

Transfer Pricing Perspectives

Asian Edition



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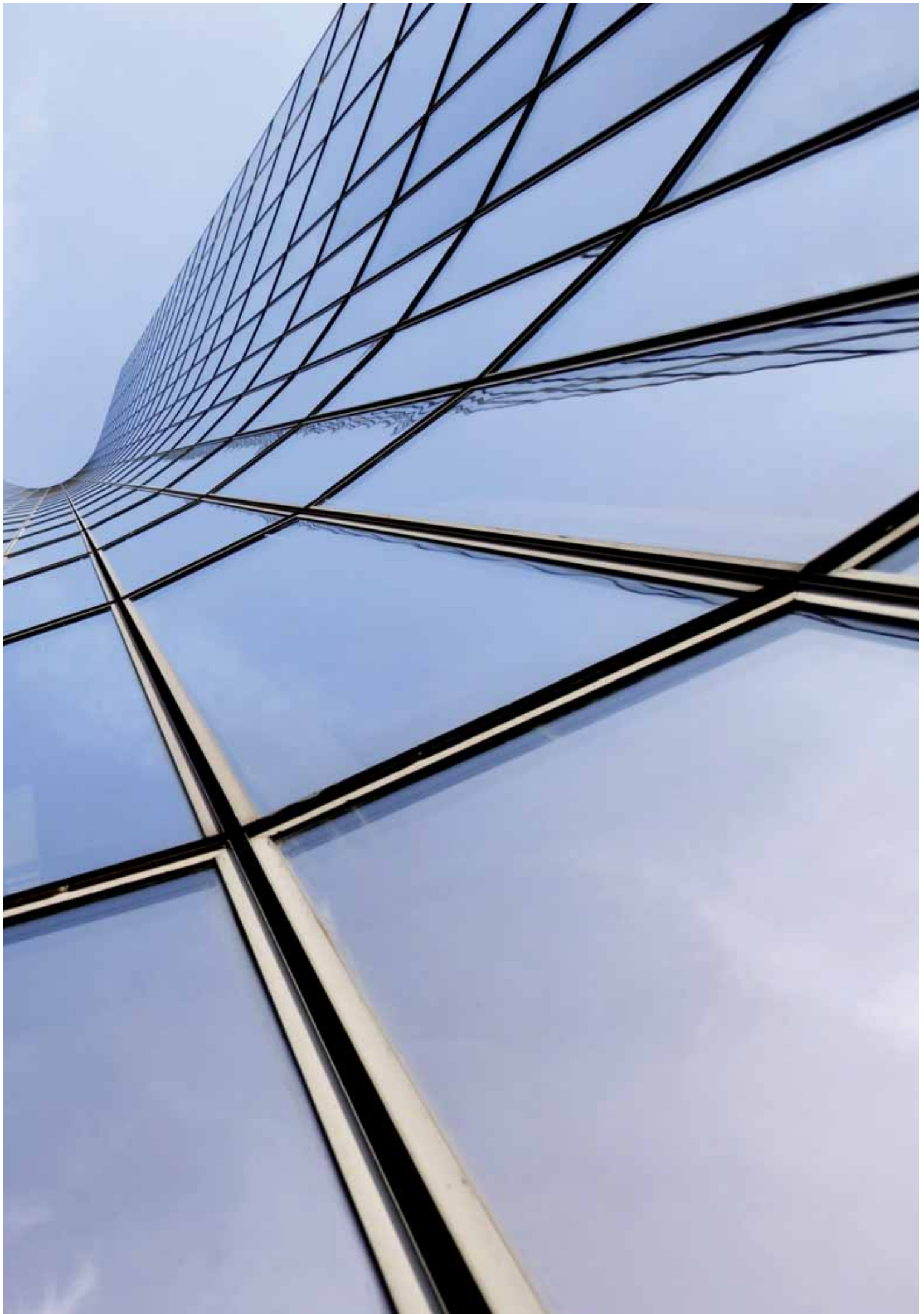
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Transfer Pricing

Transfer Pricing is a multidisciplinary practice that involves close cooperation between subject matter experts in economic analysis, tax law and accounting. Our global network of dedicated transfer pricing professionals assist multi-jurisdictional companies with determining intercompany prices in accordance with the arm's length standard. Intercompany pricing is applicable to companies conducting both international and domestic intercompany transactions. PwC's Transfer Pricing services include helping companies understand and assess the tax impact of business operations and transactions in multiple jurisdictions, allocate taxable profits to jurisdictions in accordance with tax jurisdiction regulations, understand the economic substance of the transactions and the arm's length standard, and document and defend these positions.

Regional overview

by Helen Fazzino



Dear Reader,

Welcome to the 2007 Asian edition of *Transfer Pricing Perspectives*. Through this publication we aim to provide you with up to date information about transfer pricing planning, compliance and strategy. In this edition, we focus on the latest transfer pricing developments in the Asia Pacific region.

It is of course no news to readers that the Asian region is now a key driver of the global economy. Countries such as China and India have become economic powerhouses not only in a booming export market, but also to satisfy the explosion of demand in their own domestic markets. As Multinational Corporations (MNCs) continue to establish themselves throughout the region, and develop strategic footholds, local tax authorities are looking to meet the challenges that ever increasing cross border trade poses to the local tax base. Development of effective transfer pricing rules and enforcement capability is now at the forefront of the international tax agenda for revenue authorities.

MNCs are starting to consider Asia Pacific wide strategies to manage transfer pricing exposures and to implement tax efficient structures. However they quickly discover that Asia is far from a homogeneous region in many respects, including transfer pricing.

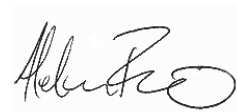
Tax authorities across Asia Pacific are at varying stages in the development of their transfer pricing administrations. Some, like Japan, Korea, Australia and New Zealand, long ago established local transfer pricing guidelines, have rolled out a program of taxpayer education, and have been effective in enforcing compliance with the arm's length principle. While reviews and audits focussing on 'traditional' transfer pricing issues, such as manufacturing and distribution, are still a day-to-day proposition in these jurisdictions, tax authorities are now turning their attention to more complex matters such as:

- business restructuring, with particular focus on economic or commercial rationale
- permanent establishments
- identification and exploitation of intellectual property, and
- financing structures, including guarantee fees.

We are also witnessing a significant level of training, knowledge transfer and general sharing of information from jurisdictions with significant transfer pricing experience to those such as China, Indonesia, Malaysia, Thailand and Taiwan, which are fast developing local tax infrastructures, (including transfer pricing compliance and Advance Pricing Agreement programs), to ensure they protect their share of the global tax base. The extent to which countries such as China and India are investing resources into their transfer pricing administrations clearly indicates their perception that transfer pricing is an area of considerable risk and opportunity for improved compliance.

The region continues to provide many challenges for MNCs, and transfer pricing is no exception. Tax authorities throughout the region currently have different interpretations and approaches on various transfer pricing matters which must be taken into account. In the medium to longer term however, increased communication and information sharing amongst tax authorities in the region is expected to bring a degree of harmonisation through Asia. Against this backdrop, best practice demands the adoption of a regional approach to transfer pricing policies and documentation whilst recognising and respecting the need for some differences or variations as dictated by some local country requirements.

We trust that this Asian edition of *Transfer Pricing Perspectives* helps you understand the emerging issues across the rapidly changing Asia Pacific region, and in turn assists in managing your organisation's transfer pricing strategies.



Helen Fazzino
Transfer Pricing Leader – Asia

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Business restructuring under the microscope: are you ready?

by Helen Fazzino, Nicole Fung,
Pete Calleja & Ben Lannan

Including an appropriate transfer pricing review in the cross border restructuring of your company should no longer be on the wish list. In the current risk environment it is an imperative.

With leveraging intangible assets and capturing operational efficiencies across jurisdictions taking a high priority, the centralisation of Multinational Corporations (MNCs) key business activities is continuing unabated.

Principal structures: a simplified approach?

From a tax compliance perspective the desire to obtain a simple global model and achieve tax certainty in the face of often vague and inconsistent approaches by revenue authorities has also encouraged the adoption of 'principal' head quarter company structures. A consistent approach to rewarding routine distributors and manufacturers has been a focus to ensure compliance and a defensible international transfer pricing structure.

Typically, MNC's are adopting a global and/or a regional principal model. This involves a headquarter entity being responsible for coordinating and developing the core value drivers of the business, and directing the execution of strategy implemented by the operating units. The operating units, directed by the principal, often have the commercial characteristics of routine distribution and manufacturing entities operating under instruction of the principal.

This wider use of principal companies is creating both push and pull effects in the government policy and regulatory arena. Some jurisdictions, like Singapore (refer box right), recognise the opportunities for significant future investment that principal structures present. Accordingly, they have been very active in providing support and incentives to attract the mobile capital and profits that such principal companies generate.

Targeting foreign direct investment

The Singapore government has long offered a variety of tax and financial incentives to investors and companies as a means to attract foreign direct investment (FDI) to Singapore. While other countries in the region are working hard to encourage FDI, Singapore appears to be the most successful territory doing this and as such shall be the focus of this article.

One of the key incentives offered by the Singapore government is the Development Expansion Incentive (DEI) that the Economic Development Board (EDB) unveiled in 1996. This incentive is used to encourage multinational companies to utilise Singapore as a headquarters, not only for services but also manufacturing and management of intellectual property (IP). The normal concessionary tax rate under the DEI may range from 5% to 15% on income from qualifying activities. Another tax incentive employed by the EDB is the 'Pioneer Incentive', which offers a lower tax rate than the DEI for qualifying activities that are comparatively more onerous.

Broadly, the criteria used to determine the concessionary tax rates and incentive periods for both these incentives include the following:

- the number of skilled people employed by the company
- the total business spending in Singapore
- whether the company aids the development of skills and capabilities in Singapore
- the brand name of the company
- whether group IP will be transferred to and exploited from Singapore, and
- whether research and development (R&D) activities will be conducted in Singapore.

As the above list indicates substance is the key requirement of these incentives.

A separate incentive that builds on Singapore's entrepot trading history is the Global Trader Programme (GTP). Launched in 2001, this incentive was introduced to

facilitate and develop international trading activities. While this programme was originally targeting commodity trading, it has now expanded application to all types of products. The programme encourages global trading companies to use Singapore as their regional or global base to conduct activities from procurement through to distribution. In order to qualify for this programme, companies must:

- conduct substantial offshore trading activities on a principal basis
- incur a significant amount of directly attributable local business spending, and
- employ a commensurate number of experienced trading professionals in Singapore.

While there are several tax incentives currently being offered in Singapore, an underlying theme for the incentive programmes is the set of substantive conditions that need to be met in order to qualify for these incentives. These conditions are structured such that companies qualifying for the incentives bring sufficient economic and commercial substance into Singapore. Thus, the relevant Singapore agencies typically scrutinise the substance of the investments that companies are making on an ongoing basis.

In addition, the Inland Revenue Authority of Singapore (IRAS) also work to ensure that Singapore receives its arm's length share of revenues. While the EDB and International Enterprise (IE) Singapore¹ award the incentives to the companies willing to locate in Singapore, the IRAS analyses these companies to understand the functions, risks and assets to identify their key value drivers. The IRAS reviews companies under internally accepted transfer pricing principles to ensure the entities are being appropriately compensated for the functions that they perform.

However, taxation authorities in those jurisdictions that host existing operations (that may be reduced) are concerned by the impact restructuring and corresponding income realignment may have on their revenue base. Accordingly, the level of revenue scrutiny by taxation authorities on business restructures and the consequent level of tax controversies are increasing.

¹ International Enterprise (IE) Singapore was formally known as the Singapore Trade Development Board.

Australian Taxation Office on the front foot

The growth in tax controversies arising from cross border business restructuring has led to an intensive review by both the Organisation for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs and the Australian Taxation Office (ATO). The ATO has been particularly forthright in this regard by issuing a discussion paper as a platform for further dialogue with companies involved. The ATO paper presents a number of key transfer pricing propositions and other taxation issues for consideration by those companies undertaking business restructuring.

In seeking to ensure that companies consider the broader tax impact that business restructuring creates both at transition and going forward, the ATO has raised a number of specific areas of concern. The ATO have been very active at an OECD level on this topic and, in many cases, have led key aspects of the discussion on the topic. The views expressed in the ATO paper provide a valuable insight into what other key revenue authorities may be thinking but not yet pronouncing. Further in this article we describe some of the key factors which may provide insight into these issues. To provide an insight on what these issues are we describe some of the key factors immediately below.

Commerciality focus

In the ATO discussion paper, a key concern in relation to business restructures is the commercial character of the restructure itself, with an undertone that the failure to support this may reflect a tax-avoidance motive.

In this regard, the discussion paper outlines the importance of understanding the commercial logic and value of business restructures.

From a practical perspective, suspicions may arise where change programs reflect overriding involvement by the finance team rather than the operational or commercial members of senior management.

Further, in applying the arm's length principle, the ATO is likely to seek assurance that the restructure is in the best commercial interests of the global company, as well as of the Australian business specifically. In this regard, broad discussion of local benefits supported by qualitative statements of key benefits alone appears insufficient for ATO purposes. In many cases quantifiable evidence of commercial benefits and reconciliation of those benefits to the Australian business are sought to support commerciality.

Transition considerations

A particular area of concern that business restructures have raised for the ATO is the potential for a disposal of some form of intangible asset that reflects the migration from a full risk function to a lower risk business.

It is common for such restructures to involve a transfer of some IP from the operating units to the principal, to ensure the coordination and control of the core assets of the business. More commonly, this includes transfers of identifiable IP such as brands and patents. However, ultimately any relocation of an intangible asset will be a question of fact. While the disposal of identifiable IP is dealt with under capital gains tax rules in many territories, there remains a lack of clarity on how these assets should be valued and treated under transitional arrangements.

Convergence issues

The precise nature of any transition and the consequent treatment of businesses restructures are rarely limited to consideration of the transfer pricing implications alone. The establishment of toll or contract manufacture arrangements and some limited risk distribution structures such as commissionaires can generate permanent establishment issues under various double tax treaties. The revised transactional structure may give rise to a range of transaction based taxation issues, including goods and services tax and withholding tax considerations.

Accordingly, it is necessary to ensure that, where a business restructure is being contemplated, there is substantial evidence on file to demonstrate that the reorganisation is obviously and conclusively commercial. Importantly, where a business restructure has already been undertaken, quantifying the desired commercial outcomes and compiling supporting information are prudent steps in managing any potential future tax review.

What are the lessons for MNC's involved in business restructuring?

The most successful opportunities for tax optimal restructuring are realised when the business is reorganising in response to significant commercial factors. These can include merger and acquisition (M&A) activity, and changes in operating environment such as competition, customers, suppliers and industry trends.

When undertaking a business restructure, consider the following:

- ensure any transfer pricing planning is in lock step with the commercial reorganisation being undertaken in the business
- the finance team and external advisers have a role in the process to ensure all opportunities are identified and realised, but they should not be in any way directing the business change, and
- it is critical to outline the operational benefits of the business restructuring – is the commercial rationale evident? Can it be quantified?

Business restructuring is a real and necessary part of doing business for MNC's. Boards have the responsibility to ensure that all opportunities associated with business restructures are captured. However, revenue authorities concerned by the impact of business restructuring on the tax base, have demonstrated a willingness to rigorously test the substance and outcomes of the business restructuring from a tax perspective, albeit without a consistent local and international policy framework.

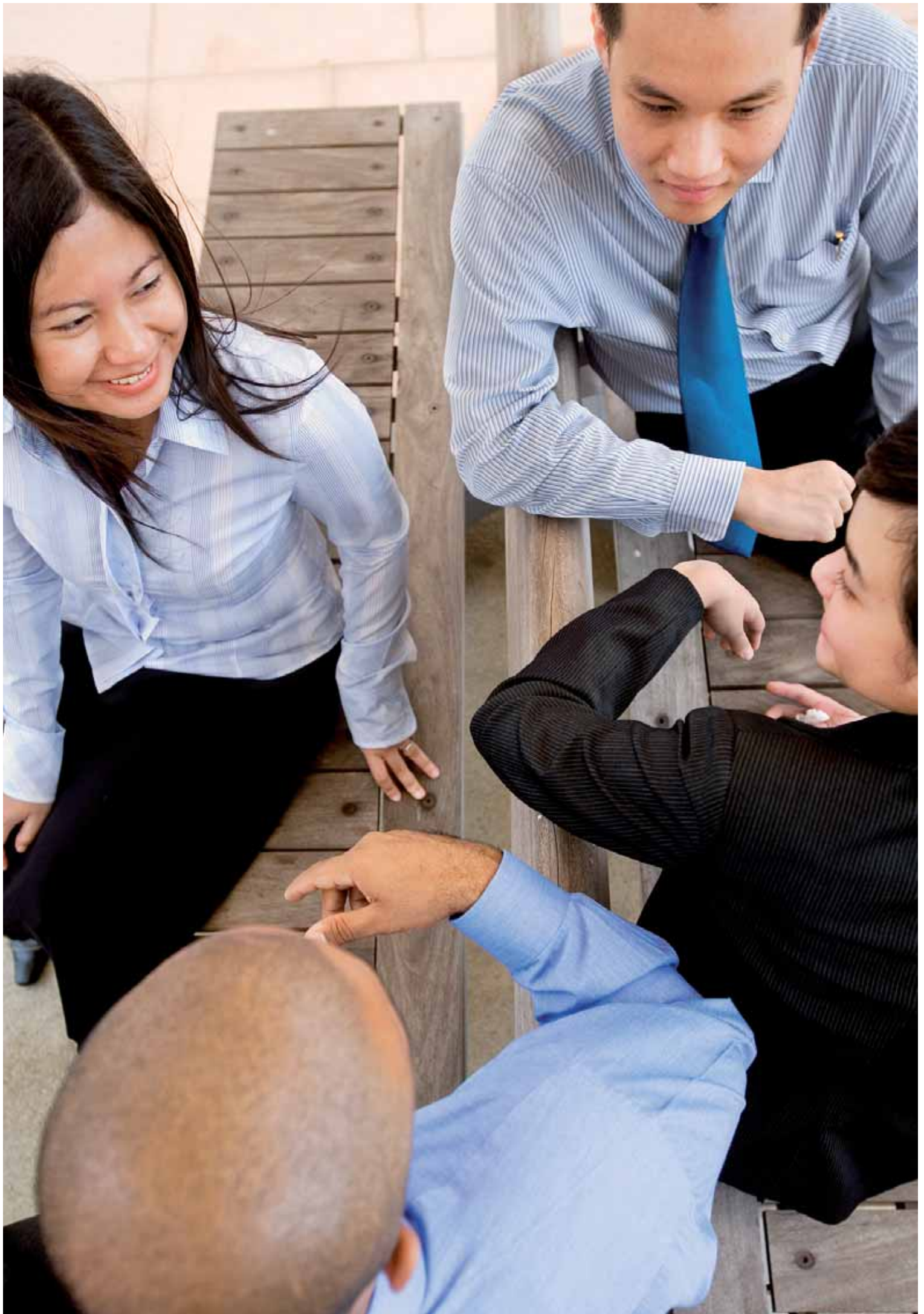
The opening of dialogue on the policy issues, both by the OECD and the ATO are welcome, but the debate is still in its early stages. The convergence of taxation issues and the underlying theme of commerciality are likely to sharpen the focus on the arm's length principle and its application to multinational businesses. The development of one single concise view from revenue authorities is necessary to relieve the existing uncertainty on taxation treatment around the key issues relevant to business restructuring.

In the interim, businesses that have completed or envisage a business restructure can take steps to mitigate the potential transfer pricing and other taxation risks that are continuing to emerge. Ensuring that the founding fact pattern underlining the commerciality of the arrangements is supported by clear evidence of operational drivers is a fundamental starting point to supporting a successful position.

Changes in the transfer pricing landscape in China after the new corporate income tax law

by Spencer Chong, Julian Hine
& Cecilia Lee





Arising from the World Trade Organisation (WTO) accession, the Peoples Republic of China (PRC) was required to have parity in the tax law for domestic and foreign enterprises. Therefore, the PRC National People's Congress passed the new Corporate Income Tax (CIT) Law on 16 March 2007. The CIT Law, which will take effect from 1 January 2008, will gradually put foreign investment enterprises on a level playing field with domestic enterprises. At the same time, to keep pace with China's rapid economic and business development as well as to align its tax regime with other tax jurisdictions internationally, the CIT Law has also introduced many new anti-avoidance measures and transfer pricing related concepts which will have a significant impact on foreign investors and their businesses in China.

At the time of publication, many details are yet to be formally announced as taxpayers wait for the issuance of the Detailed Implementation Rules (DIR). These are expected in November 2007, and there is much rumor and speculation as to what is contained within the DIRs.

Introduction

At the headline level, eventually all Chinese taxpayers will be subject to a 25% corporate tax rate. Any concessions to this will be more limited in scope than before and will be more industry than geographic focused. One of the more controversial measures which the DIRs will confirm is the likely introduction of a 10% withholding tax on dividends, reduced to 5% for Hong Kong, Singapore and Mauritius only. Needless to say, this likely change is resulting in much lobbying and corporate restructuring.

The new anti-avoidance measures and transfer pricing concepts introduced in the CIT Law include the following:

- cost sharing for jointly developing/ assigning intangible assets or jointly providing/ receiving services recognised for income tax purposes
- formalisation of Advance Pricing Arrangements (APA) in the Law
- submission of an enhanced annual related-party transactions form contemporaneously with the annual corporate tax return
- submission of relevant information to the tax authorities during transfer pricing investigations
- right to deem taxable income by the tax authorities where the taxpayer fails to provide required information or the taxpayer provides false and incomplete information
- "Controlled Foreign Corporations" rules
- "Thin Capitalisation" rules
- tax adjustments by the tax authorities where the taxpayer enters into arrangements without reasonable commercial purpose which results in reduction of taxable income, and
- imposition of a 'special interest levy' on overdue taxes arising from tax adjustments made by tax authorities.

While some uncertainty remains in relation to the detailed content of the DIRs for the above concepts, the headline concepts are a clear signal that the Chinese tax authorities are becoming more sophisticated and are gearing up their effort to scrutinise companies with inter-company transactions. This is also reflected in the recent country-wide transfer pricing queries experienced by a wide spectrum of enterprises across the PRC which we will take a closer look at in the following section.

Reinforced transfer pricing investigations

Circular Guo Shui Han [2007] No. 363

Subsequent to the release of the CIT Law, the State Administration of Taxation (SAT) released a tax circular, *Guo Shui Han [2007] No. 363*, directed to the local level tax bureaus on 27 March 2007. Pursuant to this circular, the local level tax bureaus will reinforce their transfer pricing investigations and use a set of new functional analysis questionnaires designed to facilitate the tax bureaus' transfer pricing investigations of companies engaging in inter-company transactions. Through the questionnaires, taxpayers are requested to declare the amount of their respective types of inter-company transactions as well as the detailed information on the functions, risk and intangibles of the taxpayers and their related parties. The detailed information submitted will speed up the transfer pricing investigations process conducted by the local level tax bureaus which will then report to the SAT their initial findings.

During the past few months, we have observed that approximately 300 taxpayers in Beijing and 100 taxpayers in Tianjin, as well as companies in other provinces and cities such as Hebei, Dalian and some southern PRC provinces such as Shenzhen and Guangzhou have received functional analysis information forms from their local level tax bureaus and were requested to submit the forms within 10 days. This activity indicates that local level tax bureaus are responding to the SAT's directive and are actively investigating companies with significant inter-company transactions. It is believed that more local level tax bureaus will be issuing such questionnaires to companies located in their respective locations to facilitate their future transfer pricing investigations.

Centralisation of transfer pricing audits and industry focus

Under the taxation directive circular *Guo Shui Han [2005] No. 239* released in 2005, local level tax bureaus are required to report all transfer pricing audits as well as potential targets of national joint audits to the SAT for supervision and consultation before they commence or conclude each case. Therefore, it is likely that the set of new functional analysis questionnaires are measures that the SAT have introduced to identify transfer pricing audit and national joint audits targets. Besides exchanging data with other government departments, the local level tax authorities are also required to exchange transfer pricing data among themselves under the *No. 239* circular. We observed that key players in industries such as food and beverage, semiconductors, apparel and office equipment have become common targets for local level audits. In many instances, similar audit approaches have been applied among other industry players. Since these audits require SAT approval, it is apparent that the SAT is attempting to adopt an industry focus by setting precedence for these respective industries.

Avoidance of double taxation and the prevention of fiscal evasion arrangement between China and Hong Kong

Subsequent to the accession of the PRC to the WTO, the PRC and Hong Kong signed an "Arrangement between the Mainland of China and the Hong Kong Special Region for the Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income" on 21 August 2006. *Article 24* of the arrangement provides that the SAT (or its authorised representatives) and the Hong Kong Inland Revenue Department shall exchange information for carrying out tax assessments of China and Hong Kong taxpayers for taxable years from 1 January 2007 (for China)/ 1 April 2007 (for Hong Kong). *Departmental Interpretation and Practice Notes No. 44* further clarifies that the exchange of information is not restricted to information in respect of persons who are residents of the mainland of China or Hong Kong.

With this arrangement in place, the SAT is now in a better position to collect information on PRC entities with cross-border transactions involving Hong Kong taxpayers and to identify potential audit targets that have not properly reported their profits in China. This arrangement poses new challenges to multinational corporations with business operations in both the PRC and Hong Kong in terms of information and evidence which tax authorities now have access to – especially where the economic relationship between the PRC and Hong Kong entities is very close.

Substance over form

While the Chinese tax authorities have placed much emphasis on the ‘form’ of activities in the past, it is expected that the advent of the new law will increase their focus on the ‘substance’ of business arrangements. Under *Article 47*, the CIT Law introduces a general anti-tax avoidance provision which empowers the tax authorities to adjust a taxpayer’s taxable income where business transactions are arranged “without reasonable commercial purpose” and result in a reduction of the latter’s taxable income. In the past, there might not have been much scrutiny on the substance of companies’ operational structures by the tax authorities and this in turn might have led many companies not having given sufficient consideration to the substance of their operational structures when they expanded their business operations rapidly in China. It remains to be seen how quickly local tax bureaus move away from the ‘comfort zone’ of dealing with the ‘form’ of transactions and address more complex issues around ‘substance’. Of course at the SAT level in cases such as national audits, bilateral APAs, and Mutual Agreement Procedure cases, it is more likely that ‘substance’ issues will be addressed.

In the meantime, another important substance concept which has been introduced in the CIT Law is the effective management concept for determining the tax residence status of an entity with business presence in China. Foreign enterprises established outside China with their effective management located in China are one example of those types of companies which could be affected.

Considering the imminent arrival of the effective date of the CIT Law, it is therefore important that companies in China now review the substance of their current and future business arrangements and make appropriate changes to ensure that inter-company arrangements that derive tax benefits are justified by reasonable commercial purposes.

This urgency is further aggravated by the introduction of the special interest levy on overdue taxes resulting from tax adjustments made by the tax authorities in connection with the above-mentioned general anti-tax avoidance provisions - a penalty in all but name. Currently taxpayers are not subject to any transfer pricing specific interest or penalty on the tax adjustments made by the tax authorities on top of the normal tax associated with the adjustments. While it remains to be seen in the DIRs as to how the special interest levy would be calculated, it is probable that the special interest levy will include both financial interest and penalty components.

More stringent enforcement

Over recent years, the SAT has shifted its focus to audit targets with potentially larger transfer pricing adjustments. While the number of transfer pricing audit cases reduced in 2005, the tax adjustment amount involved in transfer pricing audits actually increased significantly. For example, in 2003 the average tax adjustment was less than RMB 0.2 million per case – based on very rough estimates. However, in 2005 this figure was nearly RMB 6.4 million or approximately USD 0.8 million. Of course, in an international context, this average tax adjustment size would probably be considered as relatively small – especially when one considers China is now the fourth largest economy in the world. However, this statistic should be taken with a word of caution. Many of these adjustments would relate to much earlier years and before the economy opened up beyond just being a manufacturing base. As such, many of these cases would revolve around the ‘mark-up’ component on cost plus manufacturing arrangements. In the longer term, as the activities and operations of Multinational Corporations (MNCs) in the PRC become increasingly widespread and complex, intangibles related transfer pricing issues will become more common place. When intangibles

(and commercial substance) start to feature at the heart of transfer pricing disputes in the PRC, it is likely that the size of tax adjustments arising from transfer pricing adjustments will increase significantly – as has occurred in more developed economies with more developed transfer pricing regimes.

In cases where transfer pricing adjustments levied by the PRC result in taxation that is contrary to the provisions of a tax treaty, taxpayers may consider pursuing the Competent Authority process, or Mutual Agreement Procedure (MAP), to avoid double taxation. The SAT issued *Guoshuifa [2005] No. 115* which provides a regulatory framework for MAP. MAP has become a more common process between the tax authorities in China and Japan. Currently, there are two cases of MAP resolution between these two countries.

There is no legislative requirement for taxpayers in China to submit and/ or disclose contemporaneous transfer pricing documentation with their annual income tax returns. Taxpayers are only required to submit declaration forms on the amount and the names of the relevant related parties in respect of their inter-company transactions during the taxable year.

Under *Article 43* of the CIT Law, taxpayers will now be required to attach “annual related party transactions reports” in respect of their inter-company transactions when they submit their respective income tax returns. While detailed guidelines on the requirements for the “annual related party transactions reports” have yet to be specified in the new legislation, there is a strong signal from the CIT Law that the SAT will require more detailed information relating to inter-company transactions to be furnished by the taxpayers with their annual income tax returns when the new rule becomes effective. The more stringent disclosure requirements would facilitate tax authorities to carry out investigations on inter-company arrangements between Chinese taxpayers and their foreign related parties. However, there is no suggestion at this stage that the DIRs of the CIT Law will mandate that taxpayers must maintain transfer pricing documentation as is the case in India.

In addition, the CIT Law also provides that the Chinese tax authorities will have the right to assess a taxpayer’s taxable income on a deeming basis where the taxpayer does not provide relevant information in relation to its inter-company transactions during a transfer pricing investigation. As the statutory limitation in the PRC is 10 years, the tax authorities could potentially adjust a taxpayer’s taxable income for a period of up to 10 years.

Companies are recommended to take a proactive approach to prepare themselves for the more stringent enforcement measures of the SAT. With such measures as foreign exchange control and registration requirements in China, the implementation process subsequent to transfer pricing planning may take longer than in other jurisdictions.

Impact all along the supply chain

Production based businesses have long been a major focus for transfer pricing audits and investigations by the Chinese tax authorities. On March 5, 2007, the SAT even issued a circular which provides that foreign enterprises performing simple manufacturing functions should maintain a certain level of profit and not make losses. More recently, however, out of hundreds of companies which were issued with questionnaires to declare their function and risk profiles in connection with the SAT’s circular *Guo Shui Han [2007] No. 363*, we understand that many of them were distributors, research and design centres and service companies. As the Chinese tax authorities come to realise that the PRC economy has developed such that there are now more companies engaging in non-manufacturing types of activities than previously was the case, they are increasingly paying more attention to businesses engaging in other activities along the supply chain including those providing procurement or sourcing services, performing trading functions and engaging in retail activities. In the meantime, officials of the SAT and more senior officials of bureaus across the country are undergoing intense training on complex transfer pricing concepts and arrangements to keep themselves abreast of international commercial arrangements and issues concerning intangible structuring.

Based on recent experience, there is an increasing number of tax investigations focused on the sales (both distribution and retail) structure of companies with foreign investors. For example, loss-making sales companies of foreign branded products in the PRC may be viewed by the Chinese tax authorities as undergoing market penetration and incurring considerable marketing expenses for building market recognition of those products in the PRC. If such companies are paying royalties to foreign companies for any marketing intangibles associated with the foreign brands, the Chinese tax authorities may take the view that the brand that is introduced into the PRC has no significant value to justify the royalties since the Chinese sales companies have to incur considerable marketing expenses to market and sell the products. Moreover, the Chinese sales companies may have arguably created marketing intangibles in China which need to be remunerated appropriately by foreign entities.

Use of Advance Pricing Arrangements

A taxpayer with a significant proportion of related party dealings can consider gaining certainty of its taxable position with an Advance Pricing Arrangement (APA). An APA is an agreement between the taxpayer and one (or more) tax authorities setting out in advance the method for determining the transfer pricing for the taxpayer's related party transactions for a stipulated period in the future (typically 3-5 years). With *Guoshuifa [2004] No.118*, released by the SAT in 2004, APAs have become easier to apply in China as evidenced by the substantial increase in the number of bilateral and unilateral APAs successfully concluded in the PRC during the last two years. Key trade partners such as Japan and the U.S. have taken the lead and concluded their first bilateral APAs with China. The formalisation of APAs in the CIT Law further signifies the Chinese tax authorities' approval of the use of such arrangements. We understand that bilateral APAs with other trade partner countries are under negotiation. We expect to see more bilateral and unilateral APAs applied for and concluded over the coming years. Nevertheless, companies should still carefully evaluate the costs and benefits of such an arrangement before approaching the tax authorities.

Use of Cost Sharing Arrangements

The provision on the use of Cost Sharing Arrangements (CSAs) in the new CIT Law is a piece of welcome news for many taxpayers as it should mark the beginning of a breakthrough for CSAs in China. CSAs have been difficult to implement in China as taxpayers in China have needed to apply for and obtain approval from the tax authorities before they could implement a CSA, claim a tax deduction on CSA payments and avoid withholding taxes under the current tax regime. As evidenced by the few cases in which taxpayers have successfully been granted the approval, there has been limited guidance from the SAT on the acceptability and implementation of CSAs. Although little light was shed on the implementation details of CSAs in the CIT Law, we expect detailed guidelines to be released by the SAT in the near future.

Subject to detailed tax guidance to be released by the Chinese tax authorities on the treatment of cost sharing payment/ receipt in the PRC, the CSA could potentially be applied as a tax efficient method of financing research and development activities and providing services within an MNC. As no royalty payment is required to be paid under the CSA, withholding tax which would otherwise be applicable to royalty under licensing arrangements would therefore arguably not be payable on the cost sharing payment made to foreign entities. From the income tax angle, a cost sharing payment recognised by the tax authorities should also be tax-deductible from the Chinese taxpayer's perspective. From a Chinese recipient's perspective, logically no income tax or business tax should be imposed on the cost sharing payment received as the amount is meant to be at cost without a margin.

Time for transfer pricing planning

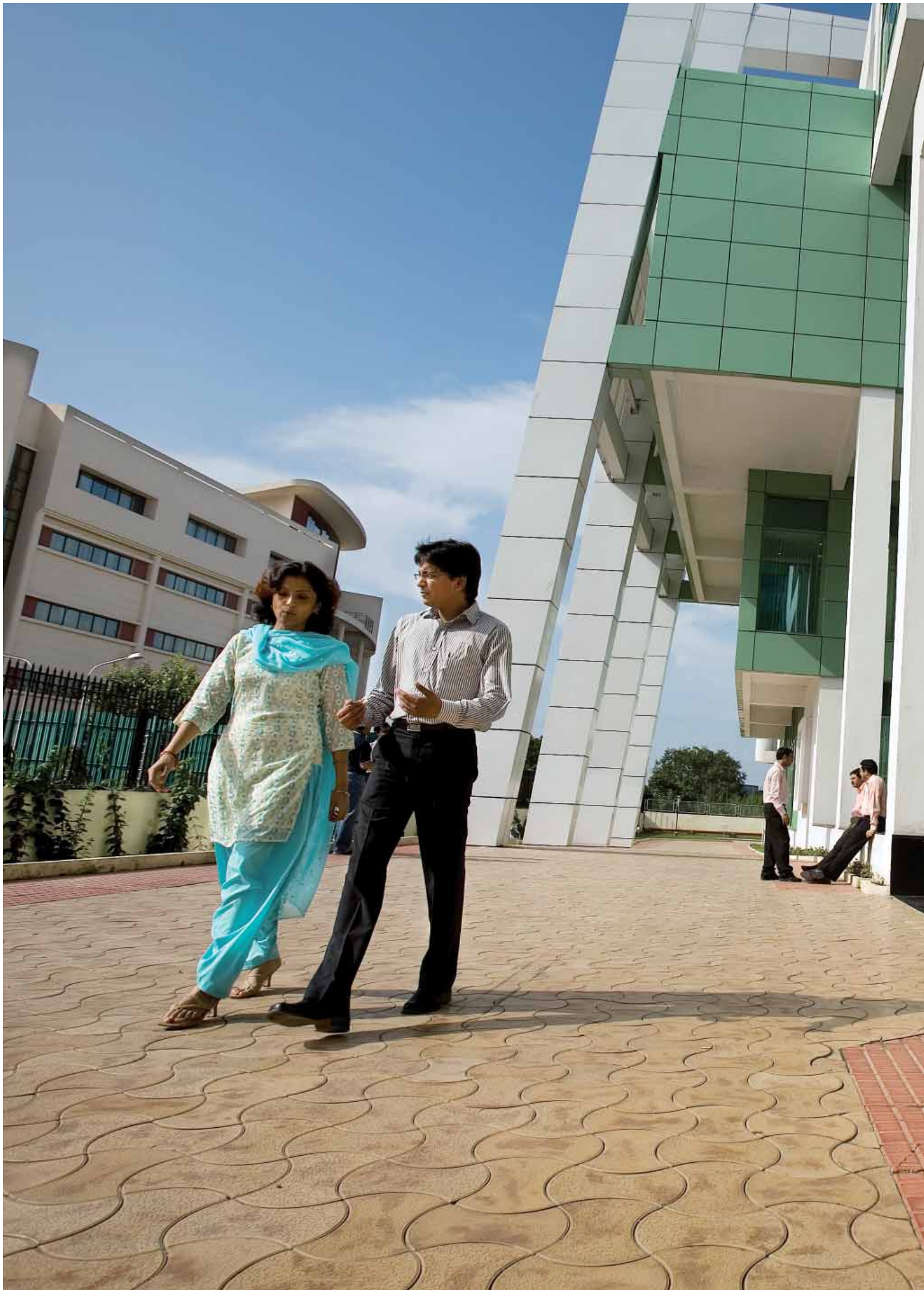
New challenges always come with opportunities. As the CIT Law introduces many new changes in the new PRC income tax framework, enterprises with and without operations in China are recommended to take immediate actions to review the location of profit, location of cash and tax costs in their existing business models and evaluate the impact and/ or opportunities the new changes made by the CIT Law would bring to them.

With proper transfer pricing planning, appropriate transfer pricing arrangements could often be a more tax efficient way of repatriating profit compared to other alternatives such as payment of dividends out of the PRC. One example is an appropriate licensing arrangement between a foreign intangible owner and a Chinese intangible user whereby the royalty payment could be claimed as an income tax deduction by the Chinese entity, as compared to a dividend payment which is not allowed for income tax deduction by the dividend paying entity. Due to the possible differential between the PRC income tax (25% under the CIT Law) and the sum of withholding tax and business tax (which is imposed on royalties), a royalty payment can often be a more tax effective way to repatriate profit overseas for entities resident in jurisdictions with whom the PRC has concluded double tax treaties.

However, enterprises having inter-company licensing arrangements are cautioned to support their inter-company licensing arrangements with robust supporting documentation and economic substance to mitigate their higher risk of being targeted for transfer pricing audits. As a licensing arrangement could result in Chinese tax savings, the Chinese tax authorities may challenge such arrangements unless they can be supported that the PRC entity benefits from the use of foreign-owned intangibles. Based on our recent experience, the Chinese tax authorities are increasingly targeting Chinese entities making inter-company royalty payments as audit targets. Enterprises are recommended to conduct proper transfer pricing planning early and avoid any tax leakages when they contemplate repatriating profit out of China.

Now, more than ever, is the time for enterprises to review their transfer pricing arrangements within the context of their overall tax positions. Enterprises should be aware that transfer pricing policy can have implications on direct income tax as well as indirect taxes such as Value-Added Tax, Business Tax and custom duties. Therefore, transfer pricing planning should be an integral part to the broader tax and corporate structural planning for businesses in the PRC.





Transfer pricing and attribution of profits to permanent establishments in India

by Shyamal Mukherjee & Tarun Arora

As businesses transcend borders and expand operations to numerous jurisdictions, tax issues are increasingly becoming more complex, requiring significant focus. Businesses of developed economies cannot afford to ignore the sheer size of developing markets as well as the technical strengths and manpower capabilities located in such jurisdictions. Similarly, businesses of developing economies need to access the technology, capabilities as well as the markets of developed countries. As the world's 'economic borders' collapse, tax authorities across all countries are concerned about preserving their tax base in order to ensure that they get their 'fair share' of taxes.

Tax authorities in India are equally concerned about getting their share of taxes from Multinational Corporations (MNCs) operating in India. Two international tax issues that have recently got significant attention from Indian tax authorities are 'Transfer Pricing' and 'Permanent Establishments'. It is well known that the existence of a Permanent Establishment (PE) of an overseas enterprise in India gives tax authorities the right to tax the foreign company in India. Accordingly, whether the foreign company has a PE in India or not (based on facts and circumstances) has been a matter of significant debate between tax authorities and MNCs. However, in the larger technical debate on the existence of a PE, the relevant economic issue of attribution of profits to the potential PE is often ignored or overlooked by both the taxpayers as well as the tax authorities. As a result, in many cases, Indian tax authorities have raised significant tax demands on foreign companies by attributing huge profits to alleged Indian PEs.

As a background, the extensive Indian Transfer Pricing (ITP) code, introduced about 6 years ago, covers the attribution of profits to Indian PEs. Accordingly, when the international tax community, including the Organisation for Economic Cooperation and Development (OECD), was still deliberating on the issue of attribution of profits to PEs, the Indian law makers went ahead and implicitly enacted the "functionally separate entity approach" (the final OECD authorised approach¹). This approach prescribed the application of TP principles for attribution of profits to Indian PEs. However, it is interesting to note that the Indian tax law also has another Rule², that has been in force prior to enactment of the TP code, which applies alternative non-TP principles (like global formulary apportionment) for determination of profits of non-residents liable to Indian tax. Accordingly, in many cases, Indian tax authorities continue to apply this old rule for determining profits attributable to alleged PEs, instead of applying TP principles. Even in such situations, a better and more robust position to be adopted by taxpayers could be to invoke the TP code that specifically covers attribution of profits to PEs.

¹ OECD Report on the Attribution of Profits to Permanent Establishments

² Rule 10(ii) of the Indian Income Tax Rules, 1962

There have been some recent court cases in India which have held that TP principles should be applied to determine profits attributable to PEs in India. A recent ruling of the Indian Supreme Court, has laid down certain interesting principles dealing with the interplay between transfer pricing and PE taxation. Briefly, the facts of the Indian supreme court case were that a US company (Co.US) had outsourced certain Business Process Outsourcing (BPO) functions to its Indian subsidiary (Co.I) against payment of fees. On a regular basis, Co.US sent its employees to the business premises of Co.I to carry out stewardship activities. In addition to the stewards, there was another category of employees of Co.US that visited India. For these employees, Co.I made specific requests to Co.US to depute such personnel to the Indian entity's business for providing services through training, etc. During such secondment, the secondees remained on the payroll of Co.US, who initially paid their salaries in the United States and thereafter recharged the same to Co.I on actual basis, i.e. without any mark-up.

The basic issues involved in the case were whether Co.US had a PE in India. If yes, what would be the profits attributable to the PE? Without going into the details of the Ruling, the Supreme Court held that Co.I did not *per se* constitute a fixed place of business PE Co.US in India. The Supreme Court held that Co.I was not a PE since it carried out back-office functions, which were in the nature of preparatory and auxiliary activities that are excluded from the threshold of PEs in tax treaties. The Supreme Court also dealt with the presence of the stewards and secondees and held that the stewards did not give rise to a Service PE of Co.US in India. The Supreme Court thereafter held that the presence of the secondees resulted in Co.I creating a Service PE of Co.US in India.

From a PE profit attribution perspective, the Court ruled that even if a PE of a foreign company exists in India, no further profits need to be attributed to the PE, if the functions, assets and risks have been appropriately captured and remunerated on an arm's length basis to the group's Indian entity that has constituted the PE. The Ruling states that the concept of 'Economic Nexus' is an important consideration for determining profit attributable to a PE.

The above mentioned conclusions of the Court lead to the following important considerations that MNCs operating in India need to be sensitive about in all cases:

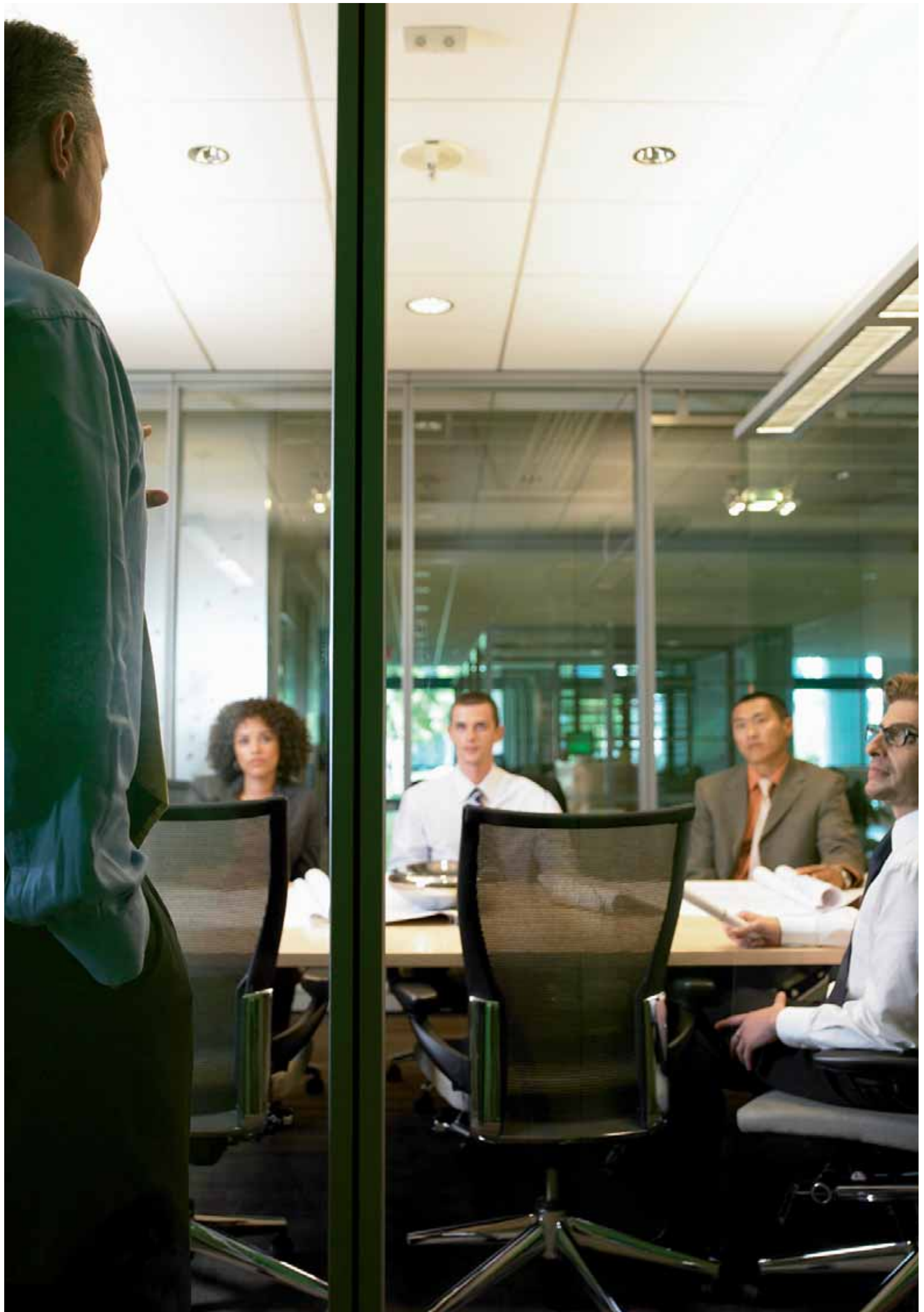
- 1) The primary issue requiring consideration is whether the foreign company has a potential PE in India. Under Indian tax treaties, apart from apparent PEs like Branches, Project Offices, etc other more nebulous PEs like Service PEs (resulting from services rendered by foreign companies to their Indian group concerns through deputed personnel), and dependent agent PE's could exist. The existence of such PEs need to be carefully examined, based on the facts of the case discussed earlier. The Supreme Court ruling in this case, other court cases and respective tax treaties need to be analysed to determine if the foreign company has a PE in India or not.
- 2) Where a PE exists, the attribution of profits to such PE needs to be undertaken applying the Indian TP Code. All necessary compliances relating to such PE also need to be carried out. Further, where there is a possible PE in India that results from activities related to the group's Indian entity, an in-depth TP analysis should be undertaken to determine the precise risk taking functions of the PE (functions, assets and risks analysis of the PE).
- 3) Evaluate if the price paid to the group's Indian entity is arm's length after considering the PE analysis undertaken in step (2). This step is critical since the PE activity analysis could reveal that the PE's activities are such that they require the application of a TP methodology that could be different from the methodology adopted for determining the transfer price for the group's Indian entity. Such a situation could require that the transfer price of the Indian entity, which may have been arm's length on a stand alone basis be determined by including the PE's activity. This makes it arm's length after including the functions, assets and risks of the PE. Only if this is achieved would the Supreme Court Ruling apply.

As an example, a Service PE could be undertaking routine activities, thus making a cost plus methodology acceptable in such circumstances. However, where the activities of the Service PE or a dependant agent PE comprise high value entrepreneurial activities that involve decision making leading to assumption of significant risks by the overseas enterprise, such situations may require the application of a different TP methodology (say percentage of sales or even a profit split in appropriate circumstances) for determining the arm's length price profits to be attributed to Indian operations. Accordingly, the analysis needs to be an in-depth analysis that takes into account all relevant factors, including industry practice, importance of contributions, and significant risks assumed.

- 4) Another important consideration in such circumstances would be the maintenance of appropriate documentation supporting the above analysis. Such documentation would be the foundation of applying the Ruling to take the position that no further profit attribution is required in respect of the PE. Further, the manner of dealing with the PE issue in the documentation, including tax return filing positions, need considerable attention, both from a legal as well as economic viewpoint.

One way to view this recent ruling could be that it is benevolent, since it prescribes an administratively convenient procedure of capturing profits attributable to the PE in the group's Indian enterprise by applying the broader Economic/ Territorial Nexus doctrine, while at the same time preserving the taxing jurisdiction of India. However, it is worthwhile to note that the ruling was given based on specific facts, for example, it dealt with a Service PE situation, and on such facts the Court concluded that the profits attributable to the PE were captured in the group's Indian entity. Taxpayers need to carefully analyse their fact pattern and assess the extent to which the Ruling applies to their specific circumstances. Ultimately, the issue requires a Transfer Pricing analysis to determine the arm's length price for the PE's activities as well as the activities of the group's Indian entity.

It may be possible that in certain circumstances MNCs have a potential PE in India (in view of commercial requirements). The nebulous nature of a PE and its activities, as compared to a company where contracts, documents and dealing are relatively easier to analyse and draw appropriate conclusions compounds this issue to an extent. In all such circumstances, it is of utmost importance for MNCs to undertake an in-depth TP analysis and strategise an optimal way forward that is technically as well as legally correct and at the same time lends more certainty in respect of their India tax position. With increasing focus of Indian tax authorities on TP matters as well as on PE issues, such analysis assumes greater significance, requiring more focus and attention.





NTA issues revised guidelines for transfer pricing

by Toshiyuki Kurauchi & Ryann Thomas

On June 25, 2007, Japan's National Tax Agency (NTA) issued expanded guidelines relating to transfer pricing (2007 Guidelines). As amendments to the *Commissioner's Directive on the Operation of Transfer Pricing*, originally issued June 1, 2001, these guidelines are designed to provide instructions to auditors in the conducting of transfer pricing audits and Advance Pricing Arrangements (APAs). For taxpayers, they provide useful guidance and direction on (i) the issues that the Japanese tax authorities are currently focusing on, and (ii) the manner in which the auditors intend to treat those issues.

As an example of (i), the revised guidelines relating to intra-group services issued on June 20, 2002, coincided with more rigorous examination of such transactions from around that time. Likewise, the revised guidelines issued on March 20, 2006 dealing with intangible properties heralded more attention to these categories of transactions during subsequent audits.

In relation to (ii), brief comments on each of the key areas addressed by the expanded guidelines are provided below.

Contents of amended guidelines

Transactions relating to intangible property

In defining the categories of asset that might lead to the creation of intangible value, the 2007 Guidelines largely mirror the wording of the March 20, 2006 amendment. However, category (c) is now described more comprehensively.

Para. 2-11 Intangible properties to be considered in examinations

- (a) Patents, trade secrets, and other properties generated through technological innovation.
- (b) Know-how generated by personnel such as employees through their experience in activities such as management, operations, production, research and development, and sales promotion.
- (c) Production processes, negotiation procedures and transaction networks pertaining to development, sales, raising of funds, etc.¹

Clearly the expanded description of point (c) is designed to reflect the NTA's belief that there are unique intangibles associated with the Japanese market. These are not only reflected in manufacturing and development processes, but should also be taken into account when considering appropriate pricing for distribution and marketing activities.

¹ PricewaterhouseCoopers translation

Points to note when calculating arm's length prices

Under *Special Taxation Measures Law Article 66-4*, the Japanese transfer pricing legislation, the tax authorities have the power to apply the presumed method if they believe a taxpayer has failed to cooperate with the audit process (e.g., refused to submit essential information requested by the auditors). In applying the presumed method, the auditors can select a comparable transaction which theoretically could be a controlled transaction, and determine transfer prices for the taxpayer based on the pricing of that selected transaction, applying any of the methodologies prescribed by the legislation. Exercise of the presumed method is a fairly draconian measure on the part of the auditors, and PricewaterhouseCoopers is aware of only one case in which this method has been applied (under the resale price method).

The 2007 Guidelines (*para. 3-7, Points to note when calculating transfer pricing assessments using the presumed method*) extends the manner in which the presumed method, using a profit split method, may be applied. To include a method 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). The 2007 Guidelines thus offer the auditors significant freedom to calculate a transfer pricing assessment under the presumed method using a high level global profit split.

Advance Pricing Arrangements – requested information

The original guidelines issued on June 1, 2001 prescribed the documents that should be provided in conjunction with the filing of an application for an APA (*para. 5-3, Documents to be attached*). Among that list of documents was contained the financial data of foreign affiliate (typically financial statements of the foreign affiliate and the foreign affiliate's segmented profit and loss statement relating to the covered transactions are requested).

Although the original guidelines confirmed that a taxpayer's application might be declined if requested information was not provided, foreign-owned taxpayers did not typically provide requested financial information about their foreign affiliate. Instead, it was standard practice to submit a letter to the tax authorities from the foreign affiliate confirming the reasons why the information was not being provided. Moreover, there was generally little negative impact on a taxpayer's APA application or the APA review process in most cases, regardless of the non-provision of such requested data.

Under the 2007 Guidelines, however, there is a more explicit message from the NTA that they may not process an APA application if the applicant does not submit requested information, including foreign related party information. This is contained within the new *para 5-10(4) Pre-filing conferences and para 5-14(1)(b) Cases where implementation of an APA request and APA procedures are not appropriate*, which both clearly state that failure to cooperate – such as by providing requested information – will lead to an APA application not being processed.

PricewaterhouseCoopers assumes that the Japanese tax authorities will not ultimately reject an application for a bilateral APA, simply because it lacks the foreign related party's financial data. However, it is possible that they may do so in unilateral applications. In any case, the introduction of *para. 5-10(4) and para 5-14(1)(b)* increases the likelihood that the auditors will argue more strongly about, or question the validity of, APA requests during their review process where a taxpayer fails to provide foreign related party information.

Advance Pricing Arrangements – lack of economic rationale

In addition to *para 5-14(1)(b)* dealing with failure to cooperate or provide information when requested, *para 5-14(1)(a)* is also worthy of mention.

Para. 5-14(1) Cases where implementation of an APA request and APA procedures are not appropriate

- (1) *In the event that an applicant corporation submits an APA request where implementation of the request is deemed inappropriate, for example, in the cases described below, the [tax authorities] shall instruct the applicant corporation to amend the request... If the applicant corporation does not follow this instruction, provide an explanation to the applicant corporation that the APA request cannot be implemented...*
- (a) *Where it is considered that the tax burden in Japan will be reduced with no economically rational reason because, for example, the APA covers a transaction in a form not usually conducted between unrelated persons.*

Comments on the meaning of the expression “transaction in a form not usually conducted between unrelated persons” have been made in a recently published book *Transfer Pricing Legislation*, by Mr. Hiroki Yamakawa, former Director of the NTA’s Office of Mutual Agreement Procedure. Mr. Yamakawa first notes that such a transaction would include a case where the economic characterisation of a transaction in an agreement between the parties is not supported by the economic substance revealed by a functional analysis. This view is not only consistent with the historic practice of the NTA when conducting audit investigations, it is also consistent with the stronger focus being placed on the need for economic substance in related party transactions by tax authorities globally.

Mr. Yamakawa also discusses in more detail cases where multinationals relocate functions, risks and intangible property amongst their group entities, such as when converting from a fully-fledged business to a limited risk business through adoption of a centralised decision-making model. Of key interest, Mr. Yamakawa states that “[w]hether functions, risks and the like have been transferred in accordance with an agreement or not generally depends on whether human resources engaged in the business activities have been transferred or not.” As part of such restructuring, Mr. Yamakawa notes that consideration should be paid to the need for compensation for intangible properties transferred, functions and risks stripped, and human resources transferred. Moreover, the most appropriate transfer pricing method with which to remunerate the new limited risk entity is not necessarily the cost plus method. Instead, a measured consideration should be given to the most appropriate method and the most appropriate profit level indicator going forward. This approach to APAs would be consistent with the audit practice that has been adopted by the NTA in past years.

Consequently, taxpayers applying for an APA following a restructuring should be prepared to address issues of compensation for lost functions, business opportunities, intangible properties and the like. More scrutiny is also likely to be applied to the methodology adopted for the stripped risk entity going forward, particularly if it is based on the cost plus method.

Transaction examples

Accompanying the 2007 Guidelines, the NTA issued an 84-page Supplementary Volume entitled *Collection of Reference Cases for the Application of Transfer Pricing Legislation*, which contains sample transactions for different transfer pricing methodologies. Given the Supplementary Volume was prepared by the NTA, taxpayers can expect that it reflects the NTA approach to audits and thus might be useful in providing guidance as to areas of concern. Unfortunately, the Supplementary Volume in fact provides little guidance in this area, as the reference cases are neither specific nor realistic in their current form: the reference case for application of the Comparable Uncontrolled Price (CUP) method for example, describes a transaction where a manufacturer sells the same product to its subsidiary and a third party distributor on the same terms and in similar quantities.² Moreover, there is little guidance in the Supplementary Volume on how a markup on costs, resale price, or other transfer prices might actually be calculated once the selection of method has been made.

One point of interest that is worthwhile to note is that the Supplementary Volume contains many cases covering the application of the residual profit split method to transactions involving intangible assets. For example, Case 19 confirms the NTA's view that the residual profit (location savings) should be allocated based on the level of intangible properties owned by the parties

(thus confirming that the new manufacturing entity receives a routine return only). Case 20 states that the residual profit split method can properly account for market fluctuations and trends (through selection of appropriate comparable transactions in the allocation of any routine returns). In addition, Case 22 lists certain expense items which might be related to the creation of intangible assets, and which largely reflect the factors identified in para 2-11 of the 2007 Guidelines (see section A-1 above).

The number of cases related specifically to the use of the residual profit split method for intangible assets confirms the NTA's focus on intangible properties, as mentioned earlier.

Yet, even in these cases the comments made are simply a reflection of existing audit practice. Thus, it is doubtful that the Supplementary Volume and the reference cases contained therein will provide much guidance to taxpayers in the setting of transfer prices going forward.

² Likewise, the reference case for application of the resale price (RP) method describes a third party distribution transaction that is similar to the distribution transaction between two related parties in terms of product distributed, trade level, and sales volume and sales functions of the distributors, etc.

Conclusion

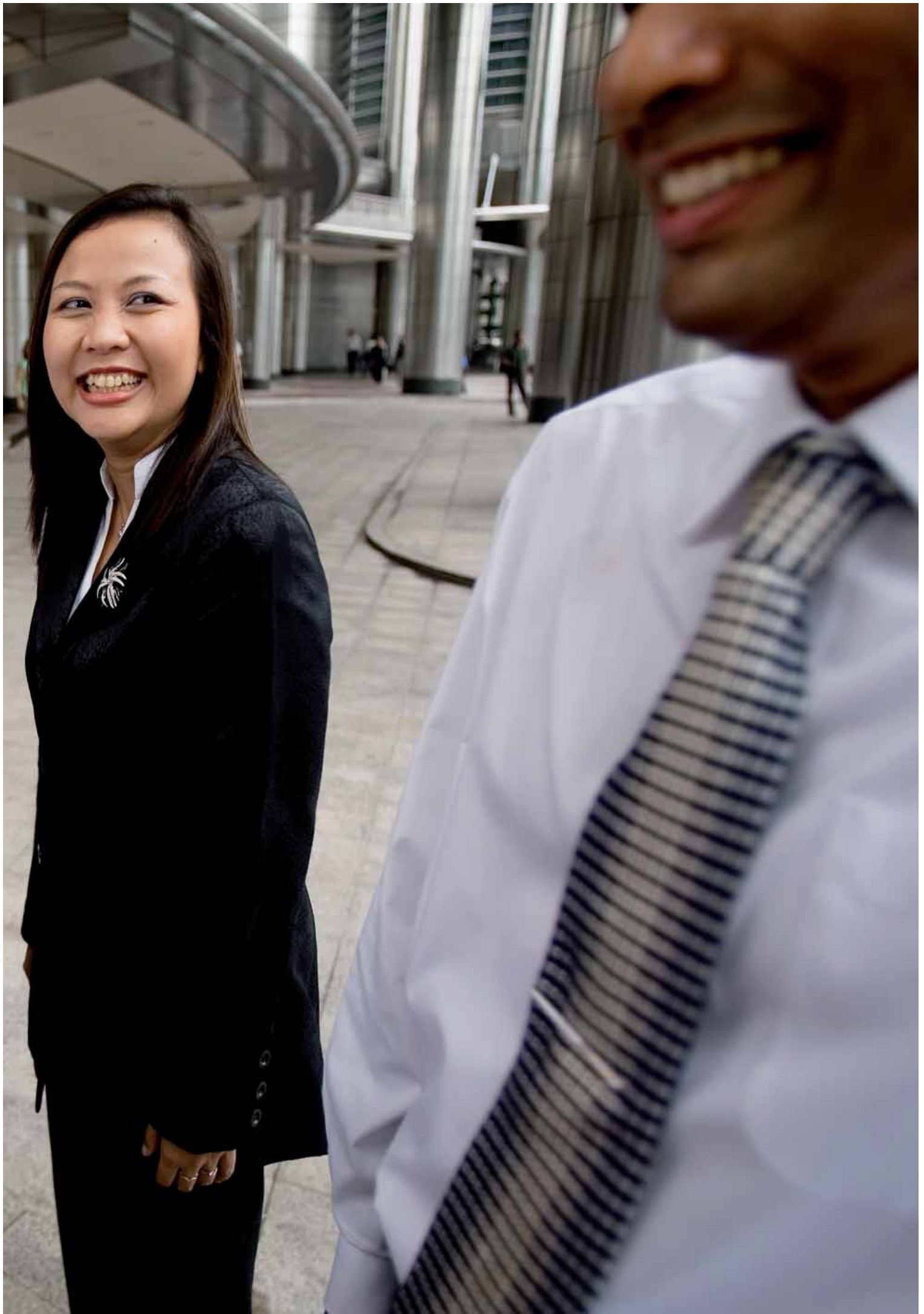
In conclusion, what can taxpayers involved in cross border transactions with Japan take from the new guidelines?

PricewaterhouseCoopers recommends bearing in mind the following points when planning for transfer pricing into or out of Japan.

- The tax authorities appear likely to continue their focus on transactions involving intangible property. The contribution made by a multinational's Japanese entity to any potential intangible property should be carefully considered. In addition, in conjunction with the guidelines issued on March 20, 2006, structures that purport to strip intangible properties out of Japan solely through funding of the activities of the Japanese entity that give rise to that property should be reviewed carefully.
- The extension of the auditors' rights under the presumed method and the changes to the APA procedures described above both demonstrate a clear intention on the part of the NTA to focus closely on a multinational's group profits earned from the Japanese market, and to try and determine the Japanese entity's "fair" share of that profit (from the Japanese tax authorities' perspective) – regardless of whether the transfer pricing method adopted by the taxpayer requires analysis of overseas profitability.
- The introduction of "lack of economic rationale" as a basis for denying a taxpayer's APA application reflects the NTA's historic audit approach to focus on economic substance. The fact that this requirement is now expressly referred to as part of the APA review process reflects the growing global requirement that changes to transfer pricing be linked to real business or commercial change.

Finally, for those practitioners who have been engaged in Japanese transfer pricing practice over the past few years, or for Japanese taxpayers that have undergone a transfer pricing audit recently, the 2007 Guidelines and the PricewaterhouseCoopers' conclusions stated in this article are unlikely to cause any great surprise. Indeed, it would be fair to say that the 2007 Guidelines are merely a formal statement of the approach taken by the transfer pricing field auditors in recent years.

Consequently, the real difference evidenced by the 2007 Guidelines is the public nature of the statement of the auditors' intention and their application to the APA process, indicating that a stricter approach to enforcement of these issues going forward is likely to be adopted.





The art of managing a transfer pricing audit in Korea

by Henry An, Heui-Tae Lee,
Joon Yang & Won-Yeob Chon

There are few things that can cause a Korean taxpayer more anxiety and frustration than a tax audit, particularly when the focus of the audit is on transfer pricing. There are several unique attributes of Korean audits that can elicit these emotions.

First, tax auditors provide taxpayers with only limited advance notification of selection for an audit, which can foster panic and distress by taking unsuspecting taxpayers completely by surprise. Second, relative to other countries, audits in Korea tend to be conducted over a short time period of time. As a result, auditors are predisposed to conduct audits with a strong sense of urgency and will expect full taxpayer cooperation, particularly with respect to responding to information requests in a timely manner. Any perceived lack of cooperation can quickly deteriorate the working relationship between the auditors and the taxpayer. Third, Korean tax auditors have earned a well deserved reputation for being highly adept at making tax assessments. Some taxpayers may even take the point of view that Korean tax auditors are aggressive, particularly with respect to proposing transfer pricing adjustments. Given the significant impact that transfer prices can have on taxable income coupled with the inherently nebulous nature of transfer pricing analysis, transfer pricing can easily become the most contentious issue between a taxpayer and the tax auditors during a tax audit. In this kind of challenging environment, taxpayers who are not adequately prepared to defend their transfer prices can face potentially severe consequences. This article reviews various aspects of transfer pricing audits in Korea and expounds on “best practices” for managing audits to obtain optimal results.

Types of audits

In Korea, audits can come in a variety of forms. At one end of the spectrum is the special audit, which is usually reserved for taxpayers suspected of engaging in some kind of illicit activity to evade taxation. In the past, illicit tax evasion activities have included the manipulation of transfer prices. Special audits can be quite dramatic with dozens of tax auditors showing up unannounced and storming a taxpayer’s premises to confiscate documents. Fortunately, special audits are not common and special transfer pricing audits are extraordinarily rare.

At the other end of the tax audit spectrum is the desk audit which essentially takes the form of an information request from the tax authorities. The information request will usually focus on gathering information on a specific tax item during a specific year that has been identified as a potential issue based on the tax authorities' review of the taxpayer's tax filing. It is noteworthy to mention that transfer pricing is increasingly becoming a primary focus of desk audits. Taxpayers are generally provided with 60 days to respond to a desk audit.

The results of a desk audit can be quite unpredictable. In some rare instances, the desk audit will conclude with the taxpayer receiving a preliminary tax assessment. A more common outcome, however, is for the desk audit to simply conclude without the tax authorities taking any further action. Unfortunately, the conclusion of a desk audit does not provide the taxpayer with any meaningful closure since the tax authorities retain the right to conduct further review at a later time. It is also noteworthy to mention that undergoing a desk audit does not prevent the taxpayer from being selected for a normal tax audit (often referred to as a field audit) in the future. In fact, a desk audit will often serve as a precursor to a field audit. This article primarily addresses field audits that focus on transfer pricing.

Tax audit procedures

Audit selection factors

The most common taxpayer reaction after receiving a notification of selection for a tax audit is "What did I do wrong?" In most cases, taxpayers are selected for an audit as a matter of course and not because of any wrongdoing. Specifically, corporate taxpayers are generally subject to a tax audit during four to five year intervals, which directly coincides with Korea's five year tax statute of limitations. Audits may come sooner or later depending on a taxpayer's unique facts and circumstances.

While tax auditors will endeavour to review all potential tax issues during a tax audit, there are several attributes that increase the likelihood that a tax audit will focus primarily on transfer pricing. These factors can include:

- significant volume of intercompany transactions
- failure to submit tax filing-related transfer pricing documentation
- payment of royalties and/or management service fees
- restructuring of business operations or changes in nature of intercompany transactions
- reporting operating losses, low profitability or fluctuations in profitability
- transactions with affiliates located in tax havens, and
- use of unusual or complex transaction structures.

Notwithstanding the various attributes listed above, transfer pricing has become a very routine part of tax audits conducted on Multinational Corporations (MNC's) operating in Korea, and taxpayers engaging in intercompany transactions can reasonably expect to receive transfer pricing-related inquiries during an audit.

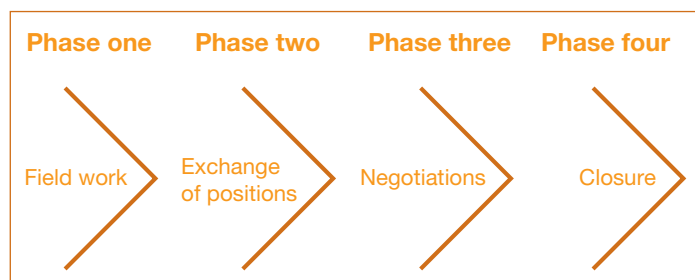
Notification

While the Korean tax regulations state that a taxpayer should receive ten days advance notification of its selection for a field audit, in reality, taxpayers often receive fewer days advance notification due to delays. Notification will be provided via an official form issued by the tax office that will be responsible for conducting the tax audit. Smaller taxpayers tend to be handled by district tax offices whereas larger taxpayers are covered by regional tax offices. The notification form will disclose the date the audit will commence, when the audit is anticipated to conclude along with contact information for the tax audit team. It is also common for the notification form to include a preliminary list of information requested. This preliminary information request enables taxpayers

to glean useful insight into the type of tax issues that the auditors are interested in investigating. When auditors are interested in reviewing transfer pricing, the notification will often (but not always) include requests for transfer pricing-related documentation including copies of corporate transfer pricing policies, intercompany agreements, transfer pricing documentation studies, legal entity organisational charts, income statements of foreign affiliates, etc. By including this request in the notification, the tax auditors will expect the taxpayer to be in a position to provide this information shortly after the onset of the tax audit.

Tax audit lifecycle

The following diagram describes the typical lifecycle of a tax audit.



Phase One: field work

Tax audits are usually conducted by a team of anywhere between four to six tax auditors, depending on the size of the taxpayer, and are led by an in-charge official. Auditors typically expect to resolve all issues during this relatively short time frame which adds to the urgency of providing information in a timely manner. Moreover, auditors also reserve the last week or so for work to be performed from their offices, i.e., preparation of formal notices and other administrative matters, which further tightens the field audit period. While audits may be extended, this is not common and is typically a result of auditors requiring additional time to further examine a critical issue.

The audit team may or may not include a transfer pricing specialist depending on the resources available at that time. Each individual auditor will tend to concentrate on certain areas but often times will be responsible for covering several areas. On major issues such as transfer prices, the in-charge officer is normally involved from the beginning.

The taxpayer will be responsible for furnishing the audit team with personal computers, access to the Internet, a printer, and a room that is large enough to comfortably accommodate the entire audit team during the field work period of the audit.

The auditors will generally conduct their field work over a period of four to eight weeks, with the possibility of extension. During this period of time, the taxpayer can generally expect the tax audit team to be on-site each and everyday from the start of business until the close of business. As mentioned above, given that each auditor concentrates on a particular area, it is not uncommon for multiple issues to be reviewed simultaneously.

Field work will generally begin at a high level with the auditors gaining basic familiarity with the business operations of the taxpayer. Auditors will also check on the status of information requested in the tax audit notification and may issue additional information requests at this time. When reviewing transfer prices, auditors will often conduct a functional analysis to obtain a more detailed understanding of the taxpayer's business activities, particularly with respect to its intercompany transactions. In this regard, auditors will often request an employee organisational chart and phone list in order to arrange interviews with operating personnel. Throughout the field audit process, the auditors will continuously request information on various topics and issues that they believe to be problematic.

Phase Two: exchange of positions

The auditors will review all of the information gathered and begin developing a series of preliminary positions on various tax items including transfer pricing. If, based on their review of the taxpayer's transfer pricing documentation the tax auditors believe that the taxpayer's transfer prices are not consistent with arm's length, they will propose a preliminary transfer pricing adjustment based on the application of the transfer pricing method that they consider to be the most reasonable. In some cases, the transfer pricing method selected by the tax auditors will be completely different from the transfer pricing method selected by the taxpayer (e.g. Profit Split Method versus Transactional Net Margin Method). In other cases, the transfer pricing method may be the same, but its application will be different (e.g. application of Transactional Net Margin Method based on different sample of comparable companies).

After receiving the preliminary transfer pricing position of the tax auditors, the taxpayer will have an opportunity to prepare a response. The most common form of response is through the submission of a position paper, which summarises the position of the tax auditors, refutes the tax auditors' selection of the most reasonable transfer pricing method and supports the taxpayer's position. Depending on the persuasiveness of the taxpayer's arguments, the tax auditors may accept the taxpayer's position, revise their initial position or simply maintain their previous position. In some cases, it may be necessary for the taxpayer to prepare multiple position papers on various transfer pricing-related issues that can range from understanding of the taxpayer's business facts to the appropriateness of making comparability adjustments to the comparable companies selected.

Phase Three: final negotiations

After the tax auditors and the taxpayer have completed their final exchange of positions, the audit will reach a point where the tax auditors will need to finalise their position for internal reporting purposes. This is when the audit reaches its climax and is arguably the most critical point during the entire audit. As is typical with any high stakes negotiation, there will be an active back-and-forth exchange of proposed settlement terms and conditions accompanied by a fair amount of pretense and posturing from both sides. It is not unusual for intense negotiations to take place up to the very last minute, often requiring taxpayers to be in a position to make quick decisions.

One particularly interesting aspect of these negotiations is that the final results of a tax audit can be affected by whether or not the taxpayer intends to pursue an appeal.¹ In most cases, a taxpayer will be able to negotiate a more favourable transfer pricing adjustment by providing the tax auditors with a tacit agreement that it will accept the transfer pricing adjustment and not pursue an appeal. If a taxpayer intends to pursue an appeal, however, it is standard protocol for the taxpayer to disclose this to the tax auditors. Unfortunately, making this disclosure can result in a significant increase in the magnitude of the transfer pricing adjustment.

¹ There are a variety of domestic appeal options available to taxpayers including Pre-Assessment Notice Protest to district, regional or head office of the NTS, Request for Investigation to the NTS, Request for Adjudication to the National Tax Tribunal (NTT) or Appeal to the Board of Audit and Inspection (BAI). Taxpayers may only pursue court litigation after an appeal to the NTS, NTT or BAI. Taxpayers may also pursue Competent Authority (CA) procedures.

Transfer pricing review committee

Irrespective of whether the taxpayer intends to pursue an appeal, all transfer pricing adjustments proposed by tax auditors that are in excess of KRW 1 billion or otherwise disputed by a taxpayer will be submitted to the Transfer Pricing Review Committee (TPRC) of the National Tax Service (NTS) for review prior to the finalisation of a tax audit. The TPRC was established to help ensure that taxpayers are treated fairly and consistently with respect to transfer pricing assessments. In evaluating a proposed transfer pricing adjustment, the TPRC will consider information presented by the tax auditor as well as the taxpayer. The tax auditor responsible for the proposed adjustment will also be required to present and explain the background and basis for making the adjustment.

Phase Four: closure

Upon completion of a tax audit, the taxpayer will be notified of the results of the audit through a *Pre-Assessment Notice*, which indicates the total amount of transfer pricing adjustment and the estimated tax liability for each year covered by the audit. If the taxpayer objects to the findings described in the *Pre-Assessment Notice*, the taxpayer has the option to protest the results within 30 days of the date of receipt of the *Pre-Assessment Notice*.

At the conclusion of the deadline for filing the pre-assessment protest, the relevant district or regional office of the NTS will issue a *Tax Assessment Notice*. Any additional taxes will be assessed based on the issues raised and the taxpayer will be required to pay the assessed taxes within 30 days of the date of receipt of the *Tax Assessment Notice*.

A *Notice of Temporary Treatment as Timing Difference* will usually be issued at the same time as the *Tax Assessment Notice*. The *Notice of Temporary Treatment as Timing Difference* describes the amount of the transfer pricing adjustment and interest payable for each entity involved in the intercompany transactions. These amounts should be repatriated back to Korea within 90 days from the date the notice is received.

The implications of a transfer pricing adjustment

In the event of a transfer pricing adjustment, a taxpayer will be subject to an underreporting penalty, which is generally 10% of the taxes on the underreported income and imposed on the difference between adjusted taxable income and taxable income reported on the corporate tax filing.² Taxpayers will also be subject to an underpayment penalty, which is determined by applying the interest rate prescribed in the Corporate Income Tax Law (CITL) by the number of days the tax was unpaid. The current applicable interest rate is 10.95% per annum (18.25% before 2003).

A uniquely difficult aspect of the Korean transfer pricing regulations is the concept of secondary adjustments. For the uninitiated, secondary adjustments are additional tax treatments that occur if a transfer pricing adjustment is not repatriated back to Korea. While the particular secondary adjustments applicable will depend on the relationship between the taxpayer and the transaction counterparty, as a result of recent amendments to the regulations, most adjustments will be treated as a deemed dividend subject to withholding taxes at the rate specified in either the CITL or applicable tax treaty.

Transfer pricing audit best practices

Every taxpayer has a unique set of facts and circumstances that will give rise to different potential transfer pricing considerations. Moreover, individual tax auditors tend to take different approaches to conducting transfer pricing audits. While there is no single best way to handle a transfer pricing audit, there are several general principles or “best practices” that can be applied on a holistic basis to effectively manage a transfer pricing audit and increase the likelihood of achieving a favourable outcome.

² The underreporting penalty may be waived if, as a result of CA procedures, it is determined that the transfer pricing adjustment was not a result of taxpayer negligence.

Before the audit

Assess potential transfer pricing risk

As with any tax issue, preparation is key. Taxpayers should analyse the arm's length nature of their intercompany transactions in order to identify potential transfer pricing issues/exposures in advance of a tax audit. Ideally, this risk assessment should be performed from the perspective of a tax auditor. For transfer pricing issues that are identified as being high risk, the taxpayer should consider taking remediation measures to the extent possible. When remediation is not possible, however, the only viable alternative is to develop defensive strategies/arguments to reduce potential exposure. Taxpayers tend to develop more compelling strategies and more persuasive arguments when not under the duress and time constraints of a tax audit.

Prepare comprehensive transfer pricing documentation

Since taxpayers are provided with only limited advance notification of selection for a tax audit, taxpayers should endeavour to prepare comprehensive transfer pricing documentation in advance of the tax audit. This will enable the taxpayer to submit "off-the-shelf" transfer pricing documentation to the tax auditors at the onset, which clearly demonstrates that the taxpayer made a good faith effort to document the arm's length nature of its transfer prices. It also sends a powerful message to the tax auditors, i.e. the taxpayer believes that its transfer pricing policies are consistent with arm's length and is fully prepared to defend its position. In other words, a transfer pricing study prepared in advance is far more credible than one prepared during a tax audit.

In addition, Korea's transfer pricing regulations tend to provide general guidance rather than specific recommendations. While this tends to provide flexibility, it also leaves a lot of room for interpretation. Transfer pricing documentation should be prepared in a manner to support that the interpretations taken by the taxpayer are the most reasonable and appropriate.

Prepare employees for interviews

When conducting a transfer pricing audit, tax auditors will perform a functional analysis or attempt to obtain a better understanding of the taxpayer by conducting interviews with various company personnel. These interviews focus on gathering information on a functional area and will include questions relating to the employee's own role and responsibilities. In order to avoid a situation where tax auditors contact employees at their own discretion, taxpayers should identify the employees that are most suitable for the auditors to interview. Typically, these individuals are the most knowledgeable about a specific function within the taxpayer's business organisation (i.e. marketing and sales). Since it is human nature to exaggerate one's own importance within an organisation, these employees should be coached in advance of being interviewed to ensure that they provide a clear and accurate description of their area of expertise, role and responsibilities. It goes without saying that this description should be consistent with the taxpayer's transfer pricing documentation. Where possible, one person should be designated as the main contact for the auditors and attempts made to limit interviews to only this person.

Consider applying for Advance Pricing Agreement

In Korea, taxpayers may apply for an Advance Pricing Agreement (APA) to cover prospective tax years. In addition, taxpayers may also request a "rollback" of the APA to cover open tax years as long as the APA application is submitted before the taxpayer is selected for a tax audit. Unilateral APAs can generally be rolled back for three years while bilateral APAs can generally be rolled back for five years. By applying for an APA with rollback, a taxpayer can effectively take transfer pricing "off the table" in the event that it is selected for a tax audit. Transfer pricing results negotiated through an APA tend to be more favourable than results obtained during a transfer pricing audit. The taxpayer also obtains the added advantage of securing certainty on the acceptability of transfer prices in future years.

During the audit

Strategically managing information

Taxpayers will provide tax auditors with an enormous amount of information during the course of an audit. In addition to issuing formal information requests, tax auditors will frequently make informal verbal requests to different taxpayer personnel for information related to specific tax items. In order to avoid chaos and confusion, it is often useful for taxpayers to designate a single point of contact and request that information requests be channelled through this individual.

It is not uncommon for tax auditors to request more information than the taxpayer can provide. In some cases, the tax auditors will request information that the taxpayer considers to be confidential or highly sensitive. At the same time, tax auditors can become quite belligerent about demanding the submission of information on a timely basis. For these reasons, it is absolutely essential to keep meticulous records of what information the tax auditors have requested, when it was requested, what information has been provided and when it was provided.

All information should be carefully reviewed prior to submission in order to avoid providing the tax auditors with information that will raise additional tax issues. In addition, it is generally not advisable to submit more information than requested, which can also result in “shooting yourself in the foot”. With respect to information requested by the tax auditors that the taxpayer does not intend to submit, taxpayers should be prepared to explain why this information cannot be provided or is otherwise irrelevant to the tax audit.

An example of this commonly occurs during transfer pricing audits, when tax auditors request the financial statements of the taxpayer’s foreign affiliate transaction counterparty for the purposes of gauging relative profitability. This information tends to be irrelevant except in a situation where the most reasonable transfer pricing method is determined to be the profit split method. Accordingly, one possible response to this line of inquiry is to submit a transfer pricing study that demonstrates that the taxpayer’s transfer prices are consistent with arm’s length in lieu of the financial data of foreign affiliates.

Maintain a good relationship with auditors

Despite all of the government rhetoric, it’s naïve to believe that all tax audits will be conducted in a completely objective manner. At its heart, a tax audit is basically a negotiation between people. By maintaining a good working relationship with the tax auditors, the taxpayer can avoid creating an antagonistic audit environment which can lead to aggressive tax assessments. This is especially true when it comes to transfer pricing audits, where tax auditors and taxpayers can make dramatically different interpretations of the same set of facts. Maintaining a good relationship with tax auditors will also increase the likelihood of “getting the benefit of the doubt” on those transfer pricing issues that have an uncanny tendency to become highly contentious (i.e., comparable companies, comparability adjustments, etc.).

Taxpayers can maintain a good relationship with tax auditors by providing their full cooperation, to the extent that it is possible. This means responding to information requests in a timely manner, accommodating requests for meetings or interviews, communicating on a regular basis and providing them with other support as needed.

Attempt to negotiate a favourable settlement

It is difficult for a taxpayer to successfully negotiate a settlement with the tax auditors without fully understanding the alternatives to negotiating a settlement. A fundamental concept in negotiation theory is to understand the best alternative to a negotiated settlement (BATNA), which is the course of action that will be taken in event that negotiations fail. BATNA can often be a powerful source of leverage when negotiating a settlement.

In the context of negotiating a transfer pricing adjustment, a taxpayer’s BATNA is generally pursuing an appeal. While it is difficult to reliably quantify a taxpayer’s BATNA given the unpredictable nature of tax appeals, some of the factors that should be taken into consideration include:

- probability of winning an appeal
- expected reduction in transfer pricing adjustment
- estimated advisor fees, and
- strain on taxpayer resources.

A taxpayer's BATNA should be compared to the full costs of negotiating a transfer pricing adjustment, which includes the tax on adjustment, underreporting and underpayment penalties, resident surtax as well as secondary tax adjustments and interest charges that will be applicable in the event that the transfer pricing adjustment is not repatriated back to Korea.

In negotiating a settlement, it is important for the taxpayer to communicate with tax auditors on a regular basis in order to stay informed of their internal reporting deadlines. This is particularly important since it is difficult for a tax auditor to retract a transfer pricing adjustment after it has been reported internally to superiors.

After the audit

Be mindful of deadlines

The Korean tax regulations state both the time frame in which tax assessment-related notifications should be made to a taxpayer and the period in which the taxpayer may initiate protest or appeal procedures (refer to Tax Audit Lifecycle Phase 4: Closure). However, in reality, tax assessment-related notifications are often delayed and taxpayers may have less time to act than the original time allotted to them. The tax authorities are meticulous when calculating the deadline for making payments or filing protest/appeal procedures. Accordingly, the taxpayer should be acutely aware of due dates when planning for payment of tax assessment or post-audit appeal options. Additional interest will be calculated at a daily rate on tax payable after the payment due date and even a one-day lapse will prevent the taxpayer from initiating appeal procedures.

Take necessary remedial actions

Determining the appropriate remediation will depend on the taxpayer's evaluation of the transfer pricing audit and resulting adjustment. If the taxpayer believes that it will be difficult to defend its current transfer pricing policies in a future tax audit, it may be useful to consider implementing changes, at least prospectively.

Another potential remediation option is for the taxpayer to pursue an APA. As described previously, obtaining an APA will provide a taxpayer with certainty on the acceptability of its transfer prices and will also prevent tax auditors from reviewing transfer prices in the event of a tax audit. It is noteworthy to mention that the transfer pricing methodologies negotiated through an APA tend to be more favourable than those negotiated during an audit and also tend to be more consistent with global standards. For this reason, taxpayers frequently seek APAs after undergoing a difficult transfer pricing audit.

Conclusion

Since the enactment of the Law for the Coordination of International Tax Affairs (LCITA), transfer pricing has become the single, most important tax issue facing multinational companies doing business in Korea. In recent years, the NTS has stated that the enforcement of transfer pricing compliance is their highest priority and has expended considerable efforts to train its field examiners to enhance their transfer pricing audit capabilities.

While every taxpayer's transfer pricing audit experience will be different, recent experience suggests that tax auditors may apply "aggressive" transfer pricing approaches, including reviewing segmented financial statements rather than aggregate results, focusing on results during individual years rather than average performance, and using secret comparables. Still, there is an old Korean proverb that states "You can survive a night in a tiger's den if you are attentive and keep your wits about you." While it's a bit unfair to the tax authorities to liken a tax audit to surviving a tiger attack, the key message is certainly apropos. Taxpayers can minimise the risk of transfer pricing adjustments during a tax audit through advance preparation. While there are certainly a fair number of taxpayers that can share transfer pricing audit horror stories in Korea, there are also plenty of taxpayers that have come out of a transfer pricing audit relatively unscathed.

New Zealand tax authority risk review activity

by Michael Bignell & Geoff Castle





The New Zealand Inland Revenue Department (IRD) continues to maintain the view that transfer pricing is the most significant international tax issue. In recent years it has significantly increased its audit risk review activity with transfer pricing questionnaires now being issued to taxpayers as part of the standard audit process.

More recent focus has been aimed at taxpayers within the Large Enterprises group of companies. This group represents the largest corporate taxpayers in New Zealand and comprises 0.2% of taxpayer population but contributes 48% of total tax collected.

The IRD has also implemented projects aimed at reviewing interest and royalty cross border transactions. In this article, we discuss the context of these specific initiatives, and some of the issues that arise.

Interest charges

The IRD commenced its review of taxpayers with cross border related party interest payments in excess of \$1million last year and has recently extended its review. As with the initial round last year, the IRD has issued letters to taxpayers requesting information and documentation to support intra group interest rates. The IRD is identifying taxpayers by reviewing Non Resident Withholding Tax returns.

From the first round, the IRD was reasonably satisfied with the interest rates being charged between related parties and the level of documentation prepared to support the intra group funding arrangement. It is fair to say, however, the underlying interest rates paid by the relevant taxpayers were not high. It will be interesting to see if the same outcome arises in this case.

Notwithstanding the positive outcome for most taxpayers from the original review, given the level of debt entering New Zealand to pay for New Zealand assets, the IRD feels that it must continue to monitor interest rates on cross border related party loans.

It is also clear from the original review that on larger debts, taxpayers can no longer rely on indicative interest rates provided by financial institutions and need to demonstrate, preferably by benchmarking, that the intra group interest rate is reflective of the New Zealand borrower's credit rating.

Royalty payments

The IRD is undertaking a review of outbound royalty payments by taxpayers within the Large Enterprise group.

While we assume the IRD will focus on the largest payments of royalties to offshore associated parties, it has not prescribed any other criteria for selection, e.g. a threshold amount, nor has it advised what level of documentation it expects taxpayers to have prepared. This is the first time that the IRD has specifically focused on related party royalty payments and indicates that it is continuing to raise taxpayers' expectations that they cannot just accept global royalty arrangements without having sufficient documentation and considered whether the pricing methodology is appropriate for New Zealand.

While the IRD's approach to when a royalty should be paid is similar to other Organisation for Economic Cooperation and Development (OECD) countries, the IRD is of the view that as a small country the benefit derived from IP can be lower than in some other countries and is arguably more suspicious of large outgoing royalty payments.

Intangibles need to be clearly identified and taxpayers must be able to demonstrate that they add significant and substantial value if large royalty payments are to be substantiated. Answers to the following questions will be sought as a matter of course:

- Have all intangible profit drivers been individually identified (including goodwill and any licensed IP)?
- What is the value of all intangibles owned and used by the company and have they been valued by a professional firm?
- Is the IP protected?
- Who bore the cost of creating the IP?
- How and to what extent does the IP contribute to the profit?
- Has any IP been assigned and if so what was the consideration?
- How is the IP documented?
- If a royalty is paid for the use of any IP, does the taxpayer produce appropriate profits for its functions, assets (including its own intangibles) and risks after payment of the royalty?

All these questions need to be considered when assessing whether a royalty should be charged and for what value. The IRD has expressed the view that it does not expect to see New Zealand taxpayers either in losses or low profits after the payment of royalties. It argues, in these situations, the royalty has not been as effective as expected in contributing to the super profits of the organisation. Obviously counter arguments exist.

In terms of protecting the New Zealand tax base, the IRD's preference is for the residual profit split method to ensure that New Zealand taxpayers as licensees are still rewarded for the functions performed, risks assumed and assets utilised. Applying the residual profit split, the IRD would expect the New Zealand taxpayer to receive a routine return and a percentage of the residual profit.

From our experience, the IRD considers that New Zealand is a net recipient of the benefits from intangibles subject to royalties. Where there is strong evidence of taxpayers deriving value from intangibles, the IRD adopts a fairly pragmatic approach to assessing the benefit and valuation of royalty payments. However the IRD recognises that some global royalty methodologies do not consider the unique circumstances in New Zealand and whether the New Zealand taxpayer has received something for which a royalty should be charged.

As an example, New Zealand manufacturing companies are traditionally very small operations within global groups specialising in very small production runs. These companies often have to develop their own expertise to find innovative solutions to operating profitably in this environment. The IRD may therefore question whether the New Zealand company is benefiting from the global group's processes and expertise to the same extent as larger manufacturing entities within the same group.

Interestingly, the New Zealand government has recently announced the introduction of a research and development (R&D) tax credit scheme to encourage taxpayers to undertake R&D activities in New Zealand.

This may result in more intellectual property (IP) being recognised for which royalties should be charged. It could also suggest that historically NZ because of its size may have been developing its own expertise to solve local problems, rather than use offshore IP for which it has paid large royalties. Taxpayers will have to be mindful of the balance between claiming credit for local R&D activity and justifying royalties for the use of global IP.

The IRD continues to promote Advance Pricing Arrangements (APAs) as a cooperative approach to addressing transfer pricing compliance. For complex transfer pricing issues such as intangibles, in our experience APAs are very beneficial for both the IRD and the taxpayer in establishing a practical robust pricing model.

Conclusion

As New Zealand is impacted by the global economy and the influence of new technologies, the IRD has shifted its attention from its traditional product focus to the more transparent identification and valuation of intangibles and intragroup funding arrangements. In doing so it is raising taxpayer awareness of what is required to demonstrate that these transactions are arm's length.

Taiwanese tax authorities embark on transfer pricing compliance

by Yishian Lin





Taiwan's transfer pricing regime was only introduced in late 2004, yet the Taiwanese tax authority has already begun to implement a transfer pricing compliance program. In this article, we review the Taiwanese transfer pricing regime and the resultant obligations of Taiwanese taxpayers transacting with offshore related parties. We also provide updates of recent developments on the Taiwanese tax authority's approach to ensuring taxpayers are complying with the arm's length principle.

Introduction of Taiwan transfer pricing regulations

A provision relating to transfer pricing was first enacted into *Article 43-1 of the Income Tax Act (ITA)* in 1971, which stipulates that the return on controlled transactions undertaken between related parties should be conducted at arm's length. *Article 43-1 of the ITA* addresses the adjustment of income necessary for enterprises with non-arm's length transactions. It authorises the tax authorities to adjust the calculation of an enterprise's income in order to accurately determine its tax liability. *Article 43-1* however did not prescribe methodologies for transfer pricing and the burden of proof was on the tax authorities to demonstrate that the pricing of a transaction was not at arm's length.

In light of the above, The Ministry of Finance (MOF) had on 29 December 2004 issued *Assessment Rules for Non-arm's length Transfer Pricing of Profit-Seeking Enterprises* (TP Assessment Rules) with the objective of creating a detailed transfer pricing regime and to prevent the erosion of Taiwan's tax base. The TP Assessment Rules prescribe the definition for related party transactions, TP compliance requirements, TP methodologies acceptable to the Taiwan tax authorities that can be used in determining the arm's length prices and administrative regulations, including the types of records and documentation expected from taxpayers involved in transfer pricing arrangements.

Disclosure and contemporaneous documentation requirement

With the introduction of the TP Assessment Rules, companies engaging in related party transactions are now required to submit a "Related Party Transactions Disclosure Form" together with its annual tax return. The disclosure includes, but is not limited to, the following:

- organisational structure
- name of related parties
- the related party transaction amounts, and
- types of related party transactions.

The MOF requires the local Certified Public Accountant (CPA) (appointed by the taxpayer) to disclose in the “Related Party Transactions Disclosure Form” if there is transfer pricing documentation in place when filing its income tax returns. The transfer pricing report must be submitted within one month upon request from the tax authorities. A transfer pricing report as prescribed in the TP Assessment Rules should include at least the following items:

- industry and economic analysis
- functional and risk analysis of all participants in the controlled transaction
- application of the arm’s length principle
- a description of the search for comparables
- a description of the comparability analysis
- a description of the selected best transfer pricing method and its rationale
- an analysis of the transfer pricing method adopted by related parties, and
- a conclusion of measurement of the method selected.

Unless pre-approval is obtained from the tax authorities, the transfer pricing report/documentation must be prepared in Chinese.

Upon meeting certain criteria, companies may be exempted from preparing transfer pricing documentation. Generally, the exemption is applicable to companies whose operating and non-operating income is less than NTD300M (approximately US\$9M) and total related party transactions do not exceed NTD100M (approximately US\$3M). However companies are still required to provide “other supporting documentation” such as public tendering documentation, market price information, valuation reports, etc, which are sufficient to conclude that related party transactions are at arm’s length.

Transfer pricing methodology

In determining the transfer pricing methodology, the parties involved should follow the principles of the best method rule and assess comparability on a transaction-by-transaction basis as prescribed under the TP Assessment Rules. The applicable transfer pricing methods prescribed include (i) the comparable uncontrolled price (CUP), (ii) the resale price (RPM), (iii) cost plus method (CP), (iv) comparable profit method (CPM), (v) Profit Split Method (PSM) and (vi) any other method pre-approved by the MOF.

Transfer pricing in practice

Transfer pricing audits

In August 2005, the MOF issued a Ruling providing the circumstances in which a transfer pricing audit is likely to be conducted. Below are some of the circumstances highlighted in the Ruling that may lead to a transfer pricing audit:

- significant portion of profits in low income tax jurisdiction
- abnormal profit fluctuations
- losses, and
- failure to disclose inter-company transactions according to the TP Assessment Rules.

As the transfer pricing regulations have now entered into its second year of implementation, the tax authorities have recently started requesting companies to provide their transfer pricing documentation.

In PricewaterhouseCoopers’ experience in these recent cases, it appears that tax authorities are targeting those companies that disclosed “No TP documentation available” in their “Related Party Transaction Disclosure Form” in their tax returns. Another targeted group of companies are foreign corporations’ subsidiaries or branches in Taiwan.

According to the TP Assessment Rules, if the company fails to submit its TP documentation within the stipulated timeframe, the tax authority may compute the company's income tax payable based on industry or comparable company data sourced by the MOF, which is usually much higher.

As companies are generally given one month to submit their TP documentation, most are able to meet the stipulated timeframe. However, as TP documentation is generally only prepared after the submission of the tax returns, complications can arise if the TP analysis indicates that related party transactions fall outside the arm's length range. Also, the delay in submitting TP documentation may attract greater tax authority scrutiny.

Given that the Taiwanese tax authority has only recently started to request companies' to provide TP documentation, we are yet to see any significant TP adjustments or are able to observe any particular trends in relation to the contentious issues. However, transfer pricing compliance is now firmly on the agenda in Taiwan, and companies must ensure that they are sufficiently prepared to quickly and effectively respond to TP documentation requests, or other transfer pricing queries, from the Taiwanese tax authority.

Global core TP documentation and the use of non-Taiwanese documentation

Based on PricewaterhouseCoopers' experience, global core TP documentation prepared by an overseas group company of a Taiwanese taxpayer may not immediately comply with the Taiwan TP Assessment Rules because the TP Assessment Rules have explicitly prescribed the TP methods and Profit Level Indicators (PLI) that can be applied by Taiwanese companies. Any other TP method or PLI used (e.g. full cost mark up) cannot be applied unless pre-approved by the tax authorities. Nevertheless, full cost mark up may be substituted by other PLIs such as Return on Sales or adjusted Berry Ratio.

Furthermore, unless there are no suitable local comparables found, the tax authority has indicated that Taiwanese companies must use Taiwanese comparables in their benchmarking studies. Hence, in order to defend any potential challenges from the tax authority, companies are recommended to perform local comparable searches.

Advance Pricing Agreement and Mutual Agreement Procedure

The TP Assessment Rules provide an avenue for taxpayers to apply to the MOF for an Advance Pricing Agreement (APA). In order to qualify for an APA, the aggregate amount of the controlled transaction over the prospective period of the APA must be at least NTD1 billion (approximately US\$30M) or the amount of the annual controlled transactions must be at least NTD500 million (approximately US\$15M). The applicant must also not have had any occurrence of tax evasion for the previous three years, must have complied with the transfer pricing documentation requirements, and has fulfilled other criteria prescribed by the MOF. The APA is valid for three to five years from the year in which the application is filed. However, APA applications are not yet common in Taiwan.

The TP Assessment Rules do not have a separate Article on Mutual Agreement Procedures (MAP), but according to the MOF's explanation on Article 35 of the TP Assessment Rules, if the counter-party is a foreign taxpayer, the tax authority may negotiate with the foreign tax authority for the corresponding adjustment according to the Agreement of Avoidance of Double Taxation between the two countries. However, no operational guidance has been published so far.

The TP Assessment Rules *Article 25* also cover domestic transfer pricing and stipulate that in the event of the Taiwanese tax authority making an arm's-length adjustment to a Taiwanese taxpayer, it shall make corresponding adjustments to the counter-party of the Controlled Transaction provided that it is a taxpayer under Taiwan tax jurisdiction.

Determination of business profit attributable to a PE through transfer pricing

The MOF has published a Ruling (*Tai-Tsai Sui Ruling No. 9604506050*) on 11 January, 2007, to prescribe the taxation method and provide guidance as to how business profits should be calculated in circumstances where a foreign enterprise carries on business activities in Taiwan through a permanent establishment. However, this Ruling is only applicable when the foreign enterprise is situated in a country where Taiwan has a double taxation agreement. In the absence of double taxation agreement, a foreign company which has similar issues may consider applying for an APA.

The MOF has provided in the abovementioned Ruling that if a foreign enterprise carries on business in Taiwan through a PE in Taiwan, the profits attributable to the Taiwan PE shall be taxed in Taiwan. The profits attributable to the PE shall be determined according to the TP Assessment Rules and documentation must be available in order to substantiate that the profit attributed is consistent with the arm's length principle.

In addition, in determining the profits of a PE, expenses incurred for the purpose of the PE (including general administrative expense) shall be allowed as a deduction for tax purposes. However, the TP Assessment Rules should be adhered to when charging these expenses (it is worth noting, however, that management fee allocations from head office to branch are not governed by the TP Assessment Rules).

Where a foreign enterprise files its tax returns through a business agent in Taiwan, the business agent shall be responsible for keeping separate accounting records/documentation, maintaining tax records, documents and other related information, including TP documentation.

Conclusion

Although the TP Assessment Rules are still relatively new, the Taiwanese tax authority is fast developing its expertise in order to understand the pertinent issues, and then enforce the TP rules via targeted compliance activity. With an increased understanding of transfer pricing, and the growing complexity of related party transactions, the standards expected in relation to transfer pricing compliance will inevitably increase. Hence, companies operating in Taiwan should anticipate greater TP challenges in the future.





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Upcoming Events

Please save the dates for future PricewaterhouseCoopers Transfer Pricing events hosted by our global network:

Transfer Pricing Masters Series for Financial Services Professionals:

Singapore – March, 2008

New York – May 15, 2008

Amsterdam – May 21, 2008

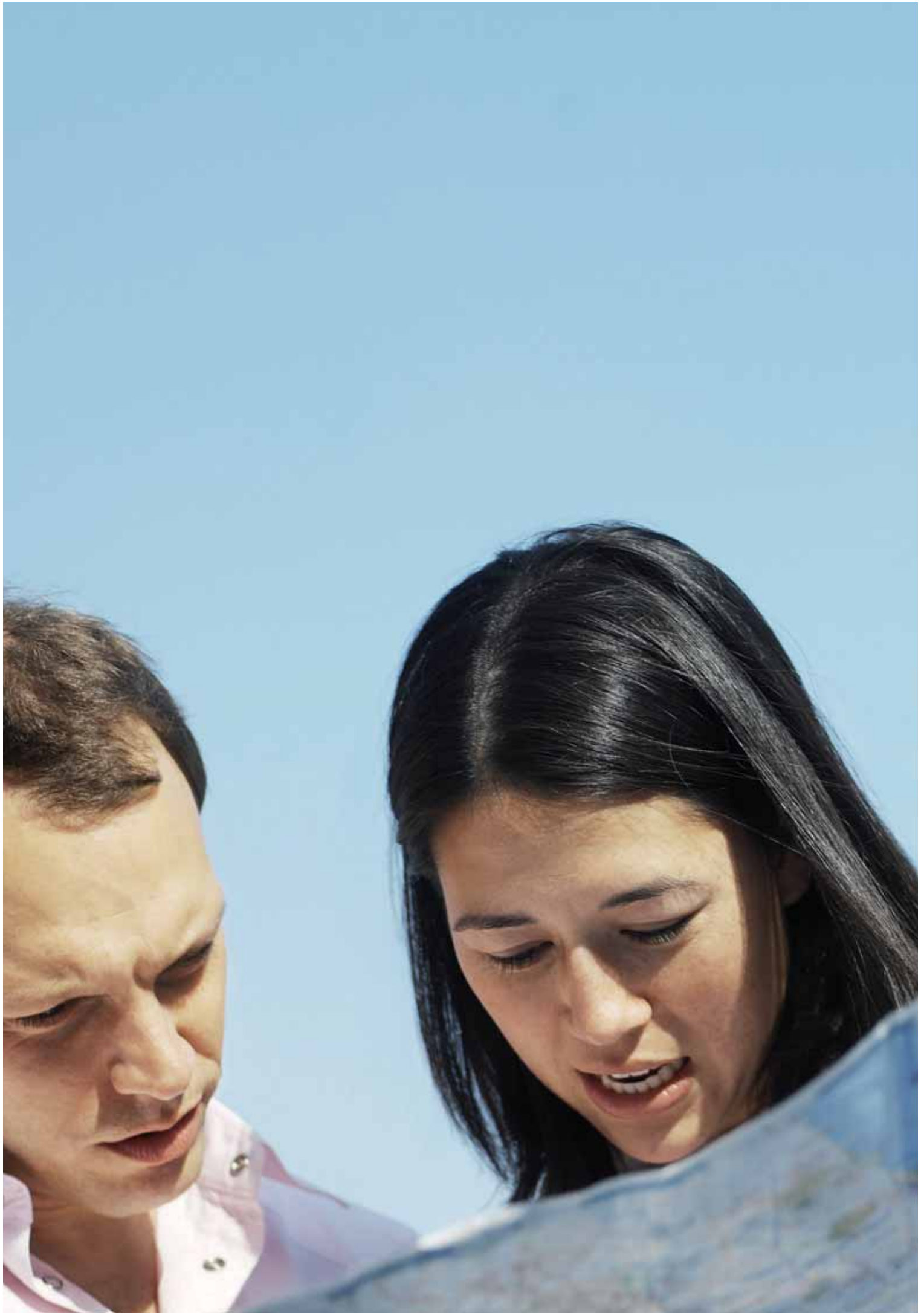
Transfer Pricing Global Conference 2008:

October 2008, Vancouver, British Columbia, Canada



The transfer pricing landscape in Asia – 2007

	Legislation	Documentation requirements	Burden of proof	Enforcement activity	Penalties	Disclosure requirements	APAs
Australia	Yes	Yes	Taxpayer	Aggressive	10-50% additional tax	Annual tax return disclosure	Extensive activity
China	Yes	Developing	Taxpayer	Aggressive	Special interest levy	Annual tax return disclosure	Extensive activity
Hong Kong	Developing	Developing	Taxpayer	Developing	No specific TP penalties	Annual tax return disclosure	Limited
India	Yes	Yes	Taxpayer	Developing	2% transaction value, 100-300% additional tax	Annual tax return disclosure	No
Indonesia	Yes	No	Taxpayer	Limited	Up to 48% additional tax	No	Yes
Japan	Yes	No	Tax authority	Aggressive	10-35% additional tax	Annual tax return disclosure	Extensive activity
Korea	Yes	Yes	Both	Developing	20-30% of extra tax or 0.1% TP adjustment	Annual tax return disclosure	Extensive activity
Malaysia	Yes	Yes	Taxpayer	Developing	15-100% additional tax	Annual tax return disclosure	Yes
New Zealand	Yes	Yes	Both	Developing	20-150% additional tax	Questionnaire	Extensive activity
Philippines	Yes	No	Both	Limited	25% general penalty, 20% interest rate	No	No
Singapore	No, but guidance issued	Developing	Taxpayer	Limited	General penalty rates apply	Annual tax return disclosure	Yes
Taiwan	Yes	Yes	Both	Developing	200-300% underreported amount	Annual tax return disclosure	Yes
Thailand	Yes	Yes	Taxpayer	Aggressive	Up to 100% added tax plus 18% interest	Annual tax return disclosure	Yes



Global Core Documentation Implementation Tool

KEY (●) = YES / BLANK = No

	AUSTRALIA	CHINA	HONG KONG	INDIA	INDONESIA	JAPAN	KOREA	MALAYSIA	NEW ZEALAND	PHILIPPINES	SINGAPORE	TAIWAN	THAILAND	ARGENTINA	BRAZIL	CANADA	CHILE	COLOMBIA	ECUADOR	MEXICO	PERU	UNITED STATES	URUGUAY
	ASIA-PACIFIC												AMERICAS										
Transfer Pricing Rules, In General																							
Q1	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Q2	●			●			●	●				●		●	●	●		●		●	●	●	●
Transfer Pricing Documentation, in General																							
Q3	●			●			●	●				●	●	●	●	●		●		●	●	●	●
Q4				●			●					●	●	●	●	●		●	●	●	●	●	●
Q5	●	●			●	●	●	●	●	●	●	●	●	●	●	●	●		●		●	●	●
Elements of Transfer Pricing Documentation																							
Q6	●	●	●	●	●	●	●	●		●	●	●	●	●	●	●		●	●	●	●	●	●
Q7	●	●		●		●	●	●			●	●	●	●	●	●		●	●	●	●	●	●
Q8	●	●		●		●	●	●	●		●	●	●	●	●	●		●	●	●	●	●	●
Q9	●	●		●		●	●	●	●		●	●	●	●	●	●		●	●	●	●	●	●
Q10		●		●		●	●	●			●	●	●	●	●	●		●	●	●	●	●	●
Timing of Transfer Pricing Documentation																							
Q11								●				●	●		●					●		●	●
Q12	●			●			●							●	●	●		●	●	●	●	●	●
Q13	●	●			●	●	●	●	●	●	●	●	●					●			●	●	●
Overall Transfer Pricing Sophistication Assessment ("TPSA")																							
Low			●		●					●							●						●
Moderate								●			●				●								
High	●	●		●		●	●	●				●	●	●	●	●		●	●	●	●	●	●

Notes: Further information related to the questions above and TPSA are provided below.

- [Q1] Formal rules include tax legislation, government proclamations, etc.
- [Q2] Transfer pricing-specific penalties refer to those other than general tax-related penalties and may include penalties for non-compliance with transfer pricing documentation rules and/or underpayments of tax that are attributable to valuation misstatements related to transfer pricing.
- [Q4] Answer "Yes" if transfer pricing documentation is required by law, decree, etc. Answer "No" if transfer pricing documentation is not formally required but is expected to be provided during a tax audit.
- [Q5] Answer "Yes" if transfer pricing documentation is not formally required (i.e., by law) but is expected to be provided during a tax audit to support the arm's length nature of the intercompany transactions.
- [Q6] Such transfer pricing-related information may include (i) financial statements, intercompany transaction amounts and/or other information of affiliated companies; (ii) identification of the pricing method(s) used for each type of transactions; etc.

- [Q7] The term "functional analysis" refers to the identification of functions performed, risks assumed, and assets used by the entities in the group.
- [Q9] The term "arm's length analysis" refers to the analysis of the nature and extent of the intercompany transactions.
- [Q11-13] It may be appropriate to consider the timing of the documentation in relation to the transaction and/or the tax return.
- [Q13] Answer "Yes" if there is no requirement to present the documentation upon request by the tax authorities.
- TPSA: The "TPSA" is a tier ranking system. The basis for TPSA are the results of the questions above. The weights for each question are as follows:

