Tax & Legal Services
Transfer Pricing

Global Transfer Pricing Perspectives*

Latin America edition, Summer 2007

*connectedthinking

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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.

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A note from Garry Stone

Dear Reader,

It is a pleasure to welcome you to the Summer edition of Transfer Pricing Perspectives, a compilation of articles focused on providing up to date information about transfer pricing planning, compliance and strategy. In this edition, we focus our discussion on the transfer pricing environment in Latin America.

In this cover letter I would like to discuss some of the additional general trends we see in transfer pricing around the globe. While the long-run concerns around attribution of profits are one of the key long-term trends, we are likely to see more immediate impact from much more aggressive tax audits and FIN 48. Below I look at how taxpayers are responding to this new paradigm and specifically how tax directors can add sustainable value while managing global transfer pricing risks.

The New Paradigm

We are seeing a shift in the way companies have to deal with Transfer Pricing issues. This shift is being driven by several key factors, some tax related, some cost-driven.

First, Transfer Pricing disputes are becoming more aggressive and integrated across countries and regions. Some of the ominous trends we see involving and driven by the tax authorities globally in their individual efforts to get "their share" are:

- An increase in information sharing across borders;
- Audits on a bilateral or multilateral basis; and
- Additional enforcement resources.

In addition, tax authorities are tightening their documentation requirements, revising their regulations (such as the IRS's Temporary Regulations for Services), adding penalties, and generally becoming more sophisticated in their audit approaches around the globe. In particular, many developing economic centers, such as China and Russia, which previously did not have significant transfer pricing audits or regulations, are developing audit capabilities which will be world class once their new rules are adopted.

Second, the unprecedented volume of global compliance and audit responses needed to manage disputes in the transfer pricing arena is driving companies to seek more cost effective ways to manage their global transfer pricing risks.

Finally, we see FIN 48 creating new information requirements with respect to uncertain tax positions and new objectives for those SEC registered companies. This is due to the future potential for tax authorities to gain access to work papers dealing with uncertain tax positions and the transparency of these positions and their ultimate outcomes which are revealed on financial statements. Given the size of many transfer pricing disputes and the multiple year nature of transfer pricing positions, it is anticipated that it will be one of the major disclosure areas in a FIN 48 world.

These factors and the ever-increasing volume of multinational business flows has spawned a need for greater global consistency, renewed focus on both the form and substance of transactions, and more efficient management of global compliance and defense costs. The changing

“Transfer Pricing disputes are becoming more aggressive and integrated across countries and regions.”

landscape will also drive renewed interest in APAs, rulings, and similar “certainty” approaches to manage transfer pricing risks globally around uncertain transfer pricing tax positions.

Because multinationals will be seeking greater certainty in their positions; the avoidance of perceived “earnings surprises” and (or) negative press related to unfavorable (favorable) transfer pricing dispute resolutions will partially drive this behavior. We think this shift in paradigm will create a new objective for many corporate tax departments: the objective to obtain the lowest sustainable effective tax rate.

In anticipation of the new environment you should begin to:

- Treat local documentation as part of your global solution and “layer one” of a defense file, not minimal local compliance;
- Be consistent in your approach to similar transfer pricing issues around the globe (while likely upgrading your analyses; you may also see efficiency gains with this approach);
- Evaluate the appropriateness of both the substance and form of your transactions (can you clearly show that your business model is consistent with the arm’s length principle?); and
- Consider alternative dispute resolution/certainty: APAs, rulings, and other similar approaches.

In addition, we see a future where tIn addition, we see a future where the transfer pricing challenges will not always be about correct transfer pricing (while respecting a transaction’s characterization), but more often in the future the tax authorities will attempt wholesale re-characterization of transactions to better suit their own interests. These attacks may manifest themselves in several potential forms:

- PE;
- disrespect for the transaction via looking through the transaction to another level; or
- re-characterization of an entity’s or transaction’s functions, risks and IP (eg, KERTs may mean different things to different people).

Therefore, in summary you must now carefully document the business purpose and arm’s length nature of any transaction structure and also have proper legal form behind it. We believe that companies can continue to sustain their tax positions when these “arm’s length standard” fundamentals are firmly in place.

Please enjoy the remainder of this edition of Transfer Pricing Perspectives, and feel free to contact us with any questions.

Garry Stone, Ph.D.
Global Leader of Transfer Pricing Services

Editorial

When a tax director for a multinational corporation analyses the matter of transfer pricing in South America, a regional approach is often determined to be the most efficient and effective approach to compliance. The advantages of a regional approach include documentation consistency, reducing times involved in discussion with the tax authorities in different countries, lower cost and centralised decision-making.

The question is how to achieve an efficient result from a regional process when:

a) Local country rules are not always consistent with the OECD;

b) There are countries that have seen the revaluation of their currency (Brazil, Chile) while in others the currency has been devalued (Argentina);

c) Comparables at regional level are scarce; and

d) Countries are constantly introducing new transfer pricing regulations and updating documentation requirements.

The resulting challenges do not invalidate the regional documentation system, but require taxpayers to take a broader view of their compliance to optimize compliance efforts and adapt them to the reality of each country in the region.

Our experience in transfer pricing matters in the region shows that a regional approach helps avoid duplication of effort and achieves economies of scale. Nevertheless, any savings could evaporate, or could lead to risky positions if not complemented by a careful local analysis that takes into account the particularities of each country in the region.

As we have seen, ignoring the effect of relations between Brazil and the remaining countries in the region could give rise to double taxation situations. Lack of awareness of the regulatory and control environment in Argentina and Venezuela could lead to costly audit processes.

Failure to keep up-to-date in relation to regulatory changes in countries such as Peru or Colombia could lead to large fines and assessments. These risks can be minimised by developing a comprehensive and co-ordinated transfer pricing approach that takes into account the distinct features of each country.

As in other areas, the region has its distinctive features. The Latin touch in transfer pricing matters has quite a large formal requirement component and a moderate bias against multi-nationals, all accompanied by the need of domestic administrations to generate revenue. It is undoubtedly a dish that can be tasty to some, but that without adequate planning could become indigestible.

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“The Latin touch in transfer pricing matters has quite a large formal requirement component and a moderate bias against multi-nationals, all accompanied by the need of domestic administrations to generate revenue.”

Tax treatment of management fees and other corporate services in Latin America

By

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Countries with significant investment abroad have introduced new rules or otherwise encouraged corporate head offices located in their countries to charge their foreign related entities the costs of the activities the head offices carry out on behalf of the local office. These charges are made with the understanding that companies located abroad use such head office services to obtain benefits in their local markets.

As an example, on August 4, 2006 the U.S. Internal Revenue Service published its "Temporary Regulations"[1] on services, effective for fiscal years ending after December 31, 2006. Changes in the United States tend to precede similar legislation in other countries with heavy foreign investment.

In general, Latin American countries have been reluctant to accept the tax deduction of such expenses, by either restricting or preventing their deduction, setting a high withholding tax on amounts remitted in payment, or a combination of both measures.

It is curious that from a legal point of view there seem to be no significant differences in the legislation of the various countries. For example, in U.S. law, a charge to the foreign entity is only required if the activity is considered to generate a benefit for the receiver, if:

- The activity results directly in a reasonably identifiable value that improves the commercial position of the receiver, or that could be reasonably be expected to do so; or
- If a taxpayer not controlled by the US entity would in similar circumstances be prepared to pay an unrelated party for the same or a similar activity that otherwise the receiving party would have had to carry out for itself the same or similar activity.

Here it is established that "an activity is not considered as supplying a benefit the receiver if, at the moment the activity is performed, the actual or reasonably anticipated benefit of that activity is so remote that the receiver would not be willing to pay an unrelated party performing a similar activity for it, even on the basis of a fixed or contingent payment, and would not be prepared to perform such an activity itself for that purpose"[2].

In general, Latin American legislation tends to recognize that an expense will be deductible when related to the generation, obtaining or maintenance of profits subject to income tax. Where then does the discrepancy arise? What is it that makes it more costly for corporations to charge their Latin American subsidiaries? In many cases it is because of the issue of specific regulations, in others, jurisprudence. First, we will review legislation in the main countries in the region, to then turn and address the benefits test issue.

1 The IRS issued these regulations on a "Temporary" basis to enable public comment before finalizing the regulations. Nevertheless, taxpayers may opt to formally apply the Temporary Regulations in any fiscal year beginning as from September 10, 2003. If adopted, the criterion should be applied to all subsequent years.

2 Treas. Reg. §1.482-9T(l)(3)(ii).

Brazil

Deductibility of charges for services provided abroad by Head Office

Expenses recognized by a Brazilian entity are deductible for tax computation purposes if:

1. actually incurred;

2. ordinary and necessary to conduct the business activities of the company; and

3. properly and adequately documented.

In the context of service fees, expenses will only be considered as actually incurred when the services (and related benefits) have been in fact received by the Brazilian Affiliate. In prior decisions, the Brazilian tax authorities and local courts have repeatedly ruled against the deductibility of expenses deriving from intercompany service agreements (particularly those related to cost sharing agreements) due to the lack of proof that the services and related benefits had actually been received by the Brazilian entity. It is indisputable from these cases that the mere documentation that the services were contracted, assumed and paid was not considered as sufficient proof.

Moreover, it should be noted that sufficient documentation is essential to substantiate any claims that the expenses are ordinary and necessary for the maintenance of the company's activities and source of income, especially in the case of international intercompany service agreements.

For deductibility purposes, the Brazilian Affiliate will have to prove that it actually received an identifiable benefit from each of the charged services listed in the corresponding agreements. In this regard, Brazilian tax authorities may question expenses related to services provided to all beneficiaries of the group (such as the "Allocated Services"), if such expenses only result in benefits for certain Affiliates and do not clearly include the Brazilian Affiliate. That service fees paid to related companies abroad are often subject to special scrutiny by the tax authorities.

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With regard to management fees and other corporative services, due to the (non-resale) nature of the transactions and in the (assumed) absence of comparable uncontrolled transactions, the Brazilian Affiliate will most likely have to apply the Brazilian equivalent of the Cost Plus Method, which can be applied based on the costs of the parent company.

Payments abroad related to charges for services provided by Head Office

Below you will find an overview of the main tax consequences associated with remittances of service fees between the Brazilian Affiliate and foreign parent company:

- Brazil imposes withholding income tax on remittances of service fees to non-resident beneficiaries at the rate of 15%. However, this rate is increased to 25% if the non-resident beneficiary is located in a country considered a tax haven for Brazilian tax purposes.

- In addition to the 15% withholding tax, as a general rule, payments of administrative and technical services are also subject to the Contribution for the Intervention of Economic Domain (CIDE) at a rate of 10% based on the amounts paid/credited. CIDE is payable by the local entity and therefore not creditable to the non-resident. CIDE does not represent a liability to the foreign recipient of the royalty payments.

- Services provided by non-residents to Brazilian entities are subject to a municipal service tax (ISS). In such case, the Brazilian entity is responsible (on behalf of the non-resident) to withhold and remit the tax to the municipal

authorities according to the city of the service's recipient.

- Importation of services is subject to the Social Integration Program Contribution (PIS) and Contribution for Social Security Financing (COFINS). Per the legislation, PIS and COFINS will be imposed on the following transactions:

  – Services rendered in Brazil by a non-resident entity (or individual) to a Brazilian entity (or individual);

  – Services rendered outside Brazil by a non-resident entity (or individual) to a Brazilian entity (or individual), provided the results of these services are applied in Brazil; and

  PIS and COFINS will be imposed no the Brazilian entity or individual (the importer of goods or services) and will apply at the rates of 1.65% and 7.6% respectively. The contributions paid upon import transactions will normally be creditable, if the Brazilian Affiliate is under PIS and COFINS non cumulative regime.

- Upon remittances to the parent company, the Brazilian Affiliate would also be subject to the Temporary Contribution on Financial Activities (CPMF) on the amount remitted. CPMF is charged on every debit (e.g.: withdrawal, transfer, etc.) made to a bank account at the rate of 0.38%.

Argentina

Deductibility of charges for services provided abroad by Head Office

In Argentina, an expense is deductible for tax purposes only when it is necessary to obtain, maintain or preserve the taxable income of the taxpayer.

For affiliates of foreign companies, deduction of expenses derived from operations carried out with related companies is subject to the transfer pricing requirements. In the case of technical assistance or advice contracts, registration before the National Institute of Industrial Property (INPI) is required for information purposes [3].

Existing jurisprudence on this matter places emphasis on the requirement that the existence of this type of expense must be verifiable and that it should be demonstrated to be necessary, fair and reasonable to obtain taxable income. It also tends to challenge the deductibility of the expenses assigned from abroad through prorating[4].

As a result, deduction of the expense is allowed as long as the actual provision of the service, the need to receive that service in relation to the activity carried out in Argentina and the reasonableness of the charges incurred can be concurrently demonstrated.

Payments abroad related to charges for services provided by Head Office

Argentine source income includes that which is provided by assets located or used for economic purposes in Argentina; the performing of activities in Argentina susceptible of generating profits; or events taking place in the country. So, two situations could arise for services rendered abroad:

- Services provided entirely abroad that are not included in point b. below. In this case, the withholding of income tax is not applicable as it does not represent Argentine-source income for the foreign company.

- However, Section 12 of the Argentine Income Tax Law provides that fees and other considerations arising from technical, financial and other

3 The enforcement authorities have recently adopted a stricter position in relation to the registration of technology transfer contracts and have enhanced control processes. At present, the INPI is not registering Service Agreement contracts, i.e. service contracts with the Head Office abroad demonstrating the providing of services resulting from activities directly related to the current operation or administration of the local firm, based on the understanding that they do not involve the transfer of technology.

4 "As no evidence was provided of the functions, operations and acts performed and the related costs to be able to evaluate their reasonableness and need to incur them for purposes of deduction from the taxable income for fiscal 1968 and based on the regulations mentioned in the previous point, I consider that the tax refund claim should be dismissed." First National City Bank – Nat. Court of Contentious and Admin. Matters - Room II (13/9/79)

advisory services provided abroad are considered to be Argentine-source income.

The law provides the following assumptions for Argentine-source net income liable to withholding from payments to beneficiaries abroad:

1. Remuneration arising from provision of technical, engineering or consultancy advisory services that are not obtainable in Argentina, as long as they are duly registered with INPI: 21% (26,58% with grossing up)

2. Remuneration arising from licenses to use patents and other items not included in (i): 28%. With grossing up: 38.89%.

3. Payments for services included in points (i) and (ii) when they are not included in the area of the Transfer of Technology Law: 31.5%. With grossing up: 45.99%.

Regardless of the points outlined above, the possible application of the international conventions to avoid double taxation signed by Argentina and other countries could affect the determination of the withholding rates to be used (generally such conventions establish reduced withholding rates).

Transfer Pricing

In matters relating to provision of intercompany services, the Income Tax Law does not lay out any specific provisions. Argentina does not belong to the Organization for Economic Cooperation and Development (OECD). However, although the OECD guidelines are generally accepted by the Argentine Tax Authorities, the lack of specific rulings for intercompany services offers uncertainties as to their application in this particular case.

From a transfer pricing point of view, several issues should be considered. The "tested party" should be the Argentine legal entity. This means that in addition to a standard analysis for services, an additional test must be conducted to demonstrate that the Argentine entity that received and paid the service indeed achieved a benefit. In this particular aspect, the Argentine law does not follow international guidelines.

On this basis, the foreign transfer pricing documentation, where the tested party is the foreign entity, could only be used by the local company as additional supporting documentation, but is not sufficient to comply with the documentation required from the standpoint of prevailing Argentine law.

Considering that the situation of the local taxpayer should be analyzed and that it is unlikely that the method of Comparable Uncontrolled Price (CUP) would be applicable, therefore the analysis likely should be made through applying the Transactional Net Margin Method – TNMM, which would require an analysis of profitability for the recipient of the service once such services have been deducted, in this case the Argentine Company, with respect to comparable companies that perform similar functions, use similar assets and assume similar risks.

This alternative means that the transfer pricing studies relating to this contract could disclose uncertain results, inasmuch as they are tied to the Company's results. If in a certain year, the Company's results drop below those of a sample of independent companies that perform similar activities and the situation cannot be duly justified, the Tax Authorities could attempt to disallow the deduction of the costs of the service.

Venezuela

General Comments

There is not a general set of rules in the Income Tax Law (ITL) dealing

specifically with tax treatment of head office charges or management services, except in the case of permanent establishments (PE). Thus, the general standards set forth in the law for the deductibility of any expense would be applicable to the head office charges and management services.

In this regard, pursuant to Article 27 of the ITL, in principle, deductions must be related to those disbursements not imputable to normal and necessary costs, and incurred in the country for the purpose of generating income. According to said provision, for instance, royalties, remunerations, fees and similar payments for technical assistance or technological services are allowed, provided that the services cannot be rendered in the country. For such purposes, the taxpayer should present proof to the Tax Administration of the efforts made to contract the services in the country.

Paragraph Sixteen of Article 27 applies to taxpayers subject to taxation on a worldwide basis. This Paragraph allows deductions incurred abroad provided that they are normal and necessary to the operations of the taxpayers. The expenses must be supported by the corresponding documents issued overseas according to the rules of the relevant foreign country, but said documents must contain at least the name of the entity rendering the services or selling the goods, its domicile, kind or object of operation, date and its amount. The taxpayer must provide these documents into Spanish.

The normal and necessary standards, according to this Paragraph, will be determined according to factors such as the relation to the sales, services, expenses or gross revenue and the same or similar expenses of taxpayers carrying out the same or similar activities in Venezuela.

Permanent Establishments

Paragraph Seventeen of Article 27 of ITL allows the deduction of charges made by a PE or Fixed Base(FB) duly documented, including management and general administration expenses, made in the country or overseas, for the purposes of the operations of the PE or FB. The rule is silent with regard to the proper documentation to support these management and administrative expenses.

There is an important restriction on the deductibility of payments by Venezuelan branches to their head offices, or to other related parties. Article 27, Paragraph Seventeen of the ITL states that payments made by a permanent establishment to its head office, or to any other branch, affiliate, subsidiary, or related company, for (i) royalties, fees, technical assistance, or similar payments in exchange for the right to use patents or other rights; or (ii) as a commission for services rendered or transactions effected, shall not be deductible except in the case of payments made as a reimbursement of actual expenses incurred by the head office.

Article 83(4) of the Regulations of the ITL adds that a reasonable share of the management and general administration expenses will be allowed as a deduction, subject to the fulfilment of the following requirements:

- The expenses must be recorded in the financial statements of the PE;
- The PE must attach the allocation criteria authorized by the Tax Administration to the Income Tax Return;
- Said criteria must be rational and permanent.

The criteria will be deemed rational when it is based on the degree of utilization of the factors by the PE and the total costs of said factors. However, other possible standards may take into consideration the business figures, costs and direct expenses, average investment in

fixed assets used for the execution of the economic activity or exploitation, and the total average investment in all assets used for the execution of the economic activity.

The regulations allow the use of the OECD Guidelines in order to determine a rational allocation method, provided that these Guidelines are consistent with the ITL and Double Taxation Agreements concluded by the Republic.

The Tax Administration must authorize the allocation method, as well any changes, for which the taxpayer must submit the corresponding request, within the first 60 days of the tax year. The Tax Administration must answer the request within 90 days. If no answer is delivered within that period, the request will be deemed denied and no deductions would be allowed, pursuant to Article 86 of the Regulations.

Transfer Pricing Rules

An important limitation on the deductibility of cost and expenses is determined by the transfer pricing rules, applying any of the following methods, which are internationally accepted: (i) Comparable Uncontrolled Price Method; (ii) Resale Price Method; (iii) Cost Plus Method; (iv) Profit Split Method; (v) Transactional Net Margin Method.

In our interpretation, the taxpayer should first apply the Comparable Uncontrolled Price Method, and if it is not possible, then evaluate which of the remaining methods would be the most appropriate, this is, which method, under the facts and circumstances, provides the most reliable measure of an arm's length result. This choice, then, has to have technical support, so the taxpayer can demonstrate their rationale in adopting one method over the others.

The standards set forth by the OECD with regards to transfer pricing may be applicable, if consistent with the ITL and the Double Taxation Conventions concluded by the Republic.

Pursuant to article 169 of the ITL, the documents and information supporting the transfer pricing determined in the information return must be kept by the taxpayers (includes the transfer pricing documentation). This provision recommends documentation of the contracts, agreements and conventions concluded between the taxpayers and related parties abroad, including contracts related to distribution, sales, credit operations, warranties, licenses, know how, use of trademarks, copyrights, industrial property, cost allocation, research and development, publicity, establishment of trusts, security investment, among others.

Although not expressly stated, best business practice in our opinion would be to document the transactions with an agreement between the parties, if possible, which should be prior to the performance of services and the payment of the charges.

Chile

General comments

There are no specific tax rules dealing with the deductibility of cross-border payments, accordingly this subject should follow general tax rules.

Accordingly, regarding the amounts paid from Chile for cross-border inter-company services, it is necessary to analyze the tax treatment of said payments under the First Category Tax (Chilean Corporate Tax).

Article 31 of the Income Tax Law says that, "the net income (…) is determine deducting of the gross income all the necessary expenses to produce the income that were not deducted pursuant article 30, paid or debt, during the correspondent commercial exercise, hence they are proved and justify before the Chilean IRS."

Pursuant to several Revenue Rulings, the IRS requires an expense to be deducted under the following circumstances:

- The expense should not have been previously deducted from the gross income;
- The expense must be already paid or indebted;
- Necessary to produce the income. For this purpose the nature of the expense and the reasonability of the amount paid, must be also taken into account;
- The expense must be duly recorded on the books;
- There should be documentation supporting the expense.

In principle, the Chilean entity, as a beneficiary of the services, should keep in its files all the documents, reports and evidence that prove the service/assistance provided by the foreign entity. The content of said assistance has to be compatible with the business purpose of the Chilean entity and the amounts paid have to be related to the services received. It is also advisable to include documentation that states the hours spent in the assistance, the technical personnel involved and the hourly rate. The mere existence of a contract and invoices, as the only documents to prove the expense, would not be enough.

Finally, please note that, in general terms, non deductible expenses are subject to a 35% sole taxation in Chile.

Tax audits on cross-border payments

As of 2005, within the frame of tax inspection plans related to international transactions in general, the Chilean Internal Revenue Service has begun to request information from certain Chilean taxpayers. As part of these notices, the taxing authority has requested documentation regarding the method utilized to price their transactions with related parties, in accordance to the following classification: (1) Fair market value of the good or service; (2) Cost plus a profit margin; (3) Resale price to third parties, less a profit margin; (4) Profitability from similar transactions; (5) Imposition by the other party; and (6) Other criteria (imposition by the purchaser).

This move of the Chilean tax authority to control transfer pricing issues is fully consistent with global and Latin American transfer pricing trends. The notification requires the disclosure of not only transactions with related parties but also with unrelated parties and tax havens.

Conclusions

US rules on transfer pricing in relation to the provision of services indicate that the tax authorities want total costs in relation to the services provided to foreign subsidiaries to be charged to those subsidiaries. As a result, this aspect is assigned priority over the recording of a profit margin on such costs, in the case of services with a low added value (administrative and services of a general nature).

It can be expected, and experience has shown, that local taxpayers will be faced with the need to analyze new contracts or changes to those in force, requiring increased charges for management services or "management fees," giving rise to doubts as to their income tax treatment, both as regards deductibility and the obligation to act as a withholding agent on the payments made to the foreign beneficiary.

Additionally, further debate can be expected regarding concepts such as additional or remote benefit, or the classification of "exclusive effect" to the benefit of the shareholder, instead of the previous "primary effect" term.

As we have seen in recent legislation, the elements of proof that may be offered by the taxpayer regarding the effective providing of the service and its relationship to the obtaining of taxable income will hold the key to the deduction of such charges as an expense. The minimum documentation should include:

- Service agreement signed by the parties, providing description of services, price agreed, terms of the contract, and terms for payment of the service fees
- Invoice issued;
- Reports, letters, manuals or any other type of outputs or documents received in connection with the services received that evidence direct involvement between parent and the local affiliate, as well as demonstrate that the services were effectively rendered and they are ordinary and necessary to conduct the business activities of the local company. Such documents should contain:
  - detailed description of services provided;
  - period when services were provided;
  - Details of all costs incurred by the parent company and how these costs were allocated based on a reasonable allocation key (e.g. hours incurred, in the case of services contracted based on an hourly rate or revenue, etc.).
- Service log or evidence demonstrating the nature and frequency of the services rendered, as well as an explanation as to why these services are necessary.

To meet the benefits test, ideally the documentation should explain how these services contribute to the generation of sales or the reduction of costs.

In this there has been no change: the existence of robust and comprehensive documentation in addition to an invoice and a spreadsheet, although not ensuring the expense deduction, will allow taxpayers in Latin America to hold firmer grounds on which to dispute the matter with the tax authorities.

“... the elements of proof that may be offered by the taxpayer regarding the effective providing of the service and its relationship to the obtaining of taxable income will hold the key to the deduction of such charges as an expense.”

Dispute resolution in Argentina

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Dispute resolution in Argentina

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The Argentine tax authorities have been particularly active in auditing international transactions between related companies. Six years after transfer pricing regulations came into effect in Argentina, we are at a stage where the first tax audits have run through administrative processes and are now beginning to enter the appeal stage at the National Fiscal Court ("NFC"). A recent NFC ruling gave taxpayers an indication of the criteria that other Argentine courts could adopt when ruling on transfer pricing matters.

The Argentine taxing authorities began to focus on taxpayers' transfer pricing practices in Fiscal Year 2000, when the country's special transfer pricing auditors began to request transfer pricing documentation for fiscal year 1999 from companies in the automotive and pharmaceuticals sectors. At the time, it was not mandatory to file this documentation with the tax authorities. Subsequently, up to March 2007, new audits were begun in the same sectors, requiring information for fiscal years 2000 and 2004.

The auto industry was selected because of its significant level of international transactions and the fact that it was the only sector that was governed by special policies resulting from international agreements, mainly with Brazil, during the 1990s.

The pharmaceuticals sector was also singled out by the taxing authorities ("AFIP") because of the large number of import and export transactions involving foreign companies, and also because the market consists of both subsidiaries of foreign companies and local capital companies, so that the tax authorities were able to use potential local comparables in their investigations.

The taxing authorities also developed specific information disclosure requirements for companies carrying out international trade with tax havens, as the Income Tax Law ("ITL") presumes that all transactions carried out with parties domiciled in jurisdictions of low or no taxation have not been carried out on an arm's length basis. Other audits were based on the matching of information between the AFIP and the national Institute for Industrial Promotion ("INPI") in relation to intercompany transfer of technology contracts. Transfer pricing reports are usually required during full inspections for income tax, value-added tax or social security, or when requesting certificates for exemption from federal tax withholdings. Towards the end of 2002, with the start of the export boom following the devaluation of the peso against the dollar, specific transfer pricing audits began for exporters of commodities (particularly cereals, oilseeds, fruit and other agricultural products), which gave rise to a change in the ITL during 2003 via Law 25784 and the creation of a specific transfer pricing method for analyzing export prices of commodities under certain circumstances in which an international intermediary participates who is not the actual recipient of the goods.

The principal aspects questioned by the tax authorities to date can be summarized as follows:

A) General Matters Under Discussion

Use of interquartile range

In the audits conducted in relation to fiscal 1999, the tax authority required the adoption of the interquartile range concept, while neither legislation nor the applicable regulations discussed such a concept. In no case had it been established that comparison should be made between the ratios obtained from the application of the validation methods laid down with the median, nor with the price range interquartiles, considerations or profits of the comparables, and less still, that in the case of presumed differences, tax adjustments should be made to arrive at the median of the range determined. By doing this, the tax authority attempted to make a retroactive application of the rules to fiscal 1999, which is an evident violation of the principle of legality that is strictly applied in tax matters.

Loss-making comparables

In some cases the tax authority has attempted to challenge comparables merely because they recorded operating losses over the last three years. Current legislation does not establish that companies with financial statements showing operating losses cannot be taken as comparables. Independent companies may have to bear losses as a result of the risks they face in the development of their activities. There is therefore no business or legal reason justifying the exclusion of companies with non-material losses, especially when the companies assume significant risks (market risk, for example).

In addition, as of fiscal year 2000, when the interquartile range became effective, comparables with significant losses are discarded, so that only companies representing 50% of the observations from the middle of the total sample remain within the interquartile range sample. It should further be pointed out that Working Party No.6 (which interprets practical aspects related to the application of OECD Guidelines in comparability matters) maintains in the case of loss-making comparable companies that it is the facts and circumstances surrounding the company in question that determine its status as a comparable, not its financial result, indicating that losses are a normal part of the business, so companies with losses should not be automatically excluded.

Translation of information on comparables

When foreign comparables are used and their financial information and descriptive details filed in their original language, the Tax Authorities have requested that taxpayers provide the same information in Spanish, translated and certified by a public translator, claiming application of section 28 of Decree 1759/72. Nevertheless, this regulation requires presentation of translated, certified documentation only in the case of proof in the context of a jeopardy assessment procedure, and not during an inspection. This is an aspect that we feel must be corrected, as the mentioned regulation (dating back to 1972) does not meet the requirements of the transfer pricing practice, which has its own distinctive features compared with other tax areas that justify the modification of the regulation for practical reasons, and carries a heavy administrative and financial burden for taxpayers.

Financial information. Multiple year data

One of the main matters challenged by the tax authorities is the use of financial information from a business cycle corresponding to the company being analyzed to document the profitability of one fiscal year

in particular. Current Argentine regulations make no specific reference to the use of a business cycle for the Argentine entity being analyzed. Nevertheless, the general nature of the rule opens up the possibility of considering elements or circumstances that reflect to a greater or lesser extent the economic reality of the transactions. As a result, it cannot be denied that certain products have a business cycle covering more than one fiscal year, and that different products have different life cycles, or that circumstantial economic conditions of the country in which the company operates might impact its profitability, and that in such circumstances, the use of a business cycle might contribute to moderate such profit dispersion.

Use of so-called "secret comprables"

Secret comparable are understood as information obtained by the tax authorities through audits or other information-gathering procedures[1], and they are given that name because confidentiality rules prevent tax authorities from making such information public. In the case of local legislation, the first question to consider is whether such behavior constitutes a violation of the secrecy rules covering third part information provided to the tax authority (DGI) as per Sect.101 of Law 11683. The Argentine Tax Authority has already had occasion to indicate its opinion in Ruling 104/2001 issued by the Bureau of Legal Advice[2], determining the use of such information to be acceptable, as:

> *Information referred to third parties required to determine "transfer prices" is excepted from tax secrecy rules, even in the period prior to initiation of jeopardy assessment procedures, that is to say, in the inspection stage, as such information initiates the "case" in the terms of section 15 of the Income Tax Law, for which reason there is no legal impediment to making known to the taxpayer being inspected through the so-called "prevista" or preliminary notice, the elements -including third party data- that have served to give rise to the adjustment.*

Nevertheless, in the recent ruling on "Laboratorios Bagó S.A. on appeal - Income Tax" Panel B of the National Tax Court issued a decision similar in result but argued on different grounds. The Court has understood that as the taxpayers requested to provide information have done so voluntarily, they are not covered by the situations foreseen in that rule, and furthermore, the law provides powers to require and make use of such information.

It is surprising that a requirement by Argentine tax authorities can be considered voluntarily by taxpayers. Such requirements are made on the basis of audit activities exercised by the tax authority, and are thus mandatory on all taxpayers. One would have to consider how many taxpayers would be willing to voluntarily provide information to the Tax Authority on their exports to independent third parties (with details of products, volumes, prices and payment terms) if the voluntary nature of compliance was clearly established in the requirement.

Although in the case under analysis the taxpayer has access to the information used by the Tax Authority, so that its right to defense was guaranteed, the use of secret comparables gives rise to an inequality in the information that affects taxpayers. For example, what guarantees does the taxpayer have that all available information was used by the Tax Authority in making its determination? The taxpayer

1 OECD - Comparability: Public Invitation to comment on a Series of Draft Sigue Notes, May 10, 2006

2 AFIP-DGI Ruling No.104/2001 - Bureau of Legal Advine - December 3, 2001.

only has access to the information used, not that which was discarded that could have benefited it. For this reason we consider that secret comparables information can and should be used by the Tax Authority to define its inspection program, but not in a process of jeopardy assessment.

It is to be hoped that this matter will be evaluated more thoroughly in the future, because of its relevance to future transfer pricing cases, and that common guidelines can be instituted by the Tax Authority and taxpayers regarding the information to be used in a transfer pricing analysis.

B) Specific aspects questioned, by industry

Auto industry

In the context of an economic recession, many companies post losses or low profitability, a situation that led to the economic crisis in Argentina at the end of 2001. In general, comparable local companies cannot be found, making it necessary to resort to international comparables. There has been a need to identify, quantify and adjust profitability because of market situations. Adjustments made to the analyzed company to increase comparability with comparable companies have given rise to discussions on matters such as:

- Idle capacity of companies analyzed in relation to idle capacity of comparables
- Adjustments for personnel severance pay and personnel suspensions
- Adjustments for special discounts granted and official sales incentives
- Adjustments for extraordinary uncollectibility
- Adjustments for new model launches

The tax authority attempted to challenge such comparability adjustments, arguing that there was a failure to demonstrate the existence of a similar situation in the comparables. Nevertheless, many cases were resolved favorably at the inspection stage, as the authorities finally accepted the comparability adjustments once companies had contributed elements to prove the extraordinary nature of the adjustments by means of accounting, economic and engineering reports.

Pharmaceutical industry

The pharmaceutical industry has features that set it apart from the rest, and requires its own set of rules and regulations for transfer pricing. Some of the features intrinsic to pharmaceuticals include:

- Social health systems differ from one country to the next
- There are countries where the price of medicine is controlled.
- Governments assume the three-fold role of regulator, purchaser and revenue collector.

In this case, comparability adjustments made for companies in the pharmaceutical industry have included:

- Extraordinary discounts for welfare funds (especially medical insurance programs for senior citizens)
- High commercial and operating cost structures
- New product launches

In one particular case, the tax

authorities accepted the adjustment corresponding to senior citizen medical insurance coverage, because of the particular features of the system, whereby a flat fixed amount per capita is agreed. If sales to senior citizens exceed this fixed amount, the excess is not absorbed by the insurance, but must be borne as a discount by the laboratories and other links in the sales chain. In this case, the Argentine tax authorities require evidence that comparable companies have not faced a similar situation to that of local laboratories, to which end it was demonstrated that the health systems in the countries in which the comparables are located do not have a system similar to that of Argentina.

Another matter under discussion in the industry is the possibility of jointly analyzing the results from the manufacturing and distributions activities carried out by a local pharmaceutical company. In such cases, the position of the tax authorities is that they should be analyzed separately, unless there are business reasons justifying their consideration in the aggregate.

C) Jurisprudence on transfer pricing

On November 16, 2006, the members of Panel B of the NFC issued a ruling in the case "Laboratorios Bagó S.A. on appeal – Income Tax" – where the matter under appeal was the taxpayer's opposition to an official assessment of the tax for the fiscal years 1997 and 1998, with the corresponding interest and fines.

Even though the current legislation on transfer pricing was not in force during those periods, the case is closely related to that legislation, since the ruling addresses such issues as the comparability of selected companies (the selection, in this case, being done by the tax authority) or the tax authorities' use of internal information for the assessment of the taxpayer's obligation.

The taxpayer, a local pharmaceutical company, exported locally manufactured products to overseas affiliates. The overseas entities' affiliate nature was undeniable, and the inspection originated in the differences in export prices between the different markets involved (both international and local).

These export operations (both of finished and semi-finished products) were performed at a cost value with a profit margin. That margin, which amounted to at least 10%, varied due mostly to the particular conditions of the destination market of each export[3].

In this case, the taxpayer argued that, even though in relation to its functions, assets and risks it is a complex entity, dedicated to the manufacture of pharmaceutical products, with regard to the exports business it only performs the activities of a manufacturer by request (of its subsidiaries) or "contract manufacturer"; i.e., it focuses its efforts only on manufacture and does not involve itself in the complex issues of research and development or advertising, sales and marketing – these tasks fall upon its overseas subsidiaries.

Once the inexistence of publicly known wholesale prices in the country of destination was ascertained, the tax authority conducted a survey of other similar companies located in Argentina, requesting segmented information on exports for the purpose of considering, as a basis for the

3 Differences as to transacted quantities or their final presentation (quality and market regulations, among others) or in the case of semi-finished products implying the suspension of an automated production process, cause a variation in costs and, consequently, in final prices.

computation of Argentine-source profits, the coefficients of the results obtained by independent companies in the same or a similar sector of activity.

Having obtained that information, the tax authority calculated the profitability average values of the independent companies and, since the company in question was below that average, adjusted the taxable basis for the Income Tax.

Issues ruled upon in the NFC's ruling

Even though the aspects analyzed by the ruling could have included several substantial issues in the matter of transfer pricing, the ruling focuses on four specific issues:

- Validity of the information obtained by the tax authority
- Use of the so-called "secret comparables"
- Nature of the adjustment performed by the tax authority
- Evidence presented by the parties

Matters such as comparability adjustments, the application of statistical measures like the interquartile range and, especially, the definition of functions, assets and risks, were mentioned in the ruling but are not material to the decision issued.

Evidence presented by the parties

Eventually, it was the evidence presented by the parties that allowed for the ruling in this case to be favorable to the taxpayer. As previously mentioned, the tax authority employed the results obtained from a sample of local pharmaceutical companies who exported products to independent third parties.

This analysis suffered from conceptual errors that affected the comparability of the operations. Thus,

1. The taxpayer trebled in those periods the total net sales of two of the local pharmaceutical companies considered by the tax authority as comparable.
2. The annual exports volume of Laboratorios Bagó was 14 to 18 times higher than those of the supposedly comparable companies.
3. The existence or otherwise of an economic relationship between the selected companies and the party importing products from them was not verified.
4. The inspection had no unified criteria for the different selected companies' allocation of income and expense for the export line.
5. The differences in volume and countries of destination between Laboratorios Bagó and some of the comparable companies were more than evident; thus, the companies selected for the purposes of the inspection are not comparable in the terms of the applicable norm, whose object is to compare results obtained by independent companies that are identical or reasonably similar to the taxpayer – in the words of the norm itself, "the basis for calculation of Argentine-source profit shall be the coefficients of results obtained by independent companies who perform activities identical or similar to that of the taxpayer".

The taxpayer demonstrated that, in several alternative scenarios, the results for the measurements of gross and net profitability were similar, even when applying the same methodology as the tax authority's inspection (but having corrected the differences affecting comparability).

This demonstration was achieved by submitting a study of transfer prices according to criteria established by the current legislation from the year 1999 onwards.

The appraisal of the evidence offered is the point on which the three judges agree. For instance, they believe that the expert testimony offered in the administrative proceedings was "plentiful" and provided details on the source of the information. In this analysis, differences arising from the system proposed by the tax authority "do not allow us so easily to disregard the results presented by the plaintiff, which, even though they do not match those averages, present similarities to some of the comparable companies and are within their range of values".

The ruling also asserts that evidence presented by the taxpayer "has challenged with reasonable precision and persuasiveness the conclusions of the defendant, which are not significant in the context of the company's results".

Final conclusion

We believe documentation to be an element of the utmost importance at the moment of resolving transfer pricing issues. What we can learn from this previously discussed ruling is that the need to offer evidence for any assertions made is not only the taxpayer's but also the tax authority's obligation – and that judges will consider the elements presented by both parties when ruling on the case.

International experience in the resolution of transfer pricing disputes shows that this is the path generally followed by judges. It is to be expected that both taxpayers and tax authorities will show a greater willingness to offer and evaluate evidence to reduce the subjectivity of these issues, avoiding confusing preconceptions that may blur our understanding of facts or reduce transfer pricing to a mathematical calculation model.

“What we can learn from this previously discussed ruling is that the need to offer evidence for any assertions made is not only the taxpayer’s but also the tax authority’s obligation - and that judges will consider the elements presented by both parties when ruling on the case.”

Managing Transfer Pricing Risk through Brazil Profit Alignment

By

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Background

Brazil, the ninth largest economy in the world, has developed a unique set of transfer pricing rules that differ from the Organization for Economic Cooperation and Development (OECD) based approach adopted by most countries around the world. As result of this uniqueness, multinational corporations (MNCs) face a number of transfer pricing difficulties which may range from an increased burden on compliance activities to double taxation. Further, Brazil has signed several Tax Information Exchange Agreements with foreign tax authorities (including one recently with the U.S.) that increase the exposure of MNCs to transfer pricing issues.

The OECD approach, set forth in article ninth of the Model Tax Convention and in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), is based on the arm's length principle. This principle requires that the price for a controlled transaction be similar to the price that unrelated parties would adopt when undertaking similar transactions under similar circumstances. In order to compare controlled and uncontrolled transactions, the OECD Guidelines set out five comparability factors: the functions that each enterprise performs, the assets employed and the risks borne; the specific characteristics of the property or services; the contractual terms; the economic circumstances of the different markets and the business strategies.

The OECD Guidelines also outline five methods for pricing controlled transactions: Comparable Uncontrolled Price Method (CUP), Resale Price Method (RPM), Cost Plus Method (CP), Profit Split Method (PSM) and Transactional Net Margin Method (TNMM). The selection of the most appropriate method or methods (if a country has no "best method rules") depends on the comparability between the facts and circumstances of the controlled transaction and those of the uncontrolled ones, taking into account the reliability of the available information. In practice this usually means selecting the related party that is involved with routine functions, risks and assets.

Overview of Brazilian Transfer Pricing Rules

Even though the Brazilian rules refer to the OECD Guidelines as precedent and formally seem to adhere to the methods set forth by the OECD Guidelines, they do not reflect the real spirit of the arm's length principle. On the contrary, instead of the arm's length principle, the Brazilian transfer pricing rules define maximum price ceilings for deductible expenses on intercompany import transactions and minimum gross income floors for intercompany export transactions. Additionally, safe-harbors have been provided regarding interest on debt paid (or received) to a foreign related entity. Further, royalties and technical, scientific, administrative or similar assistance remittances follow specific deductibility rules.

According to the Brazilian transfer pricing rules, a company has to substantiate its intercompany prices on an annual basis by comparing its actual transfer prices with benchmark prices determined under one of the methods laid out in the Brazilian transfer pricing legislation. Further, the Brazilian transfer pricing

legislation does not include a best method approach. Therefore, MNCs usually face the risks of a dual-approach to transfer pricing matters, where the same intercompany transactions are analyzed separately (and sometimes even inconsistently) from the Brazilian perspective on the one side, and the OECD rules on the other. This dual-approach often leads to double taxation issues and an increase in compliance costs.

The Brazilian methods available to analyze the imports of goods, services or rights are the Comparable Independent Method (PIC), the Resale Price Method (PRL) and the Production Cost plus Profit Method (CPL).

The PIC method is defined as the weighted average price for the year of identical or similar property, services, or intangibles obtained either in Brazil or abroad in buy-sell transactions by unrelated parties. This method, similar to the CUP, is also based on transactions between unrelated parties but it does not take into account time or market differences, the position of the transactions along the supply chain or other comparability factors that must be considered under the OECD approach.

The PRL Method is defined as the weighted average price for the year of the resale of property, services, or intangibles minus unconditional discounts, taxes and contributions on sales, commissions, and a gross profit margin of 20 percent calculated based on the resale price. If value is added before the resale, a gross profit margin of 60% should be considered based on the participation of the imported good, service or intangible on the total cost of the good resold.

The CPL is defined as the weighted average cost incurred for the year to produce identical or similar property, services or rights in the country of origin increased for taxes and duties plus a gross profit margin of 20 percent.

As can be noted, even though these two methods seem to be similar to the RPM and CP methods, respectively; they do not reflect the spirit of the arm's length principle since they require a fixed margin (minimum for the former and maximum for the latter) to be obtained regardless of the facts and circumstances applicable to the transactions and whether or not third parties involved in similar functions, risks and assets would have achieved them.

Statutory rules provide that interest income/expense on related-party loans that are duly registered with the Brazilian Central Bank will not be subject to transfer pricing adjustments. However, interest paid on a loan issued to a related entity that is not registered will be deductible only to the extent that the interest rate equals the LIBOR dollar rate for six-month loans plus 3 percent per year. Again, this ceiling rate is independent of the credit worthiness of the debtor and the characteristics of the intercompany financing arrangement.

In the case of export sales, the Brazilian regulations provide a safe-harbor whereby a taxpayer will be deemed to have an appropriate transfer price with respect to export sales when the average export sales price is at least 90 percent of the average domestic sales price of the same property, services, or intangible rights.

When the export price is less than 90 percent of the average sales price in the Brazilian market, the company is required to substantiate its export price using the Export Sales Price Method (PVEx), the Wholesale Price in Country of Destination less Profit Method (PVA), the Retail Price in Country of Destination less Profit Method (PVV) or the Purchase or Production Cost plus Taxes and Profit Method (CAP).

PVEx is defined as the weighted average of the export sales price charged by the company or by other national exporters to other customers of identical or similar property, services, or rights during the same tax year using similar payment conditions. As with the PIC, similarity with OECD's CUP method is only apparent since it does not require similarity of functions, risks, assets or circumstances to the related transaction, but rather focus on product comparability.

The Brazilian version of the Resale Price Method for export transactions is defined as the weighted average price of identical or similar property, services, or rights in the country of destination under similar payment terms reduced by the taxes included in the price imposed by that country and a profit margin of either: 15 percent, calculated by reference to the wholesale price in the country of destination (PVA); or 30 percent, calculated by reference to the retail price in the country of destination (PVV).

The CAP is defined as the weighted average cost of acquisition or production of exported property, services, or rights increased for taxes and duties imposed by Brazil plus a profit margin of 15 percent

Once again, Brazilian rules set up fixed margins to be achieved regardless of whether third parties under comparable conditions would earn them or not.

Brazil Profit Alignment

The uniqueness and complexity of the Brazilian rules often lead MNCs to document their transfer prices in Brazil separate from other countries. Frequently this documentation approach comes with inherent risk for MNCs, because the combined profit of the transaction may not be enough to satisfy both the minimum required by the Brazilian rules and an arm's length margin to its counterparty. This often results in double taxation **without the ability to go to Competent Authority for relief**.

In response to these transfer pricing challenges, PricewaterhouseCoopers has developed the "Brazilian Profit Alignment" or "BPA" approach, which is a transfer pricing planning & documentation approach designed for MNCs with operations in Brazil that aims at reconciling in a tax-efficient way the transfer pricing positions in both Brazil and foreign countries. The basic idea is simply to perform the documentation and policy setting simultaneously with Brazil and its trading partners such that compliance is achieved in both those countries who trade with Brazil, while meeting the rigid transfer pricing rules in Brazil.

Some elements of such a plan would be to:

- Avoid or minimize the risks of double economic taxation arising from the uniqueness of the Brazilian transfer pricing rules. Especially important given the absence of a double tax convention between Brazil and many of its foreign trading partners (including the U.S.);

“The basic idea is simply to perform the documentation and policy setting simultaneously with Brazil and its trading partners such that compliance is achieved in both those countries who trade with Brazil, while meeting the rigid transfer pricing rules in Brazil.”

- Relieve the burden impending on MNCs facing duplicative compliance efforts and implementing transfer pricing documentation strategies that aim at aligning OECD and Brazilian transfer pricing analyses; and

- Identify tax optimization opportunities that reduce the global effective tax rate of MNCs operating in Brazil.

At the time of filing their annual tax return, Brazilian companies are required to provide detailed information regarding intercompany cross-border transactions, the method applied to test the intercompany prices for the largest import and export transactions, and the amount of any adjustments to income resulting from the application of the method to a specific transaction during the fiscal year in question. In addition, after March 30, 2007, the signature of a Tax Information Exchange Agreement between the U.S. and Brazil (in addition to other similar agreements entered with foreign tax authorities) paves the way for a closer scrutiny of international tax issues such as transfer pricing.

Conclusion

Brazilian transfer pricing legislation does not follow the internationally accepted arm's length standard and thus differs from the transfer pricing legislation of many of Brazil's trading partners. Establishing a consistent and robust global transfer pricing strategy for companies where on each end of the spectrum of intercompany transactions lie diverging transfer pricing regulations presents many pitfalls. MNCs with operations in Brazil should consider developing a transfer pricing methodology that aims at reconciling in a tax-efficient way the transfer pricing positions in both Brazil and foreign countries. The benefits from this approach include minimizing the impact of double taxation, reducing compliance costs and identifying tax planning opportunities.

New U.S. Service Regulations helpful in Mexico although “allocations” still a problem

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On July 31, 2006, the U.S. Treasury Department and the U.S. Internal Revenue Service (IRS) issued temporary and proposed regulations providing guidance on the treatment of various types of controlled transactions, including services.

The U.S. temporary regulations respond to many comments on the 2003 Proposed Regulations and include several important changes, including the introduction of the Services Cost Method (SCM) which provides a safe harbor approach for certain types of controlled services This new transfer pricing methodology evaluates whether the price for covered services is arm's length by reference to the total costs incurred in providing these services without the need to develop an analysis of independent comparables and mark-ups.

Where the conditions on application of this new method are met, the SCM will be considered compliant with the best method rule for purposes of section 1.482-1(c) of the U.S. Internal Revenue Code.

While the Temporary Service Regulations responded in many ways to taxpayer concerns, there are still a number of questions about which types of transactions are covered and the flexibility regarding the application of certain rules.

Mexico's largest trading partner is the U.S. and Mexico is among the top five trading partners of the U.S. This economic interdependence has elevated transfer pricing concerns since many Mexican companies are affiliated? with U.S. companies. Therefore, application of the new U.S. temporary regulations could very well impact the way intercompany transactions are structured and documented.

Unfortunately, Mexico does not have detailed regulations clarifying transfer pricing rules and there is no significant judicial precedence defining the treatment of intercompany services transactions. Moreover, these new U.S. regulations are not binding on the Mexican Tax Authority. However, to the extent these rules are consistent with the Organization for Economic Cooperation and Development ("OECD") requirements, they might provide practical insights on how to deal with service issues in developing corporate transfer pricing policies and preparing transfer pricing analyses covering both jurisdictions. For example, the temporary regulations issued by the U.S. Treasury Department could provide helpful technical information regarding shared services agreements, intragroup services, classification of stewardship expenses, etc.

Notwithstanding these new U.S. regulations, there may be circumstances in which the same transaction will require a different documentation methodology in the respective countries. However, in most cases, those differences should provide congruent results in the application of the OECD principles in Mexico.

In the case of services, the following key considerations must be evaluated in order to sustain a deduction in Mexico:

1. Was the service provided for the applicable recipient?

2. Was there a benefit received by the recipient?

3. Somewhat related to the prior point, is a portion of the charge considered stewardship?

4. Was the charge for the service an arm's length charge?

5. Does the Mexican legislation create obstacles for deductibility? Some examples of obstacles in Mexico include:

   – Mexican income tax law does not permit a deduction of allocations from abroad

   – In the case of technical services, Mexican income tax law requires that the billing entity use its own resources to provide services

   – If withholding tax applies and the Mexican payor does not withhold the tax, this would render the payment as non-deductible

   – If the payor makes the payment to an unregistered permanent establishment the payments are nondeductible

   – If the service is provided by a resident of a low tax jurisdiction, payments are generally presumed not at arm's length, and therefore non-deductible, unless it can be established otherwise. This substantially shifts the burden of proof to establish that payments are deductible.

There are a number of country-specific requirements that could complicate the already difficult task of determining arm's length charges, but often the most tedious process is proving that a service was actually provided and that a benefit was received. This involves maintaining a variety and volume of detailed records for years still open under statute of limitations of the various countries receiving the services.

Another complication arises when the service provider is resident outside of Mexico and is the "tested party". In these cases, most of the records are maintained abroad. Since the service provider can be viewed as a cost (vs. profit) center, there might be a tendency to consider that most, if not all, expenses should be charged out using a practical methodology. In the course of an audit examination and compilation of evidence, this information can be voluminous. It is also sometimes challenging to establish that the services provided economic or commercial value to enhance its commercial position in Mexico. The key is to be able to establish that the recipient would be willing to pay for the activity if it was performed by an independent enterprise or would have performed the activity in-house for itself.

As the information is subjected to further review by the Mexican Tax Authorities, several controversies develop. For example, services for specific subsidiaries might be erroneously grouped by the taxpayer with other general expenses and can be misapplied as an allocation benefiting several subsidiaries. This is an easy trap when methodologies are not revised periodically, as the extent of services provided to different subsidiaries can vary from year to year. In addition, the process of identifying the time spent by various individuals and the process of assigning the cost and value of those services can be time-consuming and subject to different chargeback methods. Also, some expenses can constitute stewardship costs.

As mentioned, business circumstances for each particular

subsidiary usually change from year to year. Therefore, the first step is to ascertain directly chargeable costs for specific subsidiaries at least on a yearly basis. This usually requires interviews of persons providing or supervising the services and a review of reasonable underlying documentation supporting the accounting records. Next, indirect expenses are usually charged out using reasonable allocation methods. These indirect expenses do not necessarily require a 20/20 hindsight review of actual expenses to determine the actual allocation method for a given year. The methodology of charging indirect charges is usually developed before-hand based on reasonably anticipated benefits. However, this is not always the methodology used by the tax authorities in the course of examinations as their first task is usually to confirm that a benefit was actually received (via an evaluation of documentation using 20/20 hindsight). Once it is ascertained that a service is in fact received but cannot be attributed to a specific subsidiary on a practical basis, the allocation methodologies are then reviewed.

As previously mentioned, from a Mexican perspective one particularly difficult situation applies as concerns "allocations" of costs by a U.S. parent company to multiple subsidiaries, including Mexican subsidiaries. The Mexican rule provides that service charges shall be non-deductible expenses for corporations, when such expenses incurred abroad have been determined on a pro rata basis.

This specific provision disallowing a deduction of allocations from abroad was established several years ago, before Mexico had effective transfer pricing legislation and prior to the establishment of income tax treaties with comprehensive exchange of information agreements. Its main purpose was to discourage the possibility of tax planning through excessive intercompany charges billed from abroad in which the Mexican Tax Authorities did not have the ability to effectively review the existence and nature of such expenses.

Beginning in 1993, Mexico initiated several International Tax Treaties and comprehensive exchange of information agreements with some of Mexico's most important trade partners, including the U.S., based on the OECD Tax Model. Additionally, in 1994, Mexico became a member of the OECD.

In addition, many of the existing treaties, including the Mexico-U.S. treaty, have a broad exchange of information agreement effectively allowing Mexico to scrutinize tested parties abroad. Moreover, in 1997 the Mexican legislation was modified to incorporate OECD transfer pricing principles. With these safeguards written into the law, Mexican Tax Authorities now have a number of ways to regulate the deductibility of inappropriate or unreasonable charges from abroad, without the need to consider allocations as outright non-deductible charges.

Also, the Mexican income tax law specifically requires compliance with the OECD Transfer Pricing Guidelines to the extent consistent with income tax law and applicable tax treaties. The OECD Transfer Pricing Guidelines state that a direct charge method is preferable but is often impractical to apply to all services depending on the types of services being provided. These Guidelines establish that the application of sound accounting and allocation principles might produce arm's length results, including those based on sales, headcount, or other bases (Chapter 7, paragraphs 7.22 and 7.25).

Finally, it is important to point out that cost sharing agreements play an important role for multinational corporations. These arrangements

allow the group to achieve economies of scale, which are created when related entities pool their resources to create a product/good/service/ intellectual property which the separate entities by themselves would only be able to produce at a much higher average cost since these costs are not shared with affiliates located abroad.

For example, assume that the Mexican subsidiary of a multinational group decides to produce a radio spot for the Latin American market, but realizes that its $10,000 budget will only produce one spot. However, after consulting with its related parties in Latin America, it determines that if it joins with five other firms in the group to produce six radio spots, the total cost will be $50,000 dollars, with each company sharing equally in the costs. Increasing returns to scale for the group can be observed because the average costs to produce one spot went from $10,000 to $8,333.33 and a better spot can be developed based on the increased budget.

As can be seen, the reasons behind the non-deductibility standard for foreign expenses determined on a pro rata basis no longer apply in most cases, especially with those countries considered by Mexico as having broad exchange of information agreements, and it is generally understood in the international community that properly developed allocation techniques can provide arm's length results, and are often the only practical way to develop a basis for an intercompany charge.

In Mexico, prior to 2005, various taxpayers filed rulings requests with the Competent Authority in Mexico to confirm the possibility of effectively deducting allocated intercompany expenses with their parent company and several of these rulings concluded that the methodology should result in a deduction?
. Nevertheless, the Mexican Tax Authorities have mentioned in public forums with taxpayers that they will no longer issue rulings in this sense, and they have begun scrutinizing their own judgments and procedures for providing certain international tax rulings. Moreover, many taxpayers requesting rulings prior to 2005 are currently being audited and the Mexican Tax Authorities are questioning other aspects of these taxpayers' transfer pricing methodologies.

The prior considerations require Mexican companies to develop alternative solutions which support the arm's length nature of certain services charged to the Mexican subsidiary. One of the most common solutions is the creation of separate agreements between the foreign holding company and each of its subsidiaries around the world, to support charges for specific amounts and estimated time/cost spent instead of charges based on an allocation procedure.

It is important to emphasize that most of the provisions in the new IRS services regulations are congruent with the OECD transfer pricing guidelines and generally clarify certain treatments with some relevant exceptions, dealt with in this publication, and shall therefore be useful in developing Mexican transfer pricing policies and documentation.

In the context of Mexico, many related party payments are made to U.S. affiliates; however several large multinational companies are based in Mexico and receive payments from related parties abroad. In addition, there is a growing trend to use Mexican subsidiaries of foreign-based companies as regional headquarters for various back office and other activities, such as day to day management, engineering, data processing, call centers and

the like. Therefore, these regulations provide useful guidelines for purposes of developing a reasonable methodology for cross-border charges.

Below we focus on the principal changes to the U.S. regulations impacting the structuring and documentation of international transactions between the U.S. and Mexico.

Services Cost method (SCM)

For purposes of the SCM, the temporary proposed regulations establish two categories of covered services:

(a) Specified covered services, and (b) Low margin covered services.

In the first case, the U.S. Treasury Department identified a list of services which could be reimbursed with no mark-up, including among others: payroll; accounts receivable or payable; general and administrative; public relations; accounting and auditing; tax; staffing, recruiting and legal services.

On the other hand, and acknowledging that the specified covered services included in the aforementioned list may not encompass the entire universe of low margin services, the new regulations provide an alternative procedure to demonstrate that other services qualify for the SCM. This alternative procedure consists of demonstrating that comparable services are performed by unrelated parties at prices yielding a median mark-up on total costs that is less than or equal to seven percent.

For the alternative procedure, the arm's length price will be determined under the general transfer pricing rules without regard to the SCM, usually using the interquartile range.

Again, it is important to point out that specified covered services or low margin covered services will qualify for the safe harbor if the taxpayer reasonably concludes in its professional judgment that the services in question do not contribute significantly to key competitive advantages, core capabilities or fundamental chances of success or failure in the specific business of the recipient of the service. As can be seen, this is a business judgment according to the business person's own expertise. Exact precision will not be needed and it is expected that the taxpayer's judgment will be accepted in most of the cases.

Besides the general specifications stated above, the U.S. Treasury Department listed transactions that are considered "high margin services" and thus ineligible for the SCM. These include: manufacturing, production, extraction, exploration or processing, reselling, distribution, research and development. There is no safe harbor allowing a zero percent mark-up provided for these services.

If the service provided by a U.S. Company qualified as a specified covered service or a low margin covered service, the conclusion (from a Mexican/OECD perspective) will usually be that the operating margin obtained by the Mexican company after paying for the service would not be lower than the amount a third party would have earned after paying for the aforementioned services. Therefore, the result would probably not create a practical risk in Mexico specifically as concerns a zero percent mark-up to the assigned cost paid abroad.

On the other hand, this position could present certain challenges if Mexico

is serving as a regional service center for other affiliates abroad. If the service is rendered by a Mexican company, according to local law, the entity would normally be allowed, and may be required, to charge its related party cost plus a mark-up on the cost of the service provided. In those cases, the taxpayer will usually need to develop an arm's length mark-up since this safe harbor is not available under Mexican income tax law.

As concerns the growing trend to use Mexico as the principal services provider for back office and other activities for the benefit of U.S. and several Latin American affiliates, some South American countries impose significant withholding taxes for fees paid to Mexican service providers and this cost is occasionally viewed as an "operating expense" under Mexican generally accepted accounting principles. Thus, in these cases the Mexican foreign tax credit limitation may result in large unused foreign tax credits and these unused credits may require an additional charge in Mexico to obtain a mark-up on these unrecoverable costs. We occasionally assist clients in building models to quantify these costs in Mexico and various other jurisdications to help in the evaluation of the most appropriate site.

Stock-based compensation

The Temporary service regulations clarify that the services costs should include stock-based compensation. This is important due to the fact that this charge could have a significant effect on the intercompany charges and may not necessarily coincide with the view of the Mexican Tax Authorities since there is no clear guidance at this time.

Regarding the inclusion of this compensation expense in the service costs of a Mexican subsidiary, as of this writing, the Mexican income tax law does not provide a specific reference to any valuation procedure or accounting treatment of the stock option plan costs incurred by Mexican taxpayers.

Nevertheless, on September 3, 2004, the Secretariat of the Working Party No. 6 of the OECD issued a technical paper named "Employee stock option plans: Impact on Transfer Pricing", where the OECD country members analyze the impact of stock options on intra-group transactions where the transfer pricing method to be applied is sensitive to employee remuneration.

According to this document, any transfer pricing analysis regarding this issue should be initiated based on the premise that stock option plans should be considered deductible remuneration, and accordingly, they must be included in the costs base of a management fee, or charged back to the local affiliate in the case of key management employed by the local affiliate.

In this regard, the Mexican generally accounting principles also recognize the stock-based compensation as an accepted operating expense for the companies, and in this sense the accounting treatment of this kind of transaction should be consistent with the OECD point of view.

Finally, according article 216 of the Mexican income tax law, the revenues, costs, gross profits, net sales, expenses, operating profits, assets and liabilities shall be determined based on generally accepted accounting principles although these specific rules are not clear in Mexican income tax law.

In summary, the temporary service regulations issued by the U.S. Treasury Department in the U.S. regarding the incorporation of the stock based compensation in the

cost base appears to be generally consistent with the OECD and the requirements under the Mexican Income Tax Law, although there will be a high standard of documentation to support these increased charges from abroad.

Conclusions

The U.S. regulations provide significant guidance in transfer pricing from a U.S. perspective. These guidelines are generally consistent with the OECD transfer pricing guidelines although the Mexican documentation process will need to be congruent with Mexican laws and the OECD Transfer Pricing Guidelines, and should be useful (but not conclusive) for purposes of analyzing and documenting transactions in Mexico.

Moreover, charges from abroad that are based on allocations will need to have alternative documentation for Mexico until the tax authorities and legislators bring the Mexican rules in line with international standards.

In addition, fairly recent changes in the U.S. in generally accepted accounting principles requiring current expense recognition of stock-based compensation now requires an analysis of these expenses to be charged down to Mexican affiliates to ascertain a methodology of charge downs and to meet deductibility requirements.

Mexico's legislation is still lacking clarification in the following areas:

1. Repeal law disallowing allocations

2. Shared services or cost contribution agreements need to be addressed in a manner consistent with OECD Guidelines

3. Specific regulations should be developed regarding the stock based compensation, including guidelines for the valuation of stock options (grant or exercise date), deductibility requirements for the stock option plans, etc.

In the meantime, competent authority and rulings should be evaluated on a case-by-case basis, and alternative documentation requirements may be required.

“Moreover, charges from abroad that are based on allocations will need to have alternative documentation for Mexico until the tax authorities and legislators bring the Mexican rules in line with international standards.”

Venezuela Update: Impact of Politics on the Transfer Pricing Environment

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The impact of politics on the Venezuela economy

Since his re-election on December 3, 2006 Venezuela's President Hugo Chávez has begun to implement what he calls the "21st Century Socialism", a political campaign aimed at nationalizing ownership of communications, information services and utilities companies in Venezuela. These changes will likely have far reaching impacts on corporate taxation and enforcement in Venezuela. In December 2006 and January 2007, Chavez announced that he would revoke the license of one of the major television channels, Radio Caracas Televisión (RCTV), and nationalize the Venezuelan telephone company, CANTV (partly owned by Verizon Communications Inc.), the companies in the electric power sector, (including La Electricidad de Caracas, whose major shareholder is AES Corp.) and the foreign controlled strategic associations in the Orinoco Oil Belt. The Caracas stock exchange, where CANTV and La Electricidad de Caracas are listed and have significant importance, responded immediately, falling 32.6% during the week of January 9, 2007. Moreover, given the fact that Venezuela has exchange controls since 2003 that set an official fixed exchange rate, these announcements made the exchange rate in the "parallel" market rise more than 20%.

Chávez also ordered the National Assembly, 100% controlled by the government-related parties, to draft a law that will enable him to speed the reform and implementation of many special laws, including the presidential indefinite reelection, that will have significant impact on the private sector: Income Tax Law, Value Added Tax Law, Financial Administration Law, Banking Sector Law and Insurance Sector Law, among others. This "enabling law" was shortly approved on the first days of February.

All these announcements are affecting private companies by limiting free enterprise and private property rights, while concentrating the major economic and civil powers in the government's hands. Tax policy will also likely reflect these trends through aggressive taxation of corporations, especially foreign controlled corporations. In early 2007, SENIAT's tax audits manager reminded taxpayers that the organization's tax audit focus for 2007 will be on transfer pricing, calling it "the world's major tax evasion element". The SENIAT's goal being to collect as much as possible from companies and that they have the legal weapons and human capital to fight against this "illegal activity". Finally, he encouraged the tax audit officers to increase their efforts and "rescue the Venezuelan sovereignty regarding transfer pricing".

Transfer pricing regulations in Venezuela

The Venezuelan transfer pricing rules adopt the arm's length standard for controlled transactions and adhere to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the Organization for Economic Cooperation and Development (OECD Guidelines). Therefore a controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in comparable

transactions under comparable circumstances.

A controlled transaction may be compared to an uncontrolled transaction if that transaction meets at least one of the following conditions:

- none of the differences, if any, between compared transactions or between companies that carry out the compared transactions will materially affect the price or margin in the free market; or
- reasonably accurate adjustments may be made to eliminate the material effects of these differences.

The factors required to determine the differences between controlled and uncontrolled transactions, in accordance with the method used, are the following:

- the characteristics of the transactions,
- the functions or activities, including the assets used and risks assumed in the transactions, of each of the parties involved in the transactions,
- the contractual terms,
- the economic circumstances, and
- the business strategies, including those related to the penetration, permanence, and expansion of the market.

The transfer pricing methods specified in the Venezuelan law are the same as those contained in the OECD Guidelines: Comparable Uncontrolled Price Method (CUP), Resale Price Method, Cost Plus Method, Profit-Split Method and Transactional Net Margin Method. An important thing to point out is that the taxpayer is required to consider the CUP as the method of first choice, and that the tax authorities will evaluate whether the method applied by the taxpayer is the most appropriate, given the characteristics of the transaction and the economic activity performed.

Transactions and arrangements with foreign related parties must be reported to the tax authorities through an informative transfer pricing return, which must be filed within six months of the end of the fiscal year. This informative transfer pricing return must illustrate the types of intercompany transactions, transaction dates, the amounts of each type of transaction, the transfer pricing method applied, and the result of each transaction (i.e., profit or loss). Further appendices require the taxpayer to disclose a related and unrelated party segmentation of the profit and loss statement.

Moreover, the taxpayer must develop and maintain a transfer pricing study to document the analyses of its intercompany transactions, and the Venezuelan rules also require an extensive list of transfer pricing documentation that includes, among others, the following items:

- an analysis of fixed assets and the commercial and financial risks related to the transaction, including documentation to support the acquisition and use of assets;
- an organizational and functional overview of the taxpayer, and information about the relevant departments and/or divisions, strategic associations and distribution channels;
- information regarding the foreign related parties, including type

of business, main clients and holdings in group companies;

- an overview of the controlled transactions, including activities carried out, dates, prices paid or charged and the applicable currency;

- information on the main activities carried out by each of the relevant group companies as well as data on any changes affecting the group as a whole, such as capital increases or mergers;

- financial statements for the taxpayer's fiscal year, prepared according to generally accepted accounting principles, including balance sheet, income statement, stockholder's equity statement and statement of cash flow;

- agreements, conventions or treaties entered into between taxpayers and their foreign related parties, including agreements pertaining to distribution, sales, credits, guarantees, licences, know-how, use of trademarks, copyrights, industrial property, cost allocation, research and development, advertising, trusts, stock participation, investments in securities, and other transfers of intangible assets;

- the method or methods used to set the transfer prices, indicating the criteria and objective elements considered to determine that the method used is the most appropriate one;

- information regarding the operations of the uncontrolled comparable companies;

- specific information as to whether foreign related parties are or were subject to a transfer pricing audit, or if they are involved in transfer pricing competent authority or other court procedures. Should a resolution be issued by competent authorities or any final verdict issued by the courts, a copy of the findings must be filed;

- any other information that may be deemed as relevant or required by the Tax Administration.

Regarding transfer pricing penalties, the Venezuelan Tax Code specifies three types of situations where they might arise:

- various non-compliance issues relating to filing and documentation requirements;

- the illegitimate reduction of the taxable income due to action or omission of the taxpayer. The penalty ranges from 25% to 200% of the tax omitted;

- fraud on the part of the taxpayer. Punishable by a jail sentence of between six months and seven years.

Transfer pricing audits and the "Zero Tax Evasion Plan"

Transfer pricing audits began in February 2005 and have been increasing with time, both in the number of audits performed and in the scope of their requirements. In some cases, the tax authorities (SENIAT) have visited several taxpayers, requesting the transfer pricing support documentation detailed above, and giving the taxpayers a 3 to 5 day period to submit the required information.

In July 2006 the SENIAT performed the first nationwide transfer pricing audit, related to the local subsidiary of Mitsubishi Motor Corporation. The SENIAT explained that the audit procedure was applied in order to control the transactions among the Venezuelan taxpayer and their foreign related parties, to ensure in this way that such transactions were agreed at arm's length and that the tax collection in this matter was not reduced due to illicit acts, acting under the guidelines of the "Zero Tax Evasion Plan".

By the end of 2006, SENIAT's tax audits manager, Mr. Etanislao González, announced the enforcement of the "Zero Tax Evasion Plan" regarding transfer pricing audits, changing its previous focus on formal documentation compliance (if the taxpayer has it or not) to thoroughly audit the arm's length nature of the intercompany transactions that were detected by SENIAT's computerized system. Moreover, the SENIAT's transfer pricing unit was to be enlarged and relocated from the economic studies section to the tax audits management, giving it a leading role in the development of audit plans.

Consequently, a few weeks after that announcement, the SENIAT notified the local affiliate of Royal Dutch Shell of a transfer pricing adjustment of USD 17.7 million, assessed by the transfer pricing unit using its databases, studies and analyses. This was the first significant transfer pricing adjustment in Venezuela and it relates to certain financial transactions of the Venezuelan taxpayer involving its foreign related parties. In addition, SENIAT's head officer warned that the transfer pricing audits were going to receive increased enforcement and will be focused on taxpayers in the oil & gas industry.

Concluding remarks

The Venezuelan government's policies are having a strong impact on the private sector by focusing on scrutiny of foreign investors' profits. This economic and legal environment, intensified by a political plan aimed at "socializing" the economy by replacing private companies with government-owned entities, constitutes one of the biggest challenges that multinational companies have ever faced regarding transfer pricing. Therefore, special care must be taken to thoroughly document and support transfer pricing policies in order to avoid penalties and promptly respond to the increasing fiscal pressures.

“This was the first significant transfer pricing adjustment in Venezuela and it relates to certain financial transactions of the Venezuelan taxpayer involving its foreign related parties.”

Managing the Transfer Pricing and Customs Valuation Nexus

By

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In attempting to manage a financial and/or tax result between related parties, many companies perform transfer pricing analysis and develop related documentation to establish prices (or at least price ranges) for inter-company, cross-border transactions. These efforts help companies comply with certain domestic and international tax regulations while also creating a certain level of transparency and predictability to inter-company financial results. Many of these same companies, however, miss an important opportunity to further leverage their transfer pricing analyses and efforts to help provide a foundation for setting and supporting customs values. This article will consider the some of the linkages between transfer pricing and customs valuation concepts, recent developments and decisions from authorities that will likely impact importers/taxpayers going forward, and a few of the benefits that an integrated strategy may provide to companies attempting to better manage the transfer pricing and customs valuation nexus.

Similar Concepts, Different Objectives

While there is a significant overlap between valuation concepts that apply under the customs and tax regimes, there may be inconsistent results depending upon application and the specific jurisdiction at issue because customs and tax rules often have different objectives. Whereas a tax authority is focused upon the accuracy of a transfer price as reflected on an importer's tax return in transactions between related parties, a customs authority applies duty charges against the appraised value of the merchandise at the time of entry into a customs territory.

It is no surprise, therefore, that many importers dealing with related parties are confronted with a conflicting choice between two reasonable business objectives: paying as little duty as possible, but also obtaining the largest possible corporate income tax deduction. In pursuing both goals at once, the importer may be exposed to enforcement action by a tax authority that charges the importer with paying too much for imported merchandise (i.e., taking too large a tax deduction), and a customs authority that argues that the same merchandise was undervalued and thus, the duties paid were too little.

Both transfer pricing and customs valuation rules employ an "arm's-length standard" but require different approaches and applications to achieve acceptable results. The Organization for Economic Cooperation and Development (OECD) developed guidelines and methods for countries to consider in implementing transfer pricing rules and most jurisdictions adhere to the OECD model. Within this context, the primary method for establishing the arm's-length pricing between related parties is to show that comparable goods are being sold by third parties at roughly the same price. Conversely, the primary method for establishing arm's-length pricing under the Agreement on Customs Valuation (ACV) of the World Trade Organization (formerly known as the General Agreement on Tariffs and Trade) is to value imported merchandise on the price actually paid or payable, subject to certain required adjustments in accordance with Article 8 of the Agreement, and examining, as necessary, the circumstances of the sale[1].

1 See Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994. Additionally, in arriving at a proper customs value, an importer may not randomly choose to use one method in preference to another. Observing a descending order, the importer must use the first of the six methods that applies to its specific situation.

The basic principle of the ACV is that, wherever possible, valuation should be based on the 'transaction value' – the price paid or payable for the goods when sold for export to the country of importation, subject to certain prescribed conditions and adjustments. The most significant condition for acceptance of the transaction value by the customs authorities is that the price has not been influenced by any relationship between the parties. While different countries have widely varying standards to determine whether or not companies are 'related' for direct tax purposes, the ACV offers a worldwide standard for customs purposes that is more narrowly defined than many direct tax laws. Persons, whether natural or legal, are deemed to be related for customs purposes under the ACV if:

1. they are officers or directors of one another's businesses;

2. they are legally recognized partners in business;

3. they are employer and employee;

4. there is any person who directly or indirectly owns, controls or holds five per cent or more of the outstanding voting stock or shares of both of them;

5. one of them directly or indirectly controls the other[2];

6. both of them are directly or indirectly controlled by a third person;

7. together they directly or indirectly control a third person; or

8. they are members of the same family.

The interpretation and application of the ACV differs across jurisdictions and many customs authorities are only beginning to familiarize themselves with transfer pricing concepts and the nexus with customs valuation. As recently as ten years ago, just a handful of countries had implemented transfer pricing rules and adhered to the ACV. Today, more than 40 different countries enforce formal transfer pricing rules and about 100 more apply the ACV.

In many jurisdictions where the implementation of transfer pricing rules and the ACV have run a parallel if somewhat staggered course during the past few years, there is little evidence of widespread inter-agency communication or cooperation just yet. However, it is clear that in countries with more experience in both transfer pricing and customs valuation, tax and customs administrations are increasingly coordinating to determine if declared import prices and values meet the "arm's-length" standard required by each authority. It seems that they both have come to appreciate the benefits of working together in combating tax and customs fraud, improving taxpayer compliance, and collecting new revenues in the form unpaid duties, taxes, fines and penalties. In an effort to become more effective in the administration their respective rules, there is evidence that some jurisdictions (e.g., Canada, U.K., Peru) are cross-training customs officers in transfer pricing regulations and deploying them on tax investigations, and vice versa.

For its part, the U.S. Bureau of Customs and Border Protection's (CBP) experience with both transfer pricing and the ACV is relatively extensive given that both sets of rules have been in place in the U.S. since the mid-1980s, and many importers/taxpayers have come forward with customs valuation ruling requests

2 Control for this purpose means that one person is legally or operationally in a position to exercise restraint or direction over the other.

and some have requested CBP's consideration of the applicability of Advanced Pricing Agreements to customs values. Therefore, it is instructive to consider how CBP views the transfer pricing and customs valuation nexus with respect to its role in accepting declared customs values build, in whole or in part, around inter-company transfer prices.

Case-by-Case Approach

In reviewing some of CBP's positions as articulated in certain rulings on customs valuation, it is evident that the agency has shown a certain degree of flexibility in recent years in considering transfer pricing analysis as part of a broader determination of appropriate customs values. In general terms, it can be stated that CBP has not explicitly rejected transfer pricing analysis or the results determined there under as invalid, however, it has repeatedly affirmed that a traditional transfer pricing analysis alone is not sufficient to support the validity of an inter-company transfer price as the basis for customs value.

In the process of reviewing transfer pricing analysis and other documentation submitted on behalf of an importer, for example, CBP noted in Headquarters' Ruling #548482 that …

> *"The suggestion that the seller's prices to the buyer/importer are set in accordance with the normal pricing practices of [X] industry because the buyer/ importer allegedly earns an operating profit comparable [under transfer pricing analysis] to other allegedly "functionally equivalent" companies is not sufficient…"*

Looking further into CBP's positions on the matter, there is acknowledgement that there are circumstances where transfer pricing analysis could successfully be utilized to support (but not necessarily define) a customs value. Specifically, CBP has noted that the following conditions would need to be present:

1. the transfer pricing methodology applied has been accepted by the U.S. Internal Revenue Service through an Advanced Pricing Agreement (APA);
2. the APA is bilateral;
3. CBP is provided access to all data utilized in the APA analysis;
4. the transfer pricing comparables analysis focuses on product similarity rather than function comparability; and
5. CBP approves of the methodology applied and the tested party in the analysis.

Admittedly, the above conditions would seem to set a rather high bar for most importers and, with CBP reserving the right to have the final say on acceptability of a customs value, nothing would be guaranteed. Moreover, with relatively few U.S. importers (about 300) having a bilateral APA in place, the universe of potential importers to whom this may presently apply appears rather limited. Perhaps a broader segment of U.S. importers trading with related parties may more practically consider the position that CBP staked out in HQ Ruling #547382 a few years back wherein it accepted a transfer pricing methodology that had been determined without the involvement of a foreign tax authority (i.e., no APA). In that decision, CBP focused on whether the importer had satisfied the circumstances of sale test[3] via a review of a transfer pricing comparables study, the foreign party's financial statements, and an analysis of the profitability of the foreign party and the related foreign manufacturer.

3 See: Section 402(b)(2)(B) of the Trade Agreements Act; 19 USC §1401a(b)(2)(B); and 19 CFR §152.103(l)(1)(ii) and (iii).

A Formal Stand

Going beyond case-by-case, importer-specific rulings on the matter of transfer prices and customs valuation, in April 2007 CBP recently released an "Informed Compliance" publication to the importing community in the United States in an attempt to help bring more formal clarity to the issue of when and how transfer pricing analysis may support customs values. In Determining the Acceptability of Transaction Value for Related Party Transactions, CBP provided importer guidance into the usefulness and applicability of using transfer pricing studies (including APAs) for customs valuation requirements. Customs valuation regulations apply special rules when the parties involved in an import transaction are related. In particular, use of the transaction value method of appraisement is subject to certain conditions, including the ability of an import to prove the existence of an arm's-length sale. Proof of an arm's-length sale is evidenced when the importer is able to demonstrate that the transaction meets either the circumstances of sale test, or the test values method.

The circumstances of sale test is passed if the importer can properly illustrate that the related party aspect of the transaction did not influence the price. CBP offers three potential approaches to pass the test:

- The price was settled in a manner consistent with the normal pricing practices of the industry in question;
- The price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it; or
- The price is adequate to ensure recovery of all cost plus a profit that is equivalent to the firm's overall profit realized over a representative period of time in sales of merchandise of the same class or kind.

In commenting on these three approaches, CBP pointed out the need for close product similarity, as well as pricing practice in a specific industry. In particular, CBP noted that utilization of "functionally equivalent companies" is not sufficient evidence. Since utilization of functionally equivalent companies is acceptable under the transfer pricing regulations and routinely utilized, the applicability of an importer's transfer pricing study to pass the circumstances of sale test will be viewed by CBP as limited. Regarding the third point above, CBP views the costs plus profit to be a reference to the parent company profit. Since this is an objective test, utilization of an importer's transfer pricing study would not be relevant for purposes of passing the circumstances of sale test.

Regarding to the application and use of a transfer pricing study for purposes of the circumstances of sale test, CBP conceded that the broad goal of treatment of related party transactions on an arm's-length basis is similar between the tax transfer pricing regulations and the customs regulations. However, CBP further noted that substantial legal requirement differences exist between the transfer pricing regulations and the customs regulations. CBP illustrated that the transfer pricing regulations would allow a taxpayer to aggregate all imported products from a related party (or parties) for purposes of illustrating arm's-length treatment under the best method rule. However, the customs regulations require a customs value be determined for every imported product. Thus, a related party importer would have to illustrate that every individual related party transaction was arm's length, not simply the aggregate value of the transactions. Since a transfer pricing study would address the transactions in an aggregate basis, in order to comply with the transfer pricing regulations, CBP would view

its usefulness in a customs valuation setting as somewhat limited.

The CBP guidance also discusses and contrasts the methodological approaches of the transfer pricing regulations and the customs regulations. The CBP does acknowledge certain similarities between the transaction-based methods (i.e., Comparable Uncontrolled Price, Resale Price and Cost Plus) of the transfer pricing regulations and the methods of valuation in the customs regulations. However, CBP also indicates the Comparable Profits Method (CPM) has little similarity with the customs regulations methods. It notes the reliance of the CPM on a broad functional similarity, as opposed to product similarity. Since the customs valuation methods require product similarity, or comparison of pricing within an industry, CBP concludes that "the fact that the importer's transfer pricing methodology satisfies one of the IRS methods is not determinative of whether it is an acceptable transaction value for customs purposes."

As customs valuation is based on facts and circumstances, CBP indicates that a transfer pricing study can have very useful information concerning the facts of the related party transaction, as well as potential information on similar unrelated party pricing transactions. This is especially the case whereby the Comparable Uncontrolled Price (CUP) method (as opposed to a profits-based method, such as the CPM) was utilized in the transfer pricing study. CBP encourages importers that wish to utilize a transfer pricing study to support a circumstances of sale claim to submit additional evidence as to why the importer believes the transfer pricing study's conclusion are relevant to its circumstances of sale claim. CBP notes that submission of a transfer pricing study, in relation to circumstances of sale claim, without further support will be rejected.

The second approach, under the customs regulations, to illustrate the acceptability of the transaction value is a test value approach. Under this approach the related party transaction value (i.e., transfer price) is acceptable under the following "test values":

1. the transaction value of identical merchandise, or of similar merchandise, in sales to unrelated buyers in the United States;
2. the deductive value of computed value for identical merchandise of similar merchandise;
3. but only if each value referred to in clause (i) or (ii) that is used for comparison relates to merchandise that was exported to the United States at or about the same time as the imported merchandise.

It is clear from the very focused nature of the test value approach that if an importer desired to utilize its transfer pricing study to pass this customs regulation test, the study would have to use a CUP method. More specifically, the CUP would have to be identical, or similar, merchandise imported into the United States during the same time period. This very limited applicability makes utilization of a transfer pricing study for purposes of a test value claim a somewhat remote possibility.

In summary, the CBP guidance is clear: An importer's sole use and submission of a transfer pricing study (including an APA) for purposes of the transaction value method of customs valuation is insufficient. In order to meet the circumstances of sale test, or the test value approach, the importer who submits a transfer

pricing study must also submit additional supporting documentation illustrating why the transfer pricing study supports the claim of passing the circumstances of sale test or test value approach.

§1059A and Customs Valuation

For its part, the United States Internal Revenue Service ("IRS") can leverage a section of the U.S. tax code, 26 U.S.C. §1059A, to define the limits of customs values for tax purposes. This provision in the tax regulations essentially states that if any property is imported into the U.S. in a transaction between related parties, the amount of costs taken into account in determining basis or inventory cost for tax purposes cannot be greater than the customs appraised value (with some adjustments) declared for the imported goods at final liquidation.[4] (Relevant for this discussion, an interpretation of §1059A is that this provision applies to merchandise declared on the entry summary submitted to the CBP at the time of entry as dutiable, and does not apply to imported merchandise entered as duty free or with a zero rate of duty.)

In many instances, companies importing into the U.S. from related parties are required to make upward pricing adjustments in order to satisfy "arm's-length" transfer pricing requirements. Although these upward transfer pricing adjustments may satisfy "arm's-length" requirements for purposes of complying with tax laws and United IRS regulations, they may create potential uncertain tax positions due to the inventory valuation limitation under 26 U.S.C. §1059A.

The 1059A limitation could apply as a result of an upward transfer pricing adjustment, or where certain costs are excluded from the invoice value of the goods (e.g., tooling, engineering/designs, procurement fees, discounts, commissions, manufacturing technology/know-how, royalties, cost-sharing agreements, etc.) but are required to be added to the inter-company price in order to determine the proper appraised customs value of the imported goods. Where increases occur in either case (i.e., to satisfy tax or customs requirements), §1059A may require the importer to use the lower customs value determined at the time of final liquidation as the basis or inventory cost of the merchandise for tax purposes rather than the adjusted (higher) transfer price and/or customs retroactive value adjustment made after final liquidation. The application of 1059A in these instances and the requirement to record the lower price for tax reporting purposes could potentially result in an "uncertain tax position," and possibly require a financial disclosure statement under the new Financial Accounting Standards Board FIN 48 rules.

Where price increases are required to satisfy either transfer pricing tax and/or customs valuation purposes, U.S. customs laws provide for certain administrative procedures that may be used by an importer to help prevent a possible §1059A limitation issue. Among these procedures are Supplemental Information Letters, Administrative Protests and the Reconciliation program. Each of these is discussed in more detail below.

Supplemental Information Letters

As a general rule, CBP will liquidate an entry within 314 days after the date of entry. Due to this 314-day liquidation cycle and to assist importers with making changes to entry summaries prior to liquidation, CBP implemented an administrative process whereby importers could submit letters (referred to as

4 Liquidation is the process by which the U.S. Bureau of Customs and Border Protection, after receiving an entry summary (CF 7501) filed by the importer and/or broker (hereafter collectively referred to as importer) to obtain an entry or release of merchandise into the United States, fixes the final appraisement, classification, and assessment of duties, taxes and fees with respect to that entered merchandise (19 U.S.C. §1500). Generally, final liquidation of an entry will occur within 314 days after the date of entry for the imported merchandise, unless an administrative protest under 19 U.S.C. §1514 is filed by the importer within 180 days after the date of liquidation.

"supplemental information letters," or "SILs") to make post-entry amendments to their entry summaries for imported merchandise already filed but not yet liquidated. As provided for, SILs may cover issues that are "protestable," including valuation errors. Thus, provided the entry has not yet liquidated, in those instances where price increases occur (i.e., transfer pricing adjustment is made/or required for IRS tax compliance purposes, or where compliance with U.S. customs valuation laws and regulations require retroactive increases of certain costs) SILs can be filed to declare and effectuate the increased prices for the imported merchandise. This action can help an importer/taxpayer avoid the §1059A limitation on basis or inventory costs for tax purposes and, more broadly, a possible uncertain tax position.

Reconciliation Program

CBP has recognized the fact that many elements of a transaction, including customs valuation, may be undeterminable at the time the imported merchandise is entered into the U.S. In order to assist importers with declaring accurate information on the entry summaries in these instances, CBP established the Reconciliation program.

Reconciliation allows an importer, using reasonable care, to file entry summaries with CBP with the best available information at the time of importation under the mutual understanding that certain elements, such as the appraised customs value for imported merchandise, remain outstanding. The undeterminable information is "flagged" on the entry summary filed with CBP for the imported merchandise at the time of entry. At a later point in time (generally within 21 months after the entry is filed) when the specifics have been determined and are known, the importer files a Reconciliation entry providing the accurate and correct information for the given entry(s) to CBP. The reconciliation entry is then liquidated with the accurate and correct information (e.g., increased customs value) for the respective entry(s).

From the import compliance and operational management perspectives, participation in the Reconciliation program is the most effective administrative method available to avoid a potential §1059A limitation issue for future import transactions.

Administrative Protests

Although an entry may be liquidated within 314 days after the date of entry, an importer can challenge liquidation of an entry, including customs appraised value, by filing a protest within 180 days of the date of liquidation. If this route is chosen, the liquidation of an entry becomes final and binding on all parties only after the expiration of that 180-day period. Consequently, where price increases occur an administrative protest may be filed within 180 days after the date of liquidation in order to properly effectuate the increased customs value and avoid the detrimental affect of the §1059A limitation.

Voluntary Disclosure

In many instances, price increases made by importers are undeterminable or unknown until after the liquidation of the entry(s) has become final with CBP. In these cases, the increased prices and/or customs value may be voluntary disclosed to CBP for all final liquidated entries pursuant to a prior disclosure. Such an action can help an importer to avoid potential monetary penalties being assessed by CBP for valuation errors. (CBP can assess significant monetary penalties, ranging from 200% to 800% of the

duties, or 20% to 100% of the import value for duty free/zero rated goods, against a U.S. importer for using the incorrect customs value for the imported merchandise.)

However, it is important to note that the IRS has ruled that the filing of a voluntary prior disclosure with CBP does not extend the final liquidation date of an entry for customs purposes and the application of §1059A. Its stated position is that the "…customs value is considered to be finally determined, and all CBP determinations are considered final, when liquidation of the entry becomes final." As such, its view is that a taxpayer's subsequent voluntary tender of additional duties would not increase the "dutiable value" of the imported merchandise for purposes of the §1059A limitation.[5] Depending on the amounts involved, this position could create a potential uncertain tax position for the taxpayer/importer. Thus, importers/taxpayers must recognize that while a potential customs valuation exposure may be addressed via a voluntary disclosure, this remedy will not resolve a §1059A limitation.

Thanks in part to the §1059A inventory basis limitation statute, perhaps nowhere else is the transfer pricing and customs valuation nexus more formally captured than it is in the U.S. To help reduce the risk of a §1059A inventory basis limitation and the creation of a possible uncertain tax position, U.S. importers/taxpayers should carefully consider the above administrative procedures as part of their focus and diligence in managing the transfer pricing and customs valuation nexus.

Strategy Based on Balance and Leverage

Considering the above, it generally can be argued that an importer's sole reliance on transfer pricing analysis would likely not be sufficient to support the proper appraisement of merchandise for customs valuation purposes, either in the U.S. or other jurisdictions. To believe and act otherwise runs the risk of being subjected to fines, penalties and/or a mandated application of an alternative customs valuation method that may be difficult and costly to implement and sustain. Still, transfer pricing analysis and related documentation can be leveraged to provide a basis from which a customs value may be derived and supported. This assumes, of course, that all required statutory adjustments are applied and other relevant factors are considered.

Though approximately 80% of global trade activity occurs between related parties, surprisingly few multinational corporations fully appreciate all the issues and implications of the transfer price and customs valuation nexus, and arguably, even fewer have developed and implemented a comprehensive and proactive strategy to effectively manage it. Those companies that do develop and implement an integrated, balanced and coordinated transfer pricing and customs valuation strategy often times discover that there are considerable benefits, including:

- A foundation for establishing inter-company pricing policies for customs purposes that help to decrease accounting issues that are created by gaps, lack of coverage, or contradictions among inter-company pricing initiatives;
- The ability to significantly reduce the potential of a customs audit as well as the financial exposure

5 See, for example, IRS FSA 200036015 (May 31, 2000); See also, 2003 WL 18767 (IRS NSAR) 2000 IRS NSAR 274 (January 2, 2003).

“... it generally can be argued that an importer’s sole reliance on transfer pricing analysis would likely not be sufficient to support the proper appraisement of merchandise for customs valuation purposes, either in the U.S. or other jurisdictions.”

related to penalties associated with non-compliance of customs regulations;

- A global, long-term coordinated inter-company customs valuation documentation compliance solution that considers products/ product line, market conditions, and other key economic factors.

- A basis for proactively managing value adjustments to achieve arms-length results required under both tax and customs regulations;

- A foundation for pursuit of Advanced Pricing Agreements that may also be considered by customs authorities as evidence of an appropriate arm's-length value;

- The ability to identify planning opportunities related to the valuation of merchandise and intangibles (e.g., royalties, license fees, R&D, warranties, marketing & advertising, cost-sharing arrangement, etc.) via alternative methods of appraisements;

- The development of limits to customs authorities' ability to interpret Art. 1.2(a) and (b) of the WTO Customs Valuation Agreement relating to the acceptability of using the transfer price as an initial basis for the customs value of imported merchandise; and

- Enhanced financial reporting compliance related to inter-company cross-border transactions to satisfy obligations under Sarbanes-Oxley reporting requirements.

FIN 48: Uncertain Tax Positions associated with Transfer Pricing

Some Frequently Asked Questions form a Global Perspective

By

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As a result of limited authoritative literature under United States ("U. S.") Generally Accepted Accounting Principles ("GAAP"), there has been a perception that significant diversity in the accounting for uncertain tax positions in the practice has developed over time. In the current U.S. business and accounting environment, this diversity has raised many concerns, including:

- That the standards for recording tax benefits needed strengthening to provide a level of comparability;
- A perception that tax contingency reserves had become too flexible and susceptible to earnings manipulation; and
- The reporting and disclosure of taxes in financial statements were often opaque and misunderstood.

The U.S. Financial Accounting Standards Board ("FASB") undertook a project more than two years ago to address these concerns. The project concluded with the issuance of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"), dated June 2006 and released July 13, 2006. On January 17, 2006, the FASB unanimously affirmed its previous decision to make FIN 48 effective for fiscal years beginning after December 15, 2006. Accordingly, companies with calendar year-ends need to adopt the provisions of FIN 48 as of January 1, 2007.

The nature of the transfer pricing arm's length standard existing under section 482 of the Internal Revenue Code and the Treasury Regulations thereunder ("the section 482 Regulations"), the Guidelines for Multinational Enterprises issued by the Organisation for Economic Cooperation and Development ("the OECD Guidelines") and many individual local country transfer pricing rules and regulations, provide unique challenges in the application of FIN 48.

This document provides some answers to frequently asked questions around FIN 48 and transfer pricing from a global perspective.

Question 1: Broadly, what does FIN 48 prescribe?

Answer: FIN 48 prescribes a comprehensive model for how an entity should recognize, measure, present and disclose in its U.S. GAAP financial statements the impact of uncertain tax positions that management has taken or expects to take on tax returns (including a decision whether to file or not to file a return in a particular jurisdiction). In applying FIN 48, management will need to determine and assess all material uncertain tax positions existing as of the date they adopt the interpretation, in all jurisdictions for all tax years that are still subject to assessment or challenge under relevant tax statutes. Management is required to assess uncertain tax positions under the presumption that the position will be examined by the relevant tax authorities and that the authorities will have access to all relevant facts. Core concepts under FIN 48 include:

“In applying FIN 48, management will need to determine and assess all material uncertain tax positions existing as of the date they adopt the interpretation, in all jurisdictions for all tax years that are still subject to assessment or challenge under relevant tax statutes.”

- Recognition: A tax benefit from an uncertain tax position may only be recognized if it is "more likely than not" that the position is sustainable based solely on its technical merits (i.e. excluding detection risk) and any relevant widely understood administrative practices,

- Measurement: The tax benefit of a qualifying position is the greatest amount of benefit that is cumulatively greater than 50 percent likely of being realized, and

- Subsequent recognition and measurement: The assessment of the recognition threshold and the measurement of the associated tax benefit are subject to change based on new information. Unrecognized tax benefits should be recognized (derecognized) in the period the position reaches (falls below) the recognition threshold, which may occur prior to final resolution of the matter.

Question 2: What and who does FIN 48 apply to?

Answer: FIN 48 applies to all entities utilizing U.S. GAAP that are subject to income taxes, including not-for-profit organizations that are subject to income taxes. It applies to all tax positions accounted for in accordance with FASB Statement No. 109, Accounting for Income Taxes ("FAS 109"), including:

- Previously filed positions,

- Expected filing positions,

- Decisions not to file tax returns,

- Decisions to exclude potentially taxable income,

- Choices made in classifying a transaction as tax-exempt (e.g., non-taxable spin-offs), and

- Tax positions acquired or assumed in business combinations.

Uncertainties related to taxes not accounted for under FAS 109 should continue to be accounted for under FASB Statement No. 5, Accounting for Contingencies.

Given that FIN 48 applies to all entities utilizing U.S. GAAP it will potentially apply to:

- Foreign subsidiaries of U.S. entities,

- Non-U.S. entities registered with the SEC, and

- U.S. subsidiaries of foreign entities that prepare U.S. GAAP accounts.

As such, non-U.S. tax professionals will also need to become familiar with the requirements and application of FIN 48. The extent to which a parent entity's tax department relies on a local subsidiary finance department will depend on many factors including; the unique set up of an entity's global tax department, the resources available, the issues at hand and materiality levels for statutory account purposes. Local subsidiary finance personnel may be required to assist in ascertaining the facts surrounding an uncertain tax position from a local perspective and advising on the local tax authority approaches to such positions and potential settlement positions.

Question 3: Is the existence of a Transfer Pricing contemporaneous documentation report covering an entity's intercompany transactions sufficient basis to conclude that there are no uncertain tax positions associated with those transactions?

Answer: No. U.S. contemporaneous documentation reports typically conclude on the question of whether the taxpayer appears to have met the standards of reasonableness with respect to transfer pricing penalties which are set forth in section 1.6662-6 of the Regulations. Generally, transfer pricing documentation reports prepared under the OECD Guidelines and local country rules

conclude on whether the taxpayer's results are consistent with the arm's length standard as promulgated under the relevant rules. These reports do not conclude on the particular likelihood of sustaining a position, the amount of a particular position that has a greater than 50 percent cumulative probability of being sustained, or whether there are alternative outcomes that might be expected to be asserted by the respective tax authorities

Accordingly, management may need to consider alternative transfer pricing methods or profit level indicators in their analysis of alternative settlement positions. The "best method" (as prescribed under the section 482 Regulations) for transfer pricing documentation is not necessarily the only method that should be considered. The "best method" analysis contained in transfer pricing documentation may describe only why a taxpayer did not choose the other methods (and should be protected from penalty exposure). Under FIN 48, management may need to review other methods and their results more closely.

Question 4: If a taxpayer's results fall within the arm's length range identified in their transfer pricing documentation report does that mean an uncertain tax position does not need to be recognized or measured?

Answer: No. Although a taxpayer's results on its intercompany transaction(s) may fall within an arm's length range of results, as defined under the relevant country rules and regulations, an uncertain tax position may still exist. This may occur where management believes that they may ultimately settle at some other amount within or outside of the range documented.

For example, a taxpayer's results for a particular year may fall at the lower quartile of a range of results for companies performing comparable functions. Management may determine (based on their best judgment of an outcome after considering relevant law, administrative practices, and facts and circumstances) that the largest amount of tax benefit that is cumulatively greater than 50 percent likely of being realized upon ultimate settlement with a tax authority, is the median of the range. Alternatively, the taxpayer may determine that the amount would be based on another transfer pricing method selected to test a taxpayer's results and/or a different profit level indicator.

Question 5: What factors should management consider in determining units of account for transfer pricing?

Answer: Uncertain tax positions are recognized and measured based on the appropriate unit of account for that position. Broadly, a unit of account is the level at which you expect to engage the tax authority with regards to a tax position. Thus, in determining what is a unit of account for FIN 48 purposes, management need to determine the appropriate level of disaggregation of the intercompany results and/or transactions. There are no bright line tests that can be relied upon. Instead management will need to consider the facts and circumstances surrounding each intercompany arrangement. Factors influencing the determination will include the treatment and disclosure of the position in taxpayer's tax returns, consideration of how the relevant tax authorities will examine the position, and the significance and materiality of the position to the management.

For example, a unit of account could consist of a particular intercompany transaction such as a management fee charge out to a foreign subsidiary. Alternatively, it could consist of the overall results of that foreign subsidiary if management expects that they would effectively settle with a tax authority on that basis.

Given the disclosure requirements under FIN 48, units of account will generally be determined on separate jurisdictional bases and on a gross basis (e.g. before Competent Authority adjustments, as described below). Depending however, on the nature of the uncertain tax position, transactions or results could be combined in one unit. For example, if management determines that, say, the U.S. Internal Revenue Service ("IRS') is likely to adjust the total cost base of a management fee charge out to foreign subsidiaries, that cost base could form one unit of account.

Question 6: Are probability tables required for all uncertain transfer pricing positions and how are they prepared?

Answer: If there is more than one possible settlement position, a probability table may be appropriate to demonstrate the determination of the largest amount of tax benefit that is cumulatively greater than 50 percent likely of being realized upon ultimate settlement with a tax authority. Once management has identified alternative settlement positions associated with a particular transfer pricing tax position, it will then have to determine individual probabilities of each of these positions.

The assignment of probabilities to a particular outcome is not an exact science. This exercise will be heavily dependent on facts and circumstances around a particular transaction, management's experience and knowledge of the tax authority's position on particular transactions, the experience and knowledge of industry peers with respect to settlements and strategies, etc. Therefore, the likely route most companies may take with respect to transfer pricing positions is to evaluate the qualitative aspects of a possible outcome and assign varying probabilities to outcomes based on the factors outlined in the preceding paragraph. Transfer Pricing professionals can help management in identifying the factors to be considered and sharing their experience and knowledge of settlements with respect to a particular transaction in that geography or industry.

If the alternative settlement positions identified are points within an arm's length range of results of companies performing comparable functions, is it appropriate to apply probability percentages to the full range of results or the interquartile range of comparable results? The answer will depend on management's determination of whether the relevant tax authority would consider the full or interquartile range in reaching effective settlement.

Question 7: What is the impact of Competent Authority negotiations on Uncertain Tax Positions?

Answer: Competent Authority considerations add another layer of complexity to the measurement and disclosure of uncertain tax positions from a transfer pricing perspective. As discussed below, offsetting adjustments as a result of Competent Authority must be disclosed separately under FIN 48. In determining if a Competent Authority adjustment may be taken into account, management should consider issues such as:

- What is the specific unit of account?
- Which Competent Authorities are you dealing with?
- What is the likelihood that management would actually pursue Competent Authority? What has been management's historical appetite for such negotiations? Is it likely to be pursued based on a cost/benefit analysis?
- What is the likelihood of success in Competent Authority in that particular country? How controversial is the issue at hand, and how likely is it that resolution would be reached? What is management's experience with or

knowledge of negotiations with the relevant Competent Authority?

- What is the potential reduction in the adjustment, and/or would we get full offset in terms of credits?

The answers to these questions will, of course, depend on the specific facts and circumstances and management's assessment of the likelihood of success.

Question 8: Should Transfer Pricing related to uncertain tax positions be calculated and recorded on a gross or net basis?

Answer: As discussed above, transfer pricing adjustments may ultimately be settled through Competent Authority negotiations or involve other compensating adjustments. In measuring the amount of an uncertain tax position, management should separately evaluate any offsetting transaction, and record the corresponding tax payable (receivable) on a gross basis on the balance sheet. Specifically, unrecognized tax benefits (i.e., FIN 48 liabilities) from one jurisdiction may not be netted against a deferred tax asset or potential tax overpayment receivable from another jurisdiction, even if that asset or receivable relates to the same intercompany arrangement. From a profit and loss perspective the gross transfer pricing uncertain tax position is included in the disclosure of the aggregate amount of uncertain tax benefits, although both positions will enter into the determination of the effective tax rate. (Refer to FIN 48, para 21 and PwC Dataline 2007-01, Question 39 for further discussion.) Interest calculations would, similarly, be performed on a separate jurisdictional basis for the respective tax liabilities and assets.

Question 9: Will the disclosures under FIN 48 impact US and foreign transfer pricing audits?

Answer: FIN 48 requires both quantitative and qualitative disclosures including the:

- Annual roll-forward of all unrecognized tax benefits set out in the form of a reconciliation of the beginning and ending balances of the unrecognized tax benefits on a worldwide aggregated basis;
- Discussion of reasonably possible changes in the recognized tax benefits in the next 12 months; and
- Description of open tax years by major jurisdictions.

Individual units of accounts and the basis of their calculation are not required to be disclosed in an entity's U.S. GAAP financial statements (which may be filed with the SEC or otherwise made publicly available). However, the entity's statutory auditors will likely want to see documentation supporting the recognition and measurement of uncertain tax positions as well as the determination of units of account. Management should consider the possibility that the documentation of their uncertain tax positions could be reviewed by a tax authority. Therefore, the generation of such documentation should be approached carefully.

Question 10: What documentation is necessary to support an entity's identification of and accounting for its uncertain tax positions associated with Transfer Pricing?

Answer: The form and detail of documentation required to support management's identification of and accounting for its uncertain tax positions associated with transfer pricing will depend on many factors including the nature of the uncertain tax positions, the complexity of the issues under consideration and the materiality of the dollar amounts involved. Management should consult with their external independent auditors to determine the level of required documentation.

Conclusions

Management should also consider the reasonableness and consistency of statements made and analyses contained in their transfer pricing documentation with their documentation for FIN 48 purposes. As mentioned previously, transfer pricing documentation studies typically conclude on whether the taxpayer's results are consistent with the arm's length standard, as promulgated under the relevant transfer pricing rules. These documentation studies will generally only meet local requirements and provide penalty protection to the extent that the taxpayer has acted reasonably.

It is the nature of transfer pricing however, that taxpayers who establish intercompany prices in accordance with the arm's length standard, may nevertheless expect that, ultimately upon audit by a tax authority, they may settle upon a different price. It is appropriate therefore to recognize that there is a risk that a tax authority will not agree with a taxpayer's position, and that it is appropriate to account for that risk through the application of FIN 48.

Transfer Pricing by its very nature is uncertain in that it recognizes that there is an "arm's length range of results" rather than one arm's length result. FIN 48 will require management, and external advisors, to evaluate material uncertain tax positions, which for many organizations will be an extensive exercise, and will significantly increase their documentation requirements. FIN 48 may cause greater volatility in income statements as changes in assessments under FIN 48 are recognized discretely within income tax expense. Transfer pricing professionals will need to be intimately familiar with FIN 48 and future interpretive guidance and practice developments as they seek to apply the guidance in a very subjective area.

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Events

Transfer Pricing Global Conference 2007: Adding Sustainable Value While Managing Global Transfer Pricing Risk

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October 24-26, 2007
For more information, please contact TP07@us.pwc.com

Global Core Documentation Implementation Tool

KEY (●) = YES / BLANK = No

	AUSTRALIA	CHINA	HONG KONG	INDIA	INDONESIA	JAPAN	KOREA	MALAYSIA	NEW ZEALAND	PHILIPPINES	SINGAPORE
	ASIA-PACIFIC										
Transfer Pricing Rules, In General											
Q1 Are there formal transfer pricing rules?	●	●	●	●	●	●	●	●	●	●	
Q2 Are there transfer pricing-specific penalties in place?	●			●			●	●			
Transfer Pricing Documentation, in General											
Q3 Is the existence of transfer pricing documentation required by tax authorities to mitigate the imposition of transfer pricing-specific penalties?	●			●			●	●			
Q4 Is there a *formal* transfer pricing documentation requirement?				●			●				
Q5 Is there an *informal* transfer pricing documentation requirement?	●	●			●	●	●	●	●	●	●
Elements of Transfer Pricing Documentation											
Q6 Must certain transfer pricing-related information be provided as part of (or attached to) your tax return?	●	●	●	●	●	●	●	●		●	●
Q7 Is a written functional analysis a required element of transfer pricing documentation?	●	●		●		●	●	●	●		●
Q8 Is a written justification of the transfer pricing method (e.g., CUP, cost plus, etc.) selected and/or not selected a required element of transfer pricing documentation?	●	●		●		●	●	●	●		●
Q9 Is a written arm's length analysis a required element of transfer pricing documentation?	●	●		●		●	●	●	●		●
Q10 Are there other required elements of transfer pricing documentation?		●		●		●	●	●			
Timing of Transfer Pricing Documentation											
Q11 Are there requirements that transfer pricing documentation must be in existence at the time the transaction occurs in order for the documentation to either support the transaction and/or mitigate transfer pricing-specific penalties?								●			
Q12 Are there requirements that transfer pricing documentation must be in existence no later than the time the tax return is filed in order for the documentation to mitigate transfer pricing-specific penalties?	●			●			●				
Q13 Is it sufficient for the mitigation of transfer pricing-specific penalties for transfer pricing documentation merely to be presented upon request by the tax authorities?	●	●			●	●	●		●	●	●
Overall Tranfer 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.

	TAIWAN	THAILAND	ARGENTINA	BRAZIL	CANADA	CHILE	COLOMBIA	ECUADOR	MEXICO	PERU	UNITED STATES	URUGUAY	VENEZUELA	AUSTRIA	BELGIUM	CZECH REPUBLIC	DENMARK	FINLAND	FRANCE	GERMANY	GREECE
			AMERICAS																		
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[Q7] The term "functional analysis" refers to the following types of information: business overview; description of taxpayer's organizational structure; identification of functions performed, risks assumed, and assets utilized by each legal entity; description of the intercompany transactions; etc.

[Q9] The term "arm's length analysis" is intended to mean a description of the comparables used, the economic analysis performed, etc.

[Q11-13] It may be appropriate to answer "yes" to more than one of these questions.

[Q13] Answer "Yes" if there is no requirement in your country for transfer pricing documentation to be prepared prior to inquiry from the tax authorities.

TPSA: The "TPSA" is a tier ranking system that evaluates each country's transfer pricing requirements based on current local legislation. The basis for TPSA are the responses per country on the questions above. This ranking system is a quantitative approach that equally weights each positive response and allows ordering all participant countries based on the complexity of transfer pricing regulations.

	HUNGARY	IRELAND	ISRAEL	ITALY	LATVIA	LITHUANIA	NETHERLANDS	NORWAY	POLAND	PORTUGAL	ROMANIA	RUSSIA	SOUTH AFRICA	SLOVAK REPUBLIC	SLOVENIA	SPAIN	SWEDEN	SWITZERLAND	TURKEY	UKRAINE	UNITED KINGDOM
	EUROPE																				
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