy rule set in force as a general principle in the tax code will not apply to the information related to third parties that might be necessary for determining the transfer prices, whenever the administration needs to submit such information as proof before the court or in administrative proceedings (*see Resources available to the tax authorities*).

Revised assessments and the appeals procedure

Once the circumstances giving rise to the tax obligation take place, the administration makes its tax assessment through an Act of Determination, which may be appealed by the taxpayer within a term of ten days after the date the respective notification is served.

Uruguay

The resources available for the taxpayer are: the Appeal for Reversal submitted to the GTB, and the Appeal to Executive Authority submitted to the Executive Power (to which the GTB reports).

Should the Executive Power definitively confirm the Act of Determination appealed, or should it fail to issue a pronouncement within a term of 200 days after the date the appeal is presented, the taxpayer may bring an Action for Annulment at the CAM within 60 days after confirmation (either tacit or expressed). The CAM will proceed to confirm or annul the act impugned by means of a verdict, which is definitive in nature.

It is worth mentioning that the CAM is an independent court written in the Constitution of Uruguay, which is competent to judge on the legality of all the acts of the administration.

The actions of filing, performing proceedings and resolving administrative resources submitted to the executive authority and the action for annulment are not subject to prior payment of taxes or related punitive charges.

Additional tax and penalties

Specific penalty provisions for transfer pricing have been established in November 2012.

The implementation of the new legislation in 2012, in force since January 2013, implies aggravation of stipulated penalties for the noncompliance of IRAE taxpayers formal duties, which depending on the seriousness of the breach, may result to be a thousand times the maximum fine for contravention. The current maximum fine for contravention, established in Decree 465/011, is 4,750 Uruguayan pesos (UYU), whereby the maximum amount of fine which the Tax Administration could claim rises to UYU 4,750,000 (approximately USD 240,000). As well as IRAE taxpayers who are required to submit the transfer pricing study, it should be noted that the other subjects included in the transfer pricing regimen are also required to analyse operations achieved, and shall keep their tax receipts justifying the price and comparison criteria used. Therefore, in the light of the new regulation, they should conserve these documents.

Moreover, when a taxpayer is in default, a fine of 20% of the tax underpaid and interest will be charged on such tax underpaid, calculated from the original due date. In some cases, this fine can be reduced. The rates at which this interest accrues are published, but in general they are close to, but higher than, ordinary bank rates.

Examples of more severe sanctions include tax fraud both as an infringement (punished with a fine of between one and 15 times the amount of the fraudulent tax omission or attempted omission) and as a criminal act (subject to an imprisonment penalty of between six months and six years). In both cases, the behaviour subject to punishment is configured by deceit or deceitful concealment with the purpose of creating an undue fiscal benefit.

Any interest or penalties paid are not tax-deductible.

Resources available to the tax authorities

As mentioned above, the administration has broad faculties for investigation and therefore can resort to various sources of information.

Law 18,083 introduces changes on the matter of ‘secrecy of the administration’s proceedings’. The tax code establishes that the tax administration and the staff members reporting thereto are obliged to keep all information resulting from their administrative or judicial proceedings confidential. The secrecy of the proceedings may be lifted only by means of a duly founded resolution of a judge. However, Law 18,083 has changed the secrecy rule for the area of transfer pricing, adding that the secrecy of the proceedings will not be applicable in connection with third-party information that might be necessary for determining the transfer prices when the administration must offer such information as evidence in cases brought to court or administrative jurisdiction.

In conclusion, the administration may use secret comparables as a means of proof for justifying the prices it has determined.

Use and availability of comparable information

Following the OECD Guidelines, the use of comparable information is essential for any analysis concerning the transfer pricing issue. Regarding local financial information, the following rules should be taken into account:

- Enterprises are obliged to file their financial statements with the Registry of the National Internal Audit Bureau only when they show total assets in excess of the equivalent of USD 900,000 at the financial year-end or net operating revenue during that year in excess of the equivalent of USD 3 million. While this information is available for any interested party, its usefulness as comparables is subject to the degree of detail of such information.
- Large taxpayers (classified as such in the large taxpayers division) must submit financial statements accompanying their tax returns. In this case, a full audit report is required.
- In the rest of the cases, financial statements must include a professional report issued by an independent accountant when total assets shown are approximately in excess of the equivalent of USD 300,000.

Law 18.996 enacted on November 2012, empowers the Tax Administration to suspend the annual certificate validity when taxpayers fail to present their financial statements to the National Internal Audit.

This regulation has effect on the transfer price system and its methodologies, as organisations begin to present financial statements to the National Internal Audit and the spectrum of potential comparable companies increase. Accordingly, this enlarges the number of independent companies in the local market enabling their use as comparables.

Risk transactions or industries

There are no transactions or industries that are excluded from the scope of the transfer pricing legislation. Taking into account that if a particular industry or issue has come to the attention of the fiscal auditor, the tax authority is likely to use the

Uruguay

information and experience gained in dealing with one taxpayer in investigating other similar taxpayers.

Limitation of double taxation and competent authority proceedings

The Uruguayan taxation system continues adopting the source principle as the general criteria of taxability empowerment, and therefore does not recognise taxes paid abroad as creditable against taxes in Uruguay.

In order to avoid double taxation on income and on equity, Uruguay has signed agreements with 14 countries, including: Germany, Hungary, Mexico, Spain, Portugal, Finland, Switzerland and Romania. There are other agreements in force yet as they only count with parliamentary approval (Argentina). Moreover, there are treaties signed so as to exchange information with France, Argentina, Norway, Sweden and many others which are under negotiation.

Aligned with the OECD Guidelines, agreements adopt the concept of related parties and the arm's-length principle. These agreements foresee the possibility of establishing mutual agreement procedures between the competent authorities of each country in order to avoid taxation that is not within the scope of the agreement. Notwithstanding the open legal possibility of such agreements, there is no practical experience on this regard.

Advance pricing agreements (APAs)

The APA instrument was introduced by Decree 392/2009 (Article 314 of Law 18996 granted legal status to the APA provisions), which states that the GTB may execute APAs with taxpayers, which must be signed before performing the transactions under analysis and that may not exceed the term of the three following fiscal years from which the APA was signed. The term will be applicable to financial years closing after the year in which this regime becomes in force.

The GTB will establish the conditions and formalities required for subscribing such agreements.

During 2011, the first APA was issued in Uruguay.

Anticipated developments in law and practice

Given the recent approval of the transfer pricing rules, some GTB resolutions are annually published, clarifying some issues.

While the GTB resolutions are issued for internal use, the material is available to the public. These resolutions enable the taxpayer to gain knowledge about the interpretation criteria of the GTB on the current tax legislation.

In a similar way, it is expected that new tax-binding consultations will be published in the near future.

Liaison with customs authorities

Recent experience suggests that exchange of information between GTB and the customs authority does occur. Nevertheless, there is no prescribed approach for the use

of certain information of one area in the other area (e.g. transfer pricing analysis for customs purposes).

OECD issues

Uruguay is not a member of the OECD. Nevertheless, the OECD Guidelines on transfer pricing constitute international points of reference for this subject. Their influence in Uruguay has been significant to the extent that effective from year 2005, the CAM has considered these guidelines as valid directives for quantifying the transactions between related parties.

Law 18,083 does not explicitly mention the adoption of the OECD Guidelines, but the regulations in the law have conceptually followed some of them.

Joint investigations

In theory, Law 18,083 foresees the possibility of carrying out contemporary tax audits with foreign tax authorities, but these appear hardly probable in practice. Joint tax audits are only contemplated for the few states having bilateral agreements signed with Uruguay providing for sharing information between the respective fiscal authorities.

Thin capitalisation

Thin capitalisation is not considered a separate category by Uruguayan internal tax legislation that it is in other legislations. Notwithstanding there are (1) specific regulations on liabilities and interest, (2) specific provisions included in the bilateral agreements; and (3) specific regulations on the treatment of partners' accounts in partnerships and head office accounts in branches, which regulate the subject.

In general, tax legislation allows companies to be financed through equity or debt without restrictions. However, it contains certain rules (as mentioned) that discourage debt financing in some cases, by way of restraining deductible liabilities for capital tax purposes and deductible interest for income tax purposes. Particularly, Law 18,083 states that interest paid abroad will be deductible (subject to the mentioned other rules) provided they are taxable under the income tax on nonresidents or under an effective income taxation imposed abroad. Should they be levied under those taxes at an overall rate of less than the Uruguayan income tax on economic activities rate (i.e. 25%), their deduction for local income tax purposes will be proportional.

Management services

Law 18,083 does not include special regulations on the treatment of management services in the area related to transfer pricing. The methodology proposed by the law, and then defined by the regulatory decree, should be applied to operations of any kind.

Payments abroad for the concept of management services are tax-deductible provided they are taxable under the income tax on nonresidents or under an effective income taxation imposed abroad. Should they be levied under those taxes at an overall rate of less than the Uruguayan income tax on economic activities rate (i.e. 25%), their deduction will be proportional.

77.

Uzbekistan, Republic of

Introduction

As of 1 January 2008 a new edition of the Tax Code (new Tax Code) was introduced, and there were no such provision until an amendment was introduced as of 1 January 2010. As per the current Tax Code, transactions between related parties may be subject to adjustment by the tax authorities. If related parties in their operations use prices different from the prices that would have been used between unrelated entities, the tax authorities have the right to adjust such prices.

Related parties are defined as:

- legal entities registered in Uzbekistan and their foreign shareholders (participants, members)
- foreign legal entities and their Uzbek shareholders (participants, members), and
- legal entities registered in Uzbekistan and legal entities of foreign states that have the same shareholders (participants, members).

However, the effective tax legislation does not provide any further guidance on the application of these rules; therefore, there is currently no standard approach and plenty of disputes between taxpayers and the tax authorities on this matter.

Customs authorities usually challenge taxpayers from a transfer pricing perspective in regard to customs value of imported goods. The customs authorities have their own prices database and regardless of the actual value as per invoices/waybills, they assess the customs payments thereof.

Statutory rules

There is no detailed guidance on transfer pricing in the current Uzbek legislation.

Other regulations

Not applicable.

Legal cases

There are no known legal cases.

Burden of proof

Burden of proof is normally shifted to taxpayers.

Tax audit procedures

There are no separate transfer pricing audits; yet transfer pricing may be reviewed during the normal tax audit by regulators.

Revised assessments and the appeals procedure

Not applicable.

Additional tax and penalties

Not applicable.

Resources available to the tax authorities

Not applicable.

Use and availability of comparable information

There is very limited publicly available information on pricing, except for consumer goods.

Risk transactions or industries

Not applicable.

Limitation of double taxation and competent authority proceedings

Uzbekistan has effective double tax treaties with 48 countries. However, Uzbek tax authorities have limited practice in the application of double tax treaties. There are no known cases of treaty application to transfer pricing issues.

Advance pricing agreements

Not applicable.

Anticipated developments in law and practice

There are no known or expected developments in this area.

Liaison with customs authorities

The customs code contains pricing rules that allow the customs authorities to adjust the declared import or export value of cross-border transactions for customs payment (customs duty, excise and VAT) purposes.

These rules are well described and used in practice. More specifically, they include instruction for how the adjusted price can be determined for customs purposes. The Uzbek customs authorities may use any of six methods available, including the method of data on comparable goods and services.

OECD issues

OECD interpretations are not applied in Uzbekistan because these are not considered as legislative act as per Uzbek tax legislation.

Joint investigations

Not applicable.

Thin capitalisation

Current Uzbek legislation does not provide for any thin capitalisation rules, except for debt-to-equity ratios set up by the Central bank of Uzbekistan (CBU) for commercial banks.

Management services

Due to absence of transfer pricing guidance and practice, pricing of management services is not normally questioned by the tax authorities. However, deductibility of such costs for income tax purposes may be challenged if substance or documentation is questioned.

78.

Venezuela

Introduction

Venezuela experienced significant tax reform in 2001, especially in the area of transfer pricing. The 1994 Edition Venezuelan Master Tax Code (MTC) was amended in October 2001. The 2001 MTC establishes several transfer pricing principles, including penalties relating to noncompliance with transfer pricing regulations, specific rules for transfer pricing audit procedures and the introduction of advance pricing agreements (APAs) to the Venezuelan tax system. Additionally, in December 2001, Venezuela enacted new transfer pricing regulations under the Venezuelan Income Tax Law. The new Venezuelan transfer pricing rules adopt the arm's-length standard for related party transactions, adhere to the Organisation for Economic Co-operation and Development (OECD) Guidelines, eliminate the safe harbor regime established during 1999, impose transfer pricing documentation and filing requirements and contain APA provisions. With the addition of these new transfer pricing rules, Venezuela has taken an important and positive step towards the harmonisation of its tax system with the internationally accepted standards. Moreover, in February 2007, Venezuela introduced thin capitalisation rules to its Income Tax Law.

Statutory rules

The newer transfer pricing rules came into force on 28 December 2001. The provisions are applicable to all fiscal years initiated on or after 1 January 2002. The newer transfer pricing rules are based on the internationally accepted arm's-length standard, and thus eliminate the previous safe harbor approach that specifically aimed at two types of transactions: importing, exporting and analysis of interest conducted by multinationals with their related parties in Venezuela.

Related parties are defined as parties that are directly or indirectly managed, controlled or owned by the same party or group, intermediary agents and any relationship between a Venezuelan taxpayer and entities located in low-tax jurisdictions (i.e. a country included in the list of tax havens). The arm's-length standard applies to all transactions, including transfers of tangible and intangible property, services and financial arrangements.

A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances.

A controlled transaction may be compared to an uncontrolled transaction if that transaction complies with at least one of the following conditions:

- None of the differences, if any, between compared transactions or companies that carry out the compared transactions will materially affect the price or margin in the free market.
- Reasonably accurate adjustments may be made to eliminate the material effects of these differences.

The factors required to determine the differences between controlled and uncontrolled transactions, in accordance with the method used, are the following:

- The characteristics of the transactions.
- The functions or activities, including the assets used and risks assumed in the transactions, of each of the parties involved in the transactions.
- The contractual terms.
- The economic circumstances.
- The business strategies, including those related to the penetration, permanence and expansion of the market.

The transfer pricing methods specified in the Venezuelan Income Tax Law are basically the same as those contained in the OECD Guidelines:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Profit split method.
- Transactional net margin method.

In terms of selection of the method, the Venezuelan Income Tax Law establishes that the taxpayer shall consider the comparable uncontrolled price as the method of first choice. The tax authorities will evaluate whether the method applied by the taxpayer is the most appropriate one given the characteristics of the transaction and the economic activity performed.

In late December 2010, through the Official Gazette N° 39.577, the Venezuelan Tax Administration introduced the procedure for the calculation of the arm's-length range. The procedure confirms the use of the inter-quartile range. Also, the procedure establishes that when the price, margin or amount of the transaction carried out between the taxpayer and foreign related parties is not within the arm's-length range, the taxpayer must adjust the results to the median.

Documentation

Transactions and arrangements with foreign related parties must be reported to the tax authorities through an Informative Return, which must be filed within six months following the end of the fiscal year. This informative return must describe the types of inter-company transactions, the dates on which the transactions were executed, the amounts of each type of transaction, the transfer pricing method applied, and the result of each transaction (i.e. profit or loss). Further appendices require the taxpayer to disclose the profit and loss statement segregated in two columns: related and unrelated parties.

Moreover, the taxpayer must develop and maintain a transfer pricing documentation to support the analyses of its inter-company transactions. The Venezuelan rules

Venezuela

also require an extensive list of formal duties on transfer pricing (background documentation) that includes, among others, the following items:

- An analysis of fixed assets and the commercial and financial risks related to the transaction, including documentation to support the acquisition and use of assets.
- An organisational and functional overview of the taxpayer, including information about the relevant departments and/or divisions, strategic associations and distribution channels.
- Information regarding the foreign related parties, including type of business, main clients and shareholdings in group companies.
- An overview of the controlled transactions, including activities carried out, dates, prices paid or charged and the applicable currency.
- Information on the main activities carried out by each of the relevant group companies as well as data on any changes affecting the group as a whole, such as capital increases or mergers.
- Financial statements for the taxpayer's fiscal year, prepared according to generally accepted accounting principles, including balance sheet, income statement, stockholders equity statement and statement of cash flow.
- Agreements, conventions or treaties entered between the taxpayer and foreign related parties, including agreements related to distribution, sales, credits, guarantees, licenses, know-how, use of trademarks, copyrights, industrial property, cost allocation, research and development, advertising, trusts, stock participation, investments in securities, and other transfers of intangible assets.
- The method or methods used to set the transfer prices, indicating the criteria and objective elements considered to determine the proper application of the selected method.
- Information regarding the operations of the uncontrolled comparable companies.
- Specific information about whether the related parties abroad are or were subject to a transfer pricing audit or if they are involved in procedures by the transfer pricing competent authority or a court. In that case a resolution shall be issued by the competent authorities and a copy of the findings must be filed.
- Information regarding the inventory controls.
- Information related to functional analysis and transfer pricing calculations; and
- Any other information that may be deemed relevant or required by the Tax Administration.

Legal cases

Some transfer pricing cases have been brought to the courts and one of them was resolved with ruling in favor of the Tax Administration. Transfer pricing audits began in February 2005 and have been expanding since then, both in the number of audits performed and in the scope of their requirements. Initially, the National Integrated Customs and Tax Administration Service (SENIAT as per its Spanish Acronym) visited several taxpayers requiring the transfer pricing support documentation detailed above, and the Tax Administration usually gave the taxpayers a three-to five-day period to submit the required information.

In July 2006, the SENIAT conducted the first extensive transfer pricing audit to the local subsidiary of a global Japanese automotive company. The SENIAT explained that the audit procedure was applied to control the transactions among the Venezuelan taxpayer and its foreign related parties, so as to ensure that such transactions were conducted at arm's length. SENIAT, acting under the guidelines of the 'Zero Tax

Evasion Plan', ensured that tax collection in this matter was not reduced as a result of illicit acts.

By the end of 2006, SENIAT's tax audit manager announced the reinforcement of the 'Zero Tax Evasion Plan' regarding transfer pricing audits, changing its previous focus on formal documentation compliance (availability of said documentation) thorough the audit of the arm's-length nature of the inter-company transactions that were detected by SENIAT's computerised system. Moreover, he stated that SENIAT's transfer pricing unit would be expanded and certain tax inspectors would be relocated from the economic studies section to the tax audits management.

Consequently, a few weeks after that announcement, the SENIAT notified the local affiliate of a foreign global oil and gas company that a transfer pricing adjustment of 17.7 million United States dollars (USD) was assessed by the transfer pricing unit using its databases, supporting documentation and analyses. This was the first transfer pricing adjustment in Venezuela, and it is related to certain financial transactions of the Venezuelan taxpayer involved with its foreign related parties. In addition, SENIAT's head officer had warned that the transfer pricing audits were going to be reinforced and would focus on the oil and gas industry.

In April 2007, a local filial company of the foreign oil and gas company accepted part of the transfer pricing adjustment proposed by the SENIAT and paid USD 13.7 million, concluding the first transfer pricing case in Venezuela.

During 2007 and 2008, the audit activity in the oil and gas business and related sectors in Venezuela continued as part of the migration (conversion) from operating agreements and strategic associations of the Orinoco Oil Belt to mixed companies. The main issue in these audits was the transactions carried out with related parties abroad.

Since the beginning of 2009, SENIAT has carried out several transfer pricing audits of taxpayers from several industrial sectors and concluded some audits with adjustments to taxpayers, including the automotive, pharmaceuticals and good-composition companies. Transfer pricing adjustments exceeded USD 25 million in 2009, in which the main issues rejected were tax deductions and the calculation of the arm's-length ranges. Other items reviewed by the Tax Authority within audits included financial segmented information, supports related to services, shut-down costs, restructuring expenses, idle capacity and selection criteria of comparable companies in the application of the transactional net margin method.

In 2010 the Tax Administration continued with audits process and made transfer pricing adjustments to companies in the food and automotive sectors.

In 2011 an important telecommunication company paid USD 45,052 to the Tax Administration after a transfer pricing audit process due to irregularities in the adjustment to the interest rates paid on loans carried out with its headquarter domiciled abroad in 2004.

Additionally, an important automotive company paid USD 1,404,790 to the Tax Administration due to omitted taxes which generated a penalty of 10% plus default interests.

Venezuela

In the last two years and especially in 2012, the tax administration has focused on the verification of formal duties, specifically it has audited those taxpayers, who according to their databases, may be subject to the regime, but have not reported or documented the transactions under such regime.

Burden of proof

The burden of proof lies with the taxpayer. However, a challenge by the SENIAT would require adequate supporting evidence if such challenge is to be accepted by the tax courts.

Any transaction between a Venezuelan taxpayer and an entity located in a low-tax jurisdiction will automatically be presumed to be a transaction with a related party and will also be considered not to take place at arm's length. In such cases, the taxpayer has the burden of proof, and it will be necessary to demonstrate either of the following:

- The counterparty to the transaction was an independent third party.
- If the counterparty to the transaction is a related party, the transaction was carried out at arm's length.

Tax audit procedures

The Master Tax Code (MTC) establishes specific rules for transfer pricing audits:

- When a tax objection is made by the SENIAT during a transfer pricing audit, the taxpayer may either accept the objection and settle with the Tax Administration, or start summary proceedings to defend its position. The taxpayer has more time to submit the defence documents and collect proof than in a regular summary proceeding: five months as opposed to 25 days.
- Within the first 15 days of the summary proceeding, the taxpayer may designate a maximum of two representatives to evaluate the information gathered by SENIAT regarding related party transactions. Such representatives may be replaced once.
- The period for furnishing proof is the same granted to a regular proceeding with SENIAT: a maximum of 30 days. SENIAT has a two-year period to make a decision about the transfer pricing audit once the period of negotiations and information exchange is over.

Tax penalties

The MTC specifies three types of situations where penalties might arise:

- Various noncompliance issues relating to filing and documentation requirements; the most relevant penalty relates to the non-application of the transfer pricing methodology set up in the Venezuelan Income Tax Law.
- The illegitimate reduction of the taxable income because of action or omission of the taxpayer. The penalty ranges from 25% to 200% of the tax omitted.
- Fraud on the part of the taxpayer. This is subject to a jail sentence ranging from six months to seven years. The penalties established on the MTC are summarised in the table opposite.

Use and availability of comparable information

Comparable information is required to support the arm's-length nature of related party transactions and should be included in the taxpayer's transfer pricing documentation.

However, there is lack of reliable public financial information available about Venezuelan companies. Therefore, reliance is placed on foreign comparables.

The SENIAT has the power to use third-party confidential information. The taxpayer has limited access to this data through its two appointed representatives, who are then personally liable and subject to criminal prosecution if the data is disclosed.

Risk transactions or industries

No substantial basis yet exists to identify any particular industrial sector or type of transaction especially sensitive to risk. Nevertheless, the SENIAT is conducting investigations on some taxpayers in sectors that show high profitability or growth such as energy, oilfield services, automotive, pharmaceuticals, consumption goods and financial services, among others.

Advance pricing agreements

The MTC enables the Tax Administration to approve or reject APAs and establishes the formal rules governing the APA application procedure. This procedure includes a list of the various documents that must be provided along with a taxpayer's application.

The taxpayer should present a proposal to the SENIAT for the valuation of one or more transactions, providing evidence that such transactions comply with the arm's-length standard. The proposal should be prepared by the taxpayer and should be based on an accepted transfer pricing methodology. The SENIAT can determine the format of the documents to be provided by the taxpayer in the proposal. The APA proposal can be bilateral in cases involving the territories of tax treaty partners.

The APA process must be concluded by the end of the third year after the year of application. This period may be extended if the APA is being negotiated through a competent authority under a double tax treaty.

Either party may terminate the APA application process if commercial or operational changes occur in the assets, functions or risks of the relevant parties.

The SENIAT may terminate the APA if it concludes that fraud was committed or false information was provided in the APA proposal. The SENIAT may terminate an APA in the event of noncompliance with the agreed terms and conditions. If the SENIAT rejects an APA application, the taxpayer cannot seek any of the administrative solutions included in the MTC and other laws. The only course of action available is to initiate a new APA application.

OECD issues

Although Venezuela is not a member of the OECD, Venezuelan tax authorities have adopted the arm's-length standard and the use of the methodologies endorsed by the OECD Guidelines.

Joint investigations

Joint investigations with the tax authorities of tax treaty partners are possible. Currently, Venezuela has an important network of tax treaties with countries such as Spain, France, Italy, the UK, Germany, the Netherlands, Switzerland, Portugal, Sweden, the Czech Republic, Trinidad and Tobago, Norway, Mexico, and the US,

Venezuela

among others. Most of the Venezuelan tax treaties follow the OECD model and its Guidelines.

Thin capitalisation

On 16 February 2007, the partial amendment of the Venezuelan Income Tax Law included Article 118 to introduce thin capitalisation rules. These rules state that the interest paid directly or indirectly to related parties will be tax-deductible only if the amount of the debts with the related parties (directly or indirectly received) plus the debts with independent parties does not exceed the amount of the taxpayer's equity. This debt-equity ratio of 1:1 is the strictest in Latin America, where most of the countries require a 3:1 ratio.

Moreover, to determine if a debt was received at arm's-length conditions, the tax authorities will consider (1) the level of debt of the taxpayer, (2) the possibility that the taxpayer could have obtained the loan from an independent party without the intervention of a related party, (3) the amount of debt that the taxpayer could have obtained from an independent party without the intervention of a related party, (4) the interest rate that the taxpayer would have obtained from an independent party without the intervention of a related party; and (5) the terms and conditions of the debt that the taxpayer would have obtained from an independent party without the intervention of a related party.

79.

Vietnam

Introduction

Vietnam has been carrying out economic reforms since 1986 under the ‘Doi Moi’ (Renovation) policy, which focuses on market-oriented economic management. This reform has included: (1) restructuring to build a multi-sector economy; (2) financial, monetary and administrative reform; and (3) the development of external economic relations.

One of the most important aspects of economic reform in Vietnam has been the encouragement of domestic and foreign private investment with the introduction of the Law on Foreign Investment in 1987. The first tax law was introduced in the early 1990s. Since then the tax system has been subject to various changes and amendments. The first proper transfer pricing regulations were introduced at the end of 2005 and came into force in 2006.

Below is a summary of the historical evolution of transfer pricing regulations in Vietnam, which reflects not only the Vietnamese competent authorities’ increasing concerns about transfer pricing issues, but also the progress of their awareness thereon.

On 20 October 1997, the Ministry of Finance (MOF) issued Circular 74-TC/TCT which was the earliest legal document to define related parties from a Vietnamese context. However, the applicability of this circular was limited to foreign-invested enterprises. Circular 89/1999/TT-BTC which was issued on 16 July 1999 also provided guidance on the definition of related parties. However, both these circulars did not specifically stipulate the transfer pricing methods to be used or the documentation requirements

MOF issued Circular 13/2001/TT-BTC (Circular 13) on 8 March 2001 to provide guidelines on the implementation of the Law on Corporate Income Tax applicable to foreign-invested enterprises. This circular specified three traditional transfer pricing methods applicable to the determination of the arm’s-length nature of related party transactions as follows:

- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.

However, Circular 13 did not provide detailed guidelines on the application of the statutory methods or guidance on documentation requirements.

The Law on Business Income Tax (the BIT Law) issued in 2003, which came into force on 1 January 2004, requires all transactions between related parties to be conducted at market prices. Pursuant to the BIT Law, the MOF issued Circular 117/2005/TT-

Vietnam

BTC (Circular 117) in 2006 to provide guidelines on related party transactions and disclosure of documents and information thereof. Circular 117 is applicable to cross-border and domestic related party transactions. Besides the requirement for companies to comply with the arm's-length standard, it also requires companies to submit an annual transfer pricing declaration form and maintain contemporaneous transfer pricing documentation as from 2006 onwards. Non-compliance will be subject to a fine of up to 5 million Vietnamese dong (VND).

On 22 April 2010, the MOF issued Circular 66/2010/TT-BTC (Circular 66), replacing Circular 117. Circular 66 came into force on 6 June 2010.

Similar to Circular 117, Circular 66 retained the main compliance requirements (i.e. requiring corporate taxpayers to comply with the arm's-length principle, submission of annual transfer pricing declaration form, and maintaining contemporaneous transfer pricing documentation). However, Circular 66 also introduced several changes which tightened the transfer pricing requirements. For example, the circular clarifies that the median value of an interquartile range will be used to benchmark against companies' margins for the purposes of transfer pricing adjustments, and greater information is required to be disclosed in the annual transfer pricing declaration form (new categories of related party transactions, nature of related party relationships, related party addresses and tax codes are now required).

Statutory rules

At present, Circular 66 is considered the most comprehensive transfer pricing regulation in Vietnam.

From a technical viewpoint, the Vietnamese transfer pricing regulations under Circular 66 are modeled on the Organisation for Economic Co-operation and Development (OECD) Guidelines. Circular 66 adopts the arm's-length principle and the transfer pricing methods set out in the OECD Guidelines.

Scope of application (Part A, Article 1 and 2)

Persons covered

The provisions of Circular 66 are applicable to organisations that are subject to BIT in Vietnam and are carrying out business partly or wholly in Vietnam with related parties.

Transactions covered

Any transaction which is carried out between related parties (e.g. buying, selling, exchanging, leasing, renting, transferring or concession of goods or services) may come under the scope of Circular 66. However, related party transactions involving products whose price is placed under state control are excluded from the scope of the said circular.

Definition of related parties

The definition of related parties in Circular 66 is much broader than that of the OECD Model. First, the threshold of capital participation of 20%, either directly or indirectly, is much lower than that set out in many other countries. However, the definition of related parties goes beyond ownership/control criteria. It also includes significant business relationships between unrelated parties. For example, when a Vietnamese company's sales or purchases from an independent entity exceed 50% of the total sales

or the sum total of cost of raw materials, materials and supplies or input products, these transactions are regarded as related party transactions.

The related party definition also extends to intangible assets/intellectual property and company financing. For example, parties are considered as being related when:

- an enterprise uses intangible assets/intellectual property provided by another party that accounts for more than 50% of its production costs, and
- an enterprise guarantees the other enterprise's loans, or makes a loan to the other enterprise where the loans account for at least 20% of the charter capital of the borrower and more than 50% of the total liabilities of the borrower.

Under Vietnamese transfer pricing regulations, parties with any of the following management or business relationships would also be considered related:

- One party is directly or indirectly engaged in the management, control, contribution of capital to or investment in the other party.
- The parties are directly or indirectly subject to the management, control, capital contribution or investment in all forms by another party.
- The parties directly or indirectly participate in the management, control, capital contribution or investment in another party.
- Two parties have entered into a business cooperation agreement on a contractual basis.

The extension of the related party definition under Circular 66 has rendered many parties, which would otherwise be considered as unrelated, to be classified as related parties for Vietnam transfer pricing purposes.

Similar to the OECD Guidelines, Circular 66 also contains guidelines on the following four key subjects: comparability analysis, transfer pricing methods, selection and application of the most appropriate method, and documentation.

Comparability analysis

Part B, Article 4 of Circular 66 has detailed guidance with respect to the comparability analysis. When comparing a related-party transaction against a comparable unrelated-party transaction, a comparability analysis must be carried out and adjustments made (if necessary) to the following four main influential factors:

- Product property/characteristics.
- Operational functions.
- Contractual terms.
- Economic terms in which the transactions take place.

The priority given to each of the above factors in the comparability analysis varies depending on the most appropriate transfer pricing method selected. Under the comparability analysis, the factors that are considered to be the main influential factors need to be analysed in detail, while the auxiliary factors should be analysed only at a high level.

Vietnam

Transfer pricing methods

Part B, Article 5 of Circular 66 sets out five transfer pricing methods to be used for determining the arm's-length price. These methods are similar of the transfer pricing methods specified in the OECD Guidelines which are as follows:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus (CP) method.
- Comparable profit method (CPM).
- Profit split method (PSM).

Furthermore, the Vietnamese transfer pricing regulations recommend that preference be given to the comparison of the transfer price or profit margin of transactions with related parties against those with unrelated parties of the same taxpayer (internal method).

Documentation

Vietnamese taxpayers are required to record and maintain contemporaneous documentation, and to submit that documentation to the tax authorities within 30 days upon their request. Transfer pricing documentation under Circular 66 should include:

- General information on the business establishment and related parties.
- The business establishment's transactions.
- The methods of calculation of arm's-length prices.

The taxpayer is required to use data of at least three continuous fiscal years for benchmarking purposes where transfer pricing methods involve the use of profit margins.

Further, at year-end, taxpayers are required to disclose related-party transactions via a transfer pricing declaration form (i.e. form GCN-01/QLT), which is submitted together with the annual BIT return which is filed within 90 days of the end of a taxpayer's financial year end.

Other regulations

In addition to Circular 66, which specifies transfer pricing for tax purposes, the following regulations promulgated by the MOF are also relevant to transfer pricing issues:

In December 2003 the MOF issued a number of Vietnamese Accounting Standards (VAS) including Standard No. 26 'Related-Party Disclosures' which sets out general guidelines on the accounting principles and treatment in the financial statements for related-party disclosures and transactions between a reporting enterprise and its related parties.

This accounting standard provides a definition of related parties, outlines possible related-party transactions and their influences, and specifies required disclosures with regard to related-party transactions. Standard No. 26 also provides guidelines on the determination of price for transactions between related parties (i.e. the CUP method, the RPM and the CP method).

On 16 March 2007, the government also issued Decree 40/2007/ND-CP which provides guidelines on the customs valuation for import duties in the case where buyers and suppliers are considered related parties with respect to capital participation, management, business relationships and family relationships.

Based on this regulation, where the buyer and the supplier are considered to be related parties, the Customs Office uses the following methods to determine the taxable price of goods:

- Transaction value method with identical goods: Comparison with the price of identical goods imported into Vietnam within 60 days before or after the date of delivery.
- Transaction value method with similar goods: Comparison with the price of similar goods imported into Vietnam within 60 days before or after the date of delivery.
- Deductive value method: Calculation of the price of imported goods based on the resale price of similar products after the deduction of reasonable expenses.
- Computed value method: Calculation of the price of imported goods based on material costs, production expenses and profits.
- Fall-back method: Combined or modified version of the above methods.

Legal cases

No legal cases concerning transfer pricing have been decided by the courts to date. Any cases involving disputes on transfer pricing issues have so far been settled out of court and the details have not been published. In order to set examples, it is anticipated that the tax authorities could bring cases involving abuses of transfer pricing to the courts in the future.

Burden of proof

In accordance with prevailing regulations in relation to transfer pricing and tax administration, the taxpayer is obliged to satisfy the burden of proof by:

- disclosing related-party transactions on a transfer pricing declaration form accompanied by the annual BIT return, and
- documenting and reporting information/evidence regarding related-party transactions and the relevant related parties in a transfer pricing documentation demonstrating that the related-party transactions are consistent with the arm's-length principle set out in the transfer pricing regulations.

The record keeping and documentation requirements under Circular 66 are onerous. The taxpayer is required to submit transfer pricing documentation within 30 days from the date of the request. A one-time extension of another 30 days may be accepted if it is considered reasonable.

Tax audit procedures

In accordance with prevailing tax administrative regulations under Circular No. 60/2007/TT-BTC issued by the MOF on 14 June 2007, a tax audit can be conducted at the tax office or at the taxpayer's premises. Based on the result of the tax audit at the tax office, the tax authorities may decide to conduct a tax audit at the taxpayer's premises and will then issue the audit decision to the relevant taxpayer.

Vietnam

Tax audit procedure at the tax office (desk review)

Tax officials examine the tax declaration dossier filed by the taxpayer to verify whether the tax amount assessed and declared by the taxpayer is appropriate based on a comparison with relevant data available to the tax authorities. In the case of an abnormality in the declared tax amount or missing information which could point to tax evasion or the underdeclaration of taxes, the relevant taxpayer is required to provide an explanation and additional information/evidence within ten days from the date of receipt of the authorities' first request. If further information is still required by the tax authorities, the taxpayer has five days from the date of receipt of the second request of the tax authorities to provide information to justify his/her tax liability assessed and declared in the tax return.

After the second request, if the taxpayer fails to justify the appropriateness of his/her tax liability declared either with or without additional information/explanation, the tax authorities are entitled to:

- Assess the tax liability of the taxpayer in question based on the information/data available to the tax authorities.
- Issue a decision to carry out a tax audit at that taxpayer's premises if the information/data available to the tax authorities is not considered adequate to issue an assessment of the tax liability as above.

Tax audit procedure at taxpayer's premises

The execution of the tax audit must be carried out within 10 working days from the date of the issuance of the decision to perform a tax audit at the taxpayer's premises. However, the decision on such a tax audit shall be cancelled if, before the tax audit starts, the taxpayer can justify the appropriateness of the declared tax liability or accepts and pays the tax amount assessed by the tax authorities.

The duration of a tax audit at a taxpayer's premises should not exceed five working days. A one-time extension of another five days is permissible if necessary.

At the end of a tax audit, a report must be issued describing the findings and conclusions of the tax auditor team. The taxpayer has the right to make a formal objection to the conclusion of the tax audit team.

If the result of the tax audit raises concerns on potential tax evasion or fraud, the case is reported to the head of the relevant tax authority for further investigation and/or inspection.

Tax inspection

In practice, tax inspections are normally conducted on the basis of an annual plan developed by the tax authorities, except where there are signs of tax evasion and/or fraud, for the purpose of resolving appeals, or at the request of the heads of tax administration bodies at all levels or by the Minister of Finance. A taxpayer can be subject to tax inspection not more than once per year.

Where the tax law has been infringed, a tax inspection can be conducted only if the tax authorities have evidence of tax underpayment, tax evasion, or tax fraud.

A decision on tax inspection has to be communicated to the taxpayer within 15 days from the date of issuance. The duration of a tax inspection cannot exceed 30 days. A one-time extension of another 30 days may be permitted under certain conditions.

At the end of a tax inspection, a report must be issued to document the findings, including the opinion of each inspection team member. The taxpayer has the right to make a formal objection to the inspection team's observations.

Within 15 working days from the date of receipt of the inspection report, the head of the relevant tax authority must issue a letter specifying the result of the tax inspection. If the taxpayer still disagrees with the conclusion of the tax authorities, he/she can file an appeal following the procedure stipulated in the law on appeals.

As there is no audit procedure set out specifically for transfer pricing, a transfer pricing audit could be implemented separately or in conjunction with a tax audit adopting the said procedures. The tax authorities have increased their focus on transfer pricing by undertaking the following initiatives:

- Companies with related party transactions and loss making companies are likely to be targeted for audits.
- Increasing number of transfer pricing queries raised during normal tax audits.
- Compilation of a target list for transfer pricing audits, comprising both multinational enterprises and local companies that generate consecutive losses.
- Carry out desk reviews and focus on factual analysis.
- Request for transfer pricing declaration forms and transfer pricing documentation from taxpayers.

On 21 May 2012 the MOF released guidance on action plans concerning transfer pricing for the period 2012 to 2015 via issuance of Decision 1250 / QD – BTC. The General Department of Taxation (GDT) will primarily be responsible for implementation of the transfer pricing action plan.

Such action plans are not intended to create an aggressive transfer pricing/tax regime for inbound investments but focuses on transfer pricing audits and 'abusive' transfer pricing practices. Under the action plan, the focus is on five key elements:

1. Transfer pricing audits in 20% of annual tax audits / inspections at both the central and provincial levels, with a transfer pricing audit manual to be developed:

Under the said Decision, at least 20% of annual tax audits / inspections at both central and provincial levels will be carried out for transfer pricing purposes. In conjunction with such efforts, a formal transfer pricing audit manual will also be developed.

In addition audits will likely be carried out on companies with significant related parties or those which carry out transactions deemed high transfer pricing risks.

2. Enhance transfer pricing regulations by introducing specific guidance on managing abusive transfer pricing practices:

GDT will introduce specific guidance on management of abusive transfer pricing practices. As such, the requirements of taxpayers' statutory transfer pricing disclosures will also be increased.

Vietnam

3. Enhance capacity of transfer pricing auditors, by building on practical audit experience and international practices:

To set up specialised transfer pricing task force team at the GDT. Such efforts will also be replicated at provincial level.

4. Creation of a database of companies operating in 'high' transfer pricing risk sectors and of prices for certain products:

A database comprising of both secret comparables (to be collected internally within the revenue authorities and from different ministries) and external sources (including independent databases and foreign tax authorities via an exchange of information) will be set up by the GDT.

5. Coordination among government ministries and international cooperation with foreign tax authorities:

Enhance exchange of information and technical capabilities for implementation of Agreement for the Avoidance of Double Taxation and Prevention of Fiscal Evasion among government ministries and foreign tax authorities for the purpose of transfer pricing management.

Other initiatives include educating taxpayers in respect of transfer pricing compliance. Tax officers will also be educated on identifying and analysing transfer pricing abuses by taxpayers.

Revised assessments and the appeals procedure

In the event that the taxpayer considers the administrative action taken by the tax official or the decision issued by the tax authorities (e.g. in relation to tax liability, tax reimbursement, tax exemption/reduction, including the conclusion of the tax audit) is a breach of the taxpayer's rights, the taxpayer is entitled to file an appeal against this decision.

To resolve appeals the authorities follow the administrative hierarchical order from the local office to the MOF. The head of each hierarchical body is responsible for resolving the appeal against the administrative decision issued by his/her office and/or action taken by his/her staff or by him/her.

The appeals procedure is the same as that of the general laws on appeals. In practice, where the taxpayer disagrees with the conclusion of the tax inspection of the competent authorities, including the MOF, the taxpayer can file an appeal in the administrative court against the conclusion in question. However, there is no tax court in Vietnam.

Additional tax and penalties

Currently, no specific penalty is provided for in the transfer pricing regulations under Circular 66. However, tax authorities have the right to assess and make appropriate adjustment, as the case may be, to the transfer price, taxable income or tax amount payable where they have evidence that the taxpayer has committed tax evasion or fraud by manipulating transfer prices with related parties. In this case, the adjustment to be made is established by transfer prices or profit margins established by unrelated parties. The value of transfer prices or profit margins used for tax authorities' assessment is not to be lower than the median of the arm's-length range.

Further, in accordance with the Law on Tax Administration and its implementing guidelines, noncompliance subjects the taxpayer to the following categories of penalty:

- Non compliance with tax filing procedures and/or submission of incomplete returns could be subject to a penalty of up to VND 5 million.
- Late payment of tax is subject to interest of 0.05% per day of the outstanding tax amount.
- Underreporting of tax liabilities could be subject to a penalty of up to 10% of the underpaid amount, regardless of whether the taxpayer keeps all related supporting documents and presents them to the tax authorities upon request.
- Tax evasion could be subject to a penalty of up to three times the outstanding tax liability.

Resources available to the tax authorities

The various departments within the GDT that are presently handling transfer pricing matters are the Policy, Tax Reform and Modernisation department), the Inspectorate (i.e. Inspection department) and the International Cooperation (i.e. the International Taxation department).

The Inspectorate department within the GDT, along with the provincial tax departments, carries out transfer pricing audits as part of the general tax audits. In an attempt to reinforce transfer pricing audit capacity at the provincial level, the GDT has recently organised transfer pricing audit trainings for tax officials.

At the local level, each provincial tax department has a number of transfer pricing specialists who are responsible for information gathering and reporting transfer pricing compliance periodically to the GDT in addition to participating in transfer pricing audits conducted by the GDT team.

In addition to the sponsorship by international organisations, the Vietnamese tax authorities also receive support from other tax authorities in the region to build capacity internally as well as educating the public on the transfer pricing regulations.

Use and availability of comparable information

The Vietnamese transfer pricing regulations state that only the databases recognised formally by the government are acceptable to be used for benchmarking purposes. However, to date no such recognised databases that are available in Vietnam are suitable to use for benchmarking purposes. Currently in performing a comparability search, companies rely on Asia-Pacific regional comparable companies as a comparative benchmark.

Over the last couple of years, the Vietnamese tax authorities have gathered information on financial information of companies in order to establish its own database of comparable information. Once it is ready, this database will be used for tax assessment by the tax authorities.

Risk transactions or industries

Formally, no industry or transactions are classified as particularly high risk from the transfer pricing audit or investigation perspective. However, companies producing high-value goods and having significant related party transactions, such as in automobile and motorbike manufacturing and related parts manufacturing, would

Vietnam

likely be a high-risk industry. In practice, a company which posts continuous losses (e.g. for three continuous years) and/or large companies with significant related-party transactions are likely to be challenged by the tax authorities, in particular where the company carries out business with related parties located in a tax haven/harbour.

Limitation of double taxation and competent authority proceedings

Vietnam has more than 60 DTAs concluded with other countries and territorial areas. Most DTAs contain an 'Associated Enterprise' Article modeled on the OECD convention. However, a large number of DTAs exclude the provision which permits the respective tax authorities to adjust the profit of an entity where the transaction is judged not to be at arm's length (paragraph 2 of Article 9 of the OECD convention model). On the other hand, a number of DTAs include the previously mentioned provision but exclude the accompanying provisions in the article requiring one contracting country to reduce the amount of tax charged to offset the increased tax liability imposed by the other contracting country as a result of the arm's-length adjustment. Currently, there is no set procedure laid out for the initiation of an Mutual Agreement Procedure in event of double taxation as a result of transfer pricing adjustment or otherwise.

Advance pricing agreements (APAs)

Currently, there is no provision for APAs in the Vietnam Tax Legislation. The amendment to the law on tax administration is expected to include provisions that will serve as a legal basis for the application of APAs in Vietnam. The MOF is launching a pilot APA program to enter into bilateral APAs with a few large foreign investment companies operating in Vietnam in order for MOF to gain practical experience and form a basis in adopting appropriate approaches, before promulgating the formal APA regulations.

Anticipated developments in law and practice

Subsequent to the issuance of the first transfer pricing circular (Circular 117), the tax authorities have become more aware of the importance of transfer pricing issues and have attempted to improve transfer pricing compliance management by improving transfer pricing knowledge and auditing skill of tax inspectors, and by amending the transfer pricing regulations, such as the issuance of Circular 66 in April 2010.

Liaison with customs authorities

In 2002 the customs authorities (the GDC) were merged into the MOF. As a result, the cooperation between the GDT and the GDC has improved significantly. To date, each taxpayer is assigned a unique tax identification number (TIN) which is used for both domestic tax and customs duty declaration.

The GDT and GDC are now working to improve information exchange. The objective of the project is for taxpayers' information to be exchanged automatically on a regular basis between the GDT and the GDC.

OECD issues

Vietnam is not a member of the OECD. However, the Vietnamese transfer pricing regulations has adopted the arm's-length principle and the transfer pricing methodologies endorsed by the OECD Guidelines. However, the OECD Guidelines are not formally referred to in the Vietnamese transfer pricing regulations. Also, a

transfer pricing policy that is acceptable in an OECD country will not necessarily be accepted in Vietnam (e.g. besides the absence of an APA mechanism as mentioned above, the Vietnamese transfer pricing regulations do not adopt safe harbour principles recommended in the OECD Guidelines).

Joint investigations

So far, no joint investigations have been undertaken by the Vietnamese tax authorities in conjunction with other tax authorities. However, in accordance with the provision of the exchange of information of the DTAs, the GDT has actively participated in information exchange with other tax authorities.

Thin capitalisation

The arm's-length principle applies to loans and interest charges. However, at present, there are no rules dealing specifically with thin capitalisation and no set permissible debt-to-equity ratios.

Appendix 1.

Functional analysis questions

This appendix sets out a list of generic questions which might be used in performing a functional analysis of a business to understand its various functions, risks and intangibles. The list is not intended to be exhaustive and would need to be tailored to suit the needs of specific business entities.

Functions Analysis

Manufacturing

- a. Material purchasing
 1. What materials or partly finished goods are purchased?
 2. From whom are purchases made?
 3. Are any purchases made from related companies?
 4. Where and how are raw materials purchased?
 5. Who performs the purchasing function?
 6. Who plans purchasing schedules?
 7. Who negotiates purchasing arrangements?
 8. Who approves the vendor as being of acceptable quality?
 9. Do purchasing decisions require head office approval?
 10. What are the approvals required?
 11. Are any purchases made on consignment?
 12. What are your major risks?
- b. Inventory
 1. Where is stock held?
 2. Who controls the levels of inventory?
 3. How are inventory levels controlled? Is there a computer system?
 4. Are any purchases made on consignment?
 5. How many days of inventory are on hand?
 6. Has there ever been a case, for whatever reason, where you were stuck with excess inventory? Who bears the cost of obsolete inventory?
 7. What are your major risks?
- c. Production equipment
 1. Who determines the purchasing budget?
 2. Who negotiates purchasing?
 3. Who maintains the plant?
 4. Who has expenditure authority for capital equipment?
 5. Who writes specifications for the plant?
 6. From whom is production equipment purchased?
 7. Are any purchases made from related companies?
 8. Do you have discretion over the equipment used? Can you modify the equipment?

Functional analysis questions

9. What decisions require head office approval?
 10. What are the approvals required?
- d. Production scheduling
1. Who is responsible for production scheduling decisions? What factors enter the decisions? When are the decisions made?
 2. Is a computer system used?
 3. What decisions require head office approval?
 4. What are the approvals required?
 5. What are your major risks?
 6. Does your distributor always buy what you manufacture?
- e. Manufacturing and process engineering
1. What products are produced?
 2. Who designed the products and who owns the technology?
 3. What is the manufacturing process?
 4. Who developed the original process? Have any improvements been made locally?
 5. Is it possible to compare productivity between the subsidiaries in the group?
 6. Have you ever utilised a third party to produce your products?
- f. Packaging and labelling
1. What packaging and labelling is done? Where is it done?
 2. Who makes the decisions in relation to packaging and labelling? Have you complete autonomy in relation to such decisions?
- g. Quality control
1. What form does quality control take?
 2. Who sets finished product quality standards and procedures?
 3. Who performs the quality control and who bears the cost?
 4. Who provides the equipment and techniques for quality control?
 5. How much product is lost because it fails quality control checks?
 6. What are your major risks?
 7. What decisions require head office approval?
 8. What are the approvals required?
- h. Shipping of products
1. Who pays freight charges for product in and out?
 2. Who arranges shipping of products?
 3. Who ships your products? To where? How?
 4. Who is responsible for the selection of shippers?
 5. Who is responsible for shipping deadlines?
 6. What are your major risks?
 7. What decisions require head office approval?
 8. What are the approvals required?

Research and development

- a. What research and development do you carry out?
- b. Is any research and development carried out on your behalf by related companies?
- c. Do you commission third parties to carry out research and development on your behalf?
- d. Where are products designed?
- e. What input do distributors have on manufacturing, product design, or product modifications?
- f. How important is the development of patents in the industry?
- g. What patents do you own that create unique products that competitors cannot duplicate?
- h. What unpatented technical know-how have you developed that might differentiate your products from competitors, create important cost efficiencies, or give you an advantage in increasing your market share?
- i. What decisions require corporate head office approval?
- j. What are the approvals required?
- k. Who formulates the budget?
- l. Are licence agreements in existence between you and related companies or third parties?
- m. Is there a cost sharing agreement in force and if so, what are the details?

Marketing

- a. Strategic
 1. Do you carry out your own marketing?
 2. Are market surveys performed? Do you monitor market demand?
 3. What decisions require head office approval?
 4. What are the approvals required?
 5. Who are your competitors?
 6. Who assesses demand in foreign markets?
 7. What are the risks related to demand for your products?
 8. Who formulates the marketing budget?
 9. Does your distributor always buy what your manufacturer produces?
 10. Has your manufacturer ever refused to fill an order?
 11. Do related companies carry out marketing on your behalf?
 12. Are third party distributors used?
 13. Who chooses, authorises and controls third party distributors?
- b. Advertising, trade shows, etc
 1. What forms of marketing do you utilise?
 2. What form of advertising is used? Who pays for it?
 3. Are trade shows used and if so, who organises them and who pays for them?
 4. Are samples provided to distributors? Who bears the costs?
 5. Who produces product brochures, specifications sheets, etc?
 6. What marketing assistance do you receive?
 7. What decisions require head office approval?
 8. What are the approvals required?

Functional analysis questions

Sales and distribution

a. Sales

1. How are sales made and who is involved?
2. Who issues the invoice to the customer?
3. Who issues the invoice to you?
4. Who formulates the projections and sets targets?
5. Where are sales orders received?
6. Who is responsible for the achievement of sales targets?
7. Who negotiates sales contracts? Do they operate autonomously?
8. Does your distributor always buy what your manufacturer produces?
9. How much is sold to related companies?
10. Are only finished goods shipped from here?
11. Who are your competitors?
12. What are the risks related to demand for your products?
13. What decisions require corporate head office approval?
14. What are the approvals required?
15. Are products exported? If so, who is responsible for the export function?
16. What are the major risks in selling products in foreign countries?

b. Quality control

1. What form does quality control take?
2. Who sets finished product quality standards and procedures?
3. Who performs quality control and who bears the cost?
4. Who provides the equipment and techniques for quality control?
5. How much product is rejected by customers as below standard?
6. Who bears the loss on defective products?
7. What are your major risks?
8. What decisions require head office approval?
9. What are the approvals required?

c. Freight

1. Who pays freight charges for product in and out?
2. Who arranges shipping of products?
3. Who ships your products? To where? How?
4. Who is responsible for the selection of shippers?
5. Who is responsible for shipping deadlines?
6. What are your major risks?
7. What decisions require head office approval?
8. What are the approvals required?

d. Inventory

1. Do you actually receive the goods and hold stock?
2. Where is stock held?
3. Who controls the levels of inventory?
4. How are inventory levels controlled? Is there a computer system?
5. Are any purchases made on consignment?
6. How many days of inventory are on hand?
7. Has there ever been a case, for whatever reason, where you were stuck with excess inventory?
8. Who bears the cost of obsolete inventory?
9. What are your major risks?

- e. Installation and after-sales services
 1. Do you install your products?
 2. Do you provide after-sales service? If so, describe the service.
 3. Are product repairs carried out by any company and who bears the cost?
 4. Who bears the cost of installation and after-sales service?
 5. Do you provide product guarantees?
 6. Who bears warranty costs?

Administration and other services

- a. General administration
 1. Is there a complete administration function?
 2. Is any administration performed for you by related companies?
 3. What decisions require corporate head office approval?
 4. What are the approvals required?
 5. Who is responsible for administrative codes of practice?
- b. Pricing policy
 1. Who determines the product pricing?
 2. What is the pricing policy for the various goods and services?
 3. What are your major risks?
 4. What decisions require corporate head office approval?
 5. What are the approvals required?
- c. Accounting
 1. What accounting functions are carried out? By whom?
 2. Where are the financial reports prepared?
 3. What decisions require head office approval?
 4. What are the approvals required?
 5. Is a bank account maintained? For what purpose?
 6. Who has cheque signatory authority? What are the authority limits?
 7. Do you bear the credit risk on sales to customers?
 8. Who pays product liability insurance premiums?
 9. Who arranges and pays for other insurance?
- d. Legal
 1. Who is responsible for legal matters?
 2. What decisions require head office approval?
 3. What are the approvals required?
- e. Computer processing
 1. Is computer processing and programming done here? If not, by whom?
 2. Who developed the software and is any charge made for it?
 3. Who has expenditure authority for capital equipment?
 4. What decisions require head office approval?
 5. What are the approvals required?
- f. Finance/loans/credit
 1. Are there any inter-company loans or long-term receivables and if so, is interest charged?
 2. What trade credit terms are received and given?
 3. Is interest paid or charged if credit periods are exceeded?

Functional analysis questions

4. Who is responsible for borrowing requirements?
 5. What are your major risks?
 6. What decisions require head office approval?
 7. What are the approvals required?
- g. Personnel
1. Are there any secondments to or from overseas affiliates? What positions do they hold in the company?
 2. What training do you provide to your employees?
 3. What is the length of the training period?
 4. Is there on-the-job training?
 5. Where is management training done?
 6. What is the staff turnover rate?
 7. Are all employees on your payroll?
 8. Who is responsible for the employment of staff?
 9. What decisions require head office approval?
 10. What are the approvals required?
- h. Use of property/leasing
1. Is property owned or leased from affiliates?
 2. Do you lease property to affiliates?
 3. Who is responsible for this function?

Executive

- a. Does anyone report to the parent company besides the general manager?
- b. Who is responsible for dealing with government agencies?
- c. What are the key regulatory requirements?
- d. Has the parent ever told you to use more procedures than you have developed?
- e. How does manufacturing site selection occur?
- f. Where does the initial impetus in relation to corporate decisions come from?
- g. What decisions require head office approval?
- h. What are the approvals required?

Risk Analysis

Market risk

1. What are the market risks?
2. Do you bear the market risks?
3. How significant are the market risks?

Market risk

1. Does inventory become obsolete?
2. Who bears the cost of obsolete inventory?
3. Do you provide warranties in relation to finished goods?
4. Who bears the cost of returns/repairs under warranty?

Credit and bad debt risk

1. What credit terms are given and received?
2. Do you bear the cost of bad debts?
3. Is this a significant risk?

Foreign exchange risk

1. Are you exposed to foreign exchange risk?
2. How significant is the risk?

Intangible Analysis**Manufacturing**

- a. Research and development
 1. Have you developed your own products?
 2. Have you developed manufacturing processes?
 3. How important are these processes to your business? Are they unique?
- b. Manufacturing processing/technological know-how
 1. Do you possess technological know-how?
 2. If so, what is its nature?
 3. How important to your business is the know-how?
 4. Is the know-how unique?
- c. Trademarks/patents, etc
 1. Do you own any trademarks/patents?
 2. How significant are their existence to your business?
- d. Product quality
 1. Do you consider that you have a reputation for high quality?
- e. Other
 1. Are there any other manufacturing intangibles?

Marketing

- a. Trademarks/trade names
 1. Do you own any trademarks/trade names?
 2. Do you pay royalties for the use of any trademarks/trade names?
 3. Do you charge royalties for others to use trademarks/trade names that you own?
 4. How significant are they to your business?
- b. Corporate reputation
 1. Do you consider that you have a corporate reputation?
 2. What is the nature of this reputation?
 3. Is corporate reputation significant in your business?
- c. Developed marketing organisation
 1. Do you have a developed marketing organisation?
- d. Ability to provide service to customers
 1. Do you consider that you provide good service to customers?
- e. Product quality
 1. Do you consider that you have a reputation for high quality?
- f. Other
 1. Are there any other marketing techniques?

Appendix 2.

Examples of databases for use in identifying comparative information

The range of easily accessible information is increasing at a very rapid pace, driven by technological change. Vast quantities of data can be obtained on CD-ROM and DVD, an example being the AMADEUS database of information on European companies. Beyond that, the internet allows the researcher direct access to any information placed in the public domain, either by individual companies or by commercial information providers that make a charge for accessing their databases. These databases are changing day by day but many are built from 'traditional' sources, including some of those listed below.

US

Annual Report and SEC Filings and Forms (EDGAR)
Dun and Bradstreet's Hoover's (North America)
Standard and Poor's Compustat North America and Global Vantage
Thomson's Financial/Disclosure SEC and Worldscope

Pan-European

Dun and Bradstreet's Who Owns Whom (Europe) Europe Top 15,000
Fortune Top 500 (Non-US) Industrials Forbes Top 500 Foreign Companies Extel
Kompass Europe
Moody's International Manuals Directory

Each European country also has individual databases – as an example, the major UK databases are listed below.

UK

Companies House
Stock Exchange Official Year Book
Dun and Bradstreet's Who Owns Whom (UK)
FT Supplement Top Companies
UK's Top 10,000 Companies
'Business' 1,000
McMillan's Unquoted Companies
Jordan's Top 4,000 Privately Owned Companies
Kompass
Extel
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Experian Bureau van Dijk – Fame

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