

# International transfer pricing 2009



# International transfer pricing 2009

*This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.*

*©2009 PricewaterhouseCoopers. All rights reserved. 'PricewaterhouseCoopers' refers to network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.*

# Preface

It is my pleasure to present the 2009 edition of our International transfer pricing book. There have continued to be significant changes in the area of transfer pricing since our prior year edition, with several new countries implementing either formal or informal transfer pricing documentation requirements in the past twelve months.

Part I of the book provides a general overview of the global approach to transfer pricing issues. Part II is devoted to a summary survey of specific requirements of the key countries with transfer pricing rules.

We anticipate that 2009 will be an exciting year for transfer pricing as several major territories adopt new or revised requirements for transfer pricing, and as the impact of the OECD's discussion draft on business restructurings is evaluated. We also anticipate an increase in disputes globally as more and more tax authorities attempt to enforce their transfer pricing rules aggressively. It is PricewaterhouseCoopers's view that strategic dispute management (such as through dispute avoidance or resolution techniques) on a global basis will become increasingly crucial in companies' efforts to sustain their global transfer pricing strategies.

We look forward to working with you in 2009 and beyond.

Best regards,



Garry Stone, Ph.D.  
Global transfer pricing leader  
PricewaterhouseCoopers LLP (US)

This book provides general guidance to the reader on a range of transfer pricing issues. Technical material is updated with each new edition and this book is correct as at 1 April 2008. In hard copy form, this 2009 edition is the latest development of a work begun well over a decade ago and is now in its eleventh iteration.

In addition to this reference volume, many of our readers also require real-time access to current information. Readers wishing to receive news alerts on current transfer pricing developments by email can register for this service at no charge by sending an email request entitled 'Pricing Knowledge Network Registration' to the author at [nick.raby@us.pwc.com](mailto:nick.raby@us.pwc.com).

A major and growing problem facing multinational enterprises is the issue of preparing documentation to demonstrate compliance with transfer pricing rules across multiple jurisdictions. More and more countries have established documentation rules that require companies to state clearly and with supporting evidence why their transfer pricing policies comply with the arm's length standard. Many jurisdictions have also implemented strict penalty regimes to encourage taxpayers' compliance with these new procedures. However, some of the biggest challenges facing taxpayers in their efforts to abide by these requirements are the subtle differences in transfer pricing documentation expected across the various tax jurisdictions. These conflicting pressures need to be reviewed and managed very carefully, both to meet the burden of compliance and to avoid costly penalties.

As more tax authorities impose formal and informal documentation requirements to support taxpayers' inter-company pricing policies, as well as establish aggressive audit teams to review compliance, the risk of being assessed material adjustments and penalties becomes greater. For many years, companies have accepted nominal adjustments as a small price to be paid to get rid of the tax auditor. In the current environment, however, adjustments have now become potentially so material that companies cannot simply write off assessed adjustments without recourse. These developments are reflected in the increasing use of mutual agreement procedures under bilateral double taxation agreements, or the Arbitration Convention within the European Union, in order to seek relief from double taxation and unsustainable proposed adjustments. This, in turn, necessitates a more controlled and organised approach by companies to handling the audits as they take place, to ensure the process is conducted efficiently and that any areas where the transfer pricing system is deficient are corrected rapidly. Today, a properly coordinated defence strategy is a basic necessity rather than an expensive luxury.

In this book, my fellow authors and I demonstrate that transfer pricing is a matter that is of fundamental importance to multinational enterprises. It is vital for every company to have a coherent and defensible transfer pricing policy, which is responsive to the very real climate of change in which companies are operating. A sound transfer pricing policy must be developed within a reasonable timescale and be invested in by both company management and professional advisers. It needs to be re-examined regularly to allow for changes in the business, perhaps as the result of acquisitions or divestments of part of the group. We have tried to provide practical advice wherever possible on a subject where the right amount of effort can produce significant dividends in the form of a low and stable tax burden, coupled with the ability to defend a company against tax auditor examination. Naturally, no work of this nature can substitute for a specialist's detailed professional advice on the specific facts relevant

*Preface*

to a particular transfer pricing issue. However, our hope is that, with the assistance of this book, the reader can contemplate inter-company pricing considerations with greater assurance.

*N. L. Raby*

Nick Raby  
PricewaterhouseCoopers LLP (US)

*International transfer pricing 2009*

Nick Raby is the principal in charge of transfer pricing services for PricewaterhouseCoopers in the Western Region of the United States, and has extensive experience in advising on transfer pricing and tax planning for multinational companies. His international experience includes six years in London, and three in Brussels and Amsterdam. Many members of the PricewaterhouseCoopers international network of transfer pricing specialists have contributed to this book over the years. In particular, thanks are due this year to the following individuals who have edited their country materials in this edition.

| <b>Country</b>        | <b>Name</b>  |
|-----------------------|--|
| <b>Africa</b>         | Jacques Van-Rhyn<br>Nerma Hartman<br>Patty Karuaihe-Martin<br>Janet Kabiru               |
| <b>Argentina</b>      | Violeta Maresca  |
| <b>Australia</b>      | Juan Carlos Ferreiro<br>Nick Houseman<br>Cameron Smith<br>Kerry Lambrou<br>Sarah Stevens |
| <b>Austria</b>        | Herbert Greinecker   |
| <b>Azerbaijan</b>     | Movlan Pashayev  |
| <b>Belgium</b>        | Patrick Boone<br>Xavier Van Vlem<br>Shana Vroman   |
| <b>Brazil</b>         | Nélio Weiss<br>Cassius Carvalho  |
| <b>Bulgaria</b>       | Georgy Sarakostov<br>Ginka Iskrova<br>Ekaterina Dimitrova                                |
| <b>Canada</b>         | Saul Plener<br>Andrew McCrodon   |
| <b>Chile</b>          | Roberto Carlos Rivas<br>Carolina Céspedes  |
| <b>China</b>          | Spencer Chong<br>Cecilia Lee<br>Jeff Yuan<br>Winnie Di                                   |
| <b>Colombia</b>       | Carlos Mario Lafaurie<br>Rafael Parra  |
| <b>Croatia</b>        | Janos Kelemen<br>Dr. Ivo Bijelic<br>Matija Vukušić                                       |
| <b>Czech Republic</b> | David Borkovec<br>Natalia Pryhoda  |

| <b>Country</b>    | <b>Name</b>  |
|-------------------|--|
| <b>Denmark</b>    | Jørgen Juul Andersen<br>Anne Mette Nyborg                          |
| <b>Ecuador</b>    | Pablo Aguirre<br>María Jose Alarcón<br>Cesar Ortiz                 |
| <b>Estonia</b>    | Villi Tõntson  |
| <b>Finland</b>    | Merja Raunio<br>Elina Gerdt<br>Jarno Mäkelä                        |
| <b>France</b>     | Pierre Escaut<br>Marie-Laure Hublot                                |
| <b>Georgia</b>    | Sergi Kobakhidze<br>Matthew Tallarovic                             |
| <b>Germany</b>    | Lorenz Bernhardt   |
| <b>Hungary</b>    | Zaid Sethi   |
| <b>Iceland</b>    | Ásta Kristjánsdóttir<br>Valdimar Guðnason                          |
| <b>India</b>      | Dhaivat Anjaria<br>Shyamal Mukherjee                               |
| <b>Indonesia</b>  | Ay-Tjhing Phan   |
| <b>Ireland</b>    | Mary Honohan<br>Gavan Ryle<br>Barbara Abrantes                     |
| <b>Israel</b>     | Gerry Seligman<br>Vered Kirshner<br>Adi Bengal-Dotan               |
| <b>Italy</b>      | Gianni Colucci<br>Marco Meulepas                                   |
| <b>Japan</b>      | Akio Miyamoto<br>Ryann Thomas<br>Toshiyuki Kurauchi                |
| <b>Kazakhstan</b> | Courtney Fowler<br>Carmen Cancela<br>Zaure Nurova<br>Almas Nakipov |
| <b>Korea</b>      | Henry An<br>Heui-Tae Lee<br>Joon Yang<br>Wonyeob Chon              |
| <b>Latvia</b>     | Ilze Berga<br>Artūrs Breicis<br>Agate Ziverte                      |
| <b>Lithuania</b>  | Nerijus Nedzinskas<br>Martynas Novikovas<br>Arnas Laurynas         |



*International transfer pricing 2009*

| <b>Country</b>     | <b>Name</b>                |
|--------------------|----------------------------|
| <b>Luxembourg</b>  | Geetha Hanumantha Rao      |
| <b>Malaysia</b>    | Thanneermalai Somasundaram |
|                    | Jagdev Singh               |
| <b>Mexico</b>      | Fred J. Barrett            |
|                    | Mauricio Hurtado           |
|                    | Gabriel Macias             |
|                    | Raúl Sicilia               |
| <b>Netherlands</b> | Arnout van der Rest        |
|                    | Frans Blok                 |
|                    | Jeroen Peerbooms           |
| <b>New Zealand</b> | Michael Bignell            |
|                    | Geraldine Chan             |
| <b>Norway</b>      | Ola Nicolai Borge          |
|                    | Øystein Andal              |
|                    | Morten Beck                |
| <b>Peru</b>        | Rudolf Röder               |
|                    | Miguel Puga                |
|                    | Rodrigo Lopatin            |
|                    | Fernando Becerra           |
| <b>Philippines</b> | Carlos T. Carado II        |
|                    | Alexander B. Cabrera       |
|                    | Roselle K. Yu              |
| <b>Poland</b>      | Piotr Wiewiórka            |
|                    | Sebastian Lebda            |
|                    | Marcin Zbierski            |
|                    | Maja Seliga-Kre            |
| <b>Portugal</b>    | Leendert Verschoor         |
|                    | Jaime Esteves              |
|                    | Jorge Figueiredo           |
|                    | Clara Madalena Dithmer     |
| <b>Romania</b>     | Ionut Simion               |
|                    | Blanca Kovar               |
| <b>Russia</b>      | Svetlana Stroykova         |
|                    | Maria Parygina             |
| <b>Singapore</b>   | Nicole Fung                |
| <b>Slovakia</b>    | Christiana Serugová        |
|                    | Alexandra Jašicová         |
|                    | Michaela Gábiková          |
|                    | Martin Hornák              |
| <b>Slovenia</b>    | Janos Kelemen              |
|                    | Tina Klemenc               |
|                    | Vid Cibej                  |
| <b>Spain</b>       | Javier González Carcedo    |
|                    | Michael Walter             |

| <b>Country</b>     | <b>Name</b>   |
|--------------------|---|
| <b>Sweden</b>      | Mika Myllynen   |
| <b>Switzerland</b> | Jérôme Monsenego<br>Norbert A. Raschle<br>Rolando Lardelli<br>Nicolas Bonvin                    |
| <b>Taiwan</b>      | Steven Go<br>Yishian Lin<br>Wendy Chiu<br>Dave Barberi  |
| <b>Thailand</b>    | Peerapat Poshyanonda<br>Janaiporn Khantasomboon   |
| <b>Turkey</b>      | Zeki Gunduz<br>Canan Aladag<br>Ozgur Bayraktar  |
| <b>UK</b>          | Victoria Horrocks<br>Gareth Williams  |
| <b>USA</b>         | Nick Raby<br>Vu P. Tran<br>Matias Pedevilla   |
| <b>Uruguay</b>     | Leonardo Decarlini<br>Maria Jose Santos   |
| <b>Uzbekistan</b>  | Abdulkhamid Muminov<br>Akmal Rustamov   |
| <b>Venezuela</b>   | Luis Fernando Miranda<br>José Gregorio Garcia<br>María Carolina Sanchez<br>José Rafael Monsalve |
| <b>Vietnam</b>     | Dinh Thi Quynh Van<br>Khuc Chien<br>Truong Phuong Thao  |

This work also builds on the efforts of many individuals, not listed here, who contributed ideas and words to earlier editions.

The author would also like to express his gratitude to the editorial team for this edition, which consisted of Vu Tran, Matias Pedevilla, Henry An, Mika Myllynen, Arnout van der Rest, Marcus Hammarstrand and Dana Hart.

# Glossary

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

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

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

**Comparable profits method (CPM):** A transfer pricing method based on the comparison of the operating profit derived from related party transactions with the operating profit earned by third parties undertaking similar business activities.

**Comparable uncontrolled price (CUP) method:** A method of pricing based on the price charged between unrelated entities in respect of a comparable transaction in comparable circumstances.

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

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

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

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

**GATT:** General Agreement on Trade and Tariffs.

**Inland Revenue:** The UK tax authority.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**WTO:** World Trade Organisation.

# Contents

|          |      |
|----------|------|
| Preface  | i    |
| Glossary | viii |

## PART I: DEVELOPING DEFENSIBLE TRANSFER PRICING POLICIES

|          |  |          |
|----------|--|----------|
| <b>1</b> | <b>Introduction</b>  | <b>1</b> |
| 101      | At the eye of the “perfect storm”  | 1        |
| 102      | The need for adequate planning and documentation of transfer pricing policies and procedures | 2        |
| 103      | Keeping policies and procedures up to date   | 2        |
| 104      | Theory and practice  | 3        |
| 105      | Transfer pricing is not just about taxation  | 3        |
| 106      | The legacy of the 1990s  | 4        |
| 107      | The future   | 4        |
| <b>2</b> | <b>Categories of inter-company transfer</b>  | <b>6</b> |
| 201      | Introduction   | 6        |
| 202      | The arm’s length principle   | 6        |
| 203      | Sales of tangible property – definition  | 6        |
| 204      | Sales of machinery and equipment   | 7        |
| 205      | Sales of inventory   | 7        |
| 206      | Transfers of intangible property – definition  | 8        |
| 207      | Types of intangibles   | 9        |
| 208      | Modes of transfer of intangibles   | 9        |
| 209      | Manufacturing intangibles  | 9        |
| 210      | Marketing intangibles  | 10       |
| 211      | Hybrid intangibles   | 11       |
| 212      | The provision of services – definition   | 12       |
| 213      | Examples of types of service   | 12       |
| 214      | The problem of ‘shareholder’ services  | 13       |
| 215      | Financing transactions   | 16       |
| 216      | Financing short-term capital needs   | 17       |
| 217      | Market penetration payments  | 18       |
| 218      | Cost sharing   | 19       |
| 219      | Financing long-term capital needs  | 19       |
| 220      | Mortgages  | 19       |
| 221      | Lease financing  | 19       |
| 222      | Capital stock  | 20       |
| 223      | Long-term inter-company loans  | 20       |
| 224      | Other financing techniques   | 20       |
| 225      | Flexibility in managing capital needs  | 21       |

|          |   |           |
|----------|---|-----------|
| <b>3</b> | <b>The work of the OECD</b>   | <b>22</b> |
| 301      | Introduction  | 22        |
| 302      | The arm's length principle  | 23        |
| 303      | Comparable uncontrolled price method                                    | 25        |
| 304      | Resale price method   | 26        |
| 305      | Cost plus method  | 27        |
| 306      | Cost plus method – capacity adjustments                                 | 28        |
| 307      | Other methods   | 29        |
| 308      | Rate-of-return method   | 30        |
| 309      | Profit split method   | 31        |
| 310      | Transactional net margin method (TNMM)                                  | 33        |
| 311      | Berry ratio compared to return on sales (ROS)                           | 33        |
| 312      | Non-arm's length approach: global formulary apportionment               | 35        |
| 313      | OECD commentary on other matters impacting transfer pricing             | 35        |
| 314      | Recent developments at the OECD   | 37        |
| <b>4</b> | <b>Establishing a transfer pricing policy: practical considerations</b> | <b>41</b> |
| 401      | Arm's length pricing: market prices                                     | 41        |
| 402      | Functional analysis   | 42        |
| 403      | Interviews  | 42        |
| 404      | Other information or documents required                                 | 43        |
| 405      | Functions   | 43        |
| 406      | Risks   | 45        |
| 407      | Intangibles   | 47        |
| 408      | Characterisation of businesses  | 48        |
| 409      | Contract manufacturers and fully-fledged manufacturers                  | 48        |
| 410      | Characterisation of distribution/selling companies                      | 50        |
| 411      | Goals of the multinational corporation                                  | 50        |
| 412      | Manufacturing opportunities   | 52        |
| 413      | Centralised support activities  | 52        |
| 414      | Selling companies   | 53        |
| 415      | Contract service providers  | 53        |
| 416      | Contract research and development                                       | 53        |
| 417      | Other reasons for establishing contract research and development        | 54        |
| 418      | Contract maintenance  | 55        |
| 419      | Contract marketing  | 55        |
| 420      | The evaluation of pricing options                                       | 55        |
| 421      | The search for comparables  | 56        |
| 422      | Identifying appropriate comparables                                     | 58        |
| 423      | Internal comparables  | 58        |
| 424      | External comparables  | 59        |
| 425      | Functional analysis and comparable information – an overview            | 59        |
| 426      | Documentation   | 60        |
| 427      | How to document a policy  | 60        |
| 428      | Financial analyses  | 61        |
| 429      | Evaluation of financial analyses  | 62        |
| 430      | Transfer pricing policy   | 63        |

|            |  |           |
|------------|--|-----------|
| <b>431</b> | Transfer pricing guidelines  | 63        |
| <b>432</b> | Inter-company agreements   | 63        |
| <b>433</b> | Documentation of the functional analysis                                       | 63        |
| <b>434</b> | Documenting the comparables  | 63        |
| <b>435</b> | Income statements  | 64        |
| <b>436</b> | Industry evidence  | 64        |
| <b>437</b> | Implementing a transfer pricing policy   | 64        |
| <b>438</b> | Monitoring the application of the policy                                       | 64        |
| <b>439</b> | Compensation of management   | 65        |
| <b>5</b>   | <b>Specific issues in transfer pricing</b>                                     | <b>66</b> |
|            | <b>MANAGEMENT SERVICES</b>   |           |
| <b>501</b> | Management fees – introduction   | 66        |
| <b>502</b> | The importance of management fees  | 66        |
| <b>503</b> | The tax treatment of management fees – an overview                             | 67        |
| <b>504</b> | Management fees in the developed world   | 67        |
| <b>505</b> | Dealing with shareholder costs   | 67        |
| <b>506</b> | Analysing the services   | 68        |
| <b>507</b> | The cost base for service charges  | 70        |
| <b>508</b> | The cost-accounting method   | 70        |
| <b>509</b> | The computation on a full cost basis   | 70        |
| <b>510</b> | When should a profit margin be added to cost?                                  | 71        |
| <b>511</b> | The determination of an arm’s length service charge                            | 72        |
| <b>512</b> | Documentation  | 73        |
|            | <b>TRANSFER OF INTANGIBLE PROPERTY</b>   |           |
| <b>513</b> | Transfer of intangibles – introduction   | 74        |
| <b>514</b> | Sale for consideration   | 75        |
| <b>515</b> | Licence  | 75        |
| <b>516</b> | Determination of arm’s length royalty rates                                    | 76        |
| <b>517</b> | Determining an arm’s length royalty rate in the absence of perfect comparables | 77        |
| <b>518</b> | Super-intangibles  | 77        |
| <b>519</b> | Valuation of royalty rates for super-intangibles                               | 78        |
|            | <b>COST SHARING</b>  |           |
| <b>520</b> | Cost sharing – introduction  | 79        |
| <b>521</b> | Advantages of cost sharing   | 80        |
| <b>522</b> | Cost sharing arrangements  | 80        |
| <b>523</b> | Cost sharing agreements  | 81        |
| <b>524</b> | Allocation of costs among participants   | 81        |
| <b>525</b> | Deductibility of cost sharing payments   | 82        |
| <b>526</b> | Cost sharing adjustments   | 84        |
| <b>527</b> | Cost sharing and risk  | 84        |
| <b>528</b> | The participants   | 85        |
| <b>529</b> | Establishing cost sharing arrangements in mid-stream                           | 85        |
| <b>530</b> | Buy-in arrangements  | 85        |

|                              |   |           |
|------------------------------|---|-----------|
| 531                          | Ownership of intangibles                                    | 87        |
| 532                          | Other types of cost sharing agreements                      | 89        |
| FOREIGN EXCHANGE AND FINANCE |   |           |
| 533                          | Foreign exchange risk – introduction                        | 89        |
| 534                          | The arm’s length standard                                   | 89        |
| 535                          | Types of exchange rate exposure                             | 90        |
| 536                          | Translation exposure  | 90        |
| 537                          | Transaction exposure  | 90        |
| 538                          | Economic exposure   | 90        |
| 539                          | Planning opportunities                                      | 91        |
| 540                          | Loans and advances  | 92        |
| 541                          | Characterisation of loans                                   | 92        |
| 542                          | Interest on loans   | 92        |
| 543                          | Loan guarantees   | 93        |
| 544                          | Bona fide leases  | 93        |
| 545                          | Establishing an arm’s length rental rate                    | 94        |
| E-BUSINESS                   |   |           |
| 546                          | Introduction  | 94        |
| 547                          | Transfer pricing issues for the business community          | 94        |
| 548                          | Issues for tax authorities                                  | 95        |
| <b>6</b>                     | <b>Managing changes to a transfer pricing policy</b>        | <b>96</b> |
| 601                          | Introduction  | 96        |
| 602                          | Transfer pricing committee                                  | 96        |
| 603                          | Setting the group’s initial pricing policy                  | 97        |
| 604                          | Active planning of the global tax charge                    | 97        |
| 605                          | Change in the operating structure of the company            | 98        |
| 606                          | Parent company pressure                                     | 98        |
| 607                          | Tax audit settlements                                       | 99        |
| 608                          | Problems with current policy                                | 99        |
| 609                          | Making corrections through fine-tuning                      | 100       |
| 610                          | Massive change: alteration to business reality              | 100       |
| 611                          | Changes in law  | 101       |
| 612                          | Dealing with major changes                                  | 103       |
| 613                          | Year-end adjustment   | 103       |
| 614                          | Retroactive price changes                                   | 104       |
| 615                          | Defensible late adjustments                                 | 104       |
| 616                          | Timing of changes   | 106       |
| 617                          | ‘Big bang’ or gradual                                       | 106       |
| 618                          | Communicating the changes to the tax authorities            | 106       |
| 619                          | Tax return disclosure                                       | 107       |
| 620                          | Accounting disclosure                                       | 107       |
| 621                          | Impact on banks and other users of the financial statements | 107       |
| 622                          | Communicating the changes to employees                      | 107       |
| 623                          | Impact on management/employee bonus schemes                 | 108       |



## *International transfer pricing 2009*

|                                    |   |            |
|------------------------------------|---|------------|
| <b>624</b>                         | Accounting systems  | 108        |
| <b>625</b>                         | The audit trail   | 109        |
| <b>626</b>                         | Documenting the changes   | 109        |
| <b>7</b>                           | <b>Dealing with an audit of transfer pricing by a tax authority</b> | <b>110</b> |
| <b>701</b>                         | Introduction  | 110        |
| <b>702</b>                         | Establishing control of the audit process                           | 111        |
| <b>703</b>                         | Minimising the exposure   | 112        |
| <b>704</b>                         | Settling the matter – negotiation, litigation and arbitration       | 112        |
| <b>705</b>                         | Preparation   | 113        |
| <b>706</b>                         | Dealing with adjustments to existing pricing arrangements           | 114        |
| <b>707</b>                         | Advance rulings   | 114        |
| <b>8</b>                           | <b>Financial services</b>   | <b>116</b> |
| <b>801</b>                         | Introduction  | 116        |
| <b>802</b>                         | Regulation  | 116        |
| <b>803</b>                         | Global integration  | 116        |
| <b>804</b>                         | Complexity and speed  | 117        |
| <b>805</b>                         | Capital   | 117        |
| <b>806</b>                         | Branch profit allocation  | 117        |
| <b>807</b>                         | Economic analysis   | 117        |
| <b>BANKING AND CAPITAL MARKETS</b> |   |            |
| <b>808</b>                         | Introduction  | 118        |
| <b>809</b>                         | Global trading  | 118        |
| <b>810</b>                         | Fee-based businesses  | 119        |
| <b>811</b>                         | Treasury and funding  | 119        |
| <b>812</b>                         | Cross-border services   | 119        |
| <b>813</b>                         | Other issues in banking and capital markets                         | 120        |
| <b>INSURANCE</b>                   |   |            |
| <b>814</b>                         | Introduction  | 120        |
| <b>815</b>                         | Reinsurance   | 121        |
| <b>816</b>                         | Centralisation  | 124        |
| <b>817</b>                         | Investment and asset management                                     | 124        |
| <b>818</b>                         | Financing and financial guarantees                                  | 124        |
| <b>819</b>                         | Brokerage and agency activities                                     | 125        |
| <b>820</b>                         | Other issues in insurance   | 125        |
| <b>INVESTMENT MANAGEMENT</b>       |   |            |
| <b>821</b>                         | Introduction  | 125        |
| <b>822</b>                         | Asset management  | 127        |
| <b>823</b>                         | Marketing, distribution and client servicing                        | 127        |
| <b>824</b>                         | Administration and other centralised activities                     | 127        |
| <b>9</b>                           | <b>US transfer pricing rules</b>                                    | <b>129</b> |
| <b>INTRODUCTION</b>                |   |            |
| <b>901</b>                         | The importance of the US rules on transfer pricing                  | 129        |

|  |  |     |
|--|--|-----|
| <b>902</b>                                 | The rationale underlying the US Regulations  | 129 |
| <b>903</b>                                 | The history of the US reform process   | 130 |
| <b>904</b>                                 | Consistency between the US Regulations and the OECD Guidelines                             | 131 |
| <b>905</b>                                 | Transfer pricing audits in the US  | 131 |
| <b>THE US TRANSFER PRICING REGULATIONS</b> |  |     |
| <b>906</b>                                 | The best method rule   | 132 |
| <b>907</b>                                 | The arm's length range   | 132 |
| <b>908</b>                                 | Collateral adjustments and set-offs  | 133 |
| <b>909</b>                                 | Impact of foreign legal restrictions   | 133 |
| <b>910</b>                                 | Transfers of tangible property   | 133 |
| <b>911</b>                                 | Transfers of intangible property   | 134 |
| <b>912</b>                                 | Provision of intra-group services, use of intangible property and the GlaxoSmithKline case | 135 |
| <b>913</b>                                 | The comparable profits method  | 137 |
| <b>914</b>                                 | Profit split methods   | 137 |
| <b>COST SHARING</b>                        |  |     |
| <b>915</b>                                 | The US cost sharing regulations  | 137 |
| <b>916</b>                                 | A qualified cost sharing arrangement in the US   | 138 |
| <b>917</b>                                 | Cost sharing: the intangible development area and related costs                            | 139 |
| <b>918</b>                                 | Cost sharing: determination of reasonably anticipated benefits                             | 140 |
| <b>919</b>                                 | IRS adjustments to a US participant's cost-share   | 142 |
| <b>920</b>                                 | Cost sharing: buy-in/buy-out payments  | 143 |
| <b>921</b>                                 | Cost sharing: administrative requirements  | 145 |
| <b>922</b>                                 | Proposed cost sharing regulations in summary   | 145 |
| <b>SERVICE REGULATIONS</b>                 |  |     |
| <b>923</b>                                 | The US services regulations  | 146 |
| <b>924</b>                                 | Services cost method   | 146 |
| <b>925</b>                                 | Profit split method  | 147 |
| <b>926</b>                                 | Contractual arrangements and embedded intangibles  | 147 |
| <b>927</b>                                 | Ownership of intangibles   | 147 |
| <b>928</b>                                 | Benefit test   | 147 |
| <b>929</b>                                 | Pass-through costs   | 148 |
| <b>930</b>                                 | Passive association benefits   | 148 |
| <b>931</b>                                 | Stewardship and shareholder activities   | 148 |
| <b>932</b>                                 | Stock-based compensation   | 149 |
| <b>933</b>                                 | Shared services arrangements   | 149 |
| <b>934</b>                                 | Financial guarantees   | 149 |
| <b>935</b>                                 | Contractual relationships  | 149 |
| <b>936</b>                                 | Contingent payments  | 150 |
| <b>937</b>                                 | Documentation requirements   | 150 |
| <b>THE US PENALTY REGIME</b>               |  |     |
| <b>938</b>                                 | The final penalty regulations  | 150 |
| <b>939</b>                                 | The reasonableness test  | 151 |
| <b>940</b>                                 | The contemporaneous documentation requirement  | 152 |

## *International transfer pricing 2009*

|   |   |            |
|---|---|------------|
| <b>941</b>  | Principal documents   | 152        |
| <b>942</b>  | Background documents  | 153        |
| <b>943</b>  | FIN 48  | 153        |
| <b>944</b>  | SEC Roadmap: Conversion of US GAAP to IFRS  | 154        |
| <b>COMPETENT AUTHORITY</b>                                  |   |            |
| <b>945</b>  | The 2006 Revenue procedure  | 155        |
| <b>946</b>  | The scope of competent authority assistance   | 155        |
| <b>947</b>  | When to request competent authority assistance                                      | 156        |
| <b>948</b>  | Competent authority: pre-filing and post-agreement conferences                      | 156        |
| <b>949</b>  | Competent authority: small case procedures  | 157        |
| <b>950</b>  | Competent authority: statute of limitation protective measures                      | 157        |
| <b>951</b>  | Competent authority: unilateral withdrawal or reduction of US-initiated adjustments | 158        |
| <b>952</b>  | Competent authority: repatriation of funds following a transfer pricing adjustment  | 158        |
| <b>953</b>  | Interest and penalties  | 159        |
| <b>ADVANCE PRICING AGREEMENTS (APAS)</b>                    |   |            |
| <b>954</b>  | APAs: US procedures   | 159        |
| <b>955</b>  | Rollbacks   | 160        |
| <b>956</b>  | Bilateral and unilateral APAs – impact on competent authority                       | 160        |
| <b>957</b>  | APAs for small business taxpayers and IRS-initiated APAs                            | 160        |
| <b>958</b>  | Developments in the APA program   | 161        |
| <b>COMPARISON WITH THE OECD TRANSFER PRICING GUIDELINES</b> |   |            |
| <b>959</b>  | The best method rule  | 161        |
| <b>960</b>  | Comparability analysis  | 161        |
| <b>961</b>  | Market penetration strategies   | 162        |
| <b>962</b>  | Arm's length range  | 162        |
| <b>963</b>  | What has to be at arm's length? Setting prices versus evaluating the result         | 162        |
| <b>964</b>  | Traditional transactional methods   | 163        |
| <b>965</b>  | Other methods   | 164        |
| <b>966</b>  | Transactional net margin method (TNMM)  | 164        |
| <b>967</b>  | Intangible property   | 164        |
| <b>968</b>  | Periodic adjustments under the OECD Guidelines                                      | 165        |
| <b>969</b>  | Services  | 165        |
| <b>970</b>  | Documentation and penalties   | 166        |
| <b>10</b>   | <b>Transfer pricing and indirect taxes</b>  | <b>167</b> |
| <b>1001</b>   | Customs duty implications   | 167        |
| <b>1002</b>   | WTO Valuation Agreement   | 167        |
| <b>1003</b>   | Relationship between customs and tax rules  | 168        |
| <b>1004</b>   | Intangibles   | 168        |
| <b>1005</b>   | The Brussels definition of value  | 168        |
| <b>1006</b>   | Specific duties and fixed values  | 169        |
| <b>1007</b>   | Sales taxes, value added taxes and excise duties                                    | 169        |

|  |   |            |
|--|---|------------|
| <b>1008</b>                                  | Antidumping duties / countervailing duties                        | 169        |
| <b>1009</b>                                  | Establishing a transfer pricing policy – technical considerations | 170        |
| <b>1010</b>                                  | Adjustments   | 170        |
| <b>1011</b>                                  | Validation of the transfer price for customs purposes             | 171        |
| <b>1012</b>                                  | Transfer prices below the acceptable customs value                | 172        |
| <b>1013</b>                                  | Transfer price exceeds acceptable customs value                   | 173        |
| <b>1014</b>                                  | Alternative methods of valuation                                  | 173        |
| <b>1015</b>                                  | Implementation of the customs pricing policy                      | 175        |
| <b>1016</b>                                  | Transfers of intangibles  | 175        |
| <b>1017</b>                                  | Royalties and licence fees  | 176        |
| <b>1018</b>                                  | Intangible assists  | 177        |
| <b>1019</b>                                  | Interest  | 178        |
| <b>1020</b>                                  | Computer software   | 178        |
| <b>1021</b>                                  | Design, development, engineering and similar charges              | 179        |
| <b>1022</b>                                  | The impact of transfer pricing policy changes                     | 179        |
| <b>1023</b>                                  | The impact of retrospective transfer price adjustments            | 180        |
| <b>1024</b>                                  | The impact of international structure                             | 181        |
| <b>1025</b>                                  | Dealing with an audit of pricing by an indirect tax authority     | 182        |
| <b>1026</b>                                  | Strategy based on balance and leverage                            | 183        |
| <b>11</b>                                    | <b>Procedures for achieving an offsetting adjustment</b>          | <b>185</b> |
| <b>1101</b>                                  | Introduction  | 185        |
| <b>1102</b>                                  | Competent authority   | 185        |
| <b>EUROPEAN UNION ARBITRATION CONVENTION</b> |   |            |
| <b>1103</b>                                  | Background  | 186        |
| <b>1104</b>                                  | The scope of the Convention                                       | 187        |
| <b>1105</b>                                  | The required level of control                                     | 187        |
| <b>1106</b>                                  | Adjustments to profits  | 187        |
| <b>1107</b>                                  | Mutual agreement and arbitration procedures                       | 188        |
| <b>1108</b>                                  | Serious penalty proceedings                                       | 188        |
| <b>1109</b>                                  | The advisory commission   | 189        |
| <b>1110</b>                                  | Resolution of the problem   | 189        |
| <b>1111</b>                                  | Term of the Convention  | 189        |
| <b>1112</b>                                  | Interaction with non-member states                                | 189        |
| <b>1113</b>                                  | Experience of the Convention                                      | 190        |
| <b>1114</b>                                  | Further EU developments in transfer pricing                       | 190        |
| <b>1115</b>                                  | International updates in cross-border dispute resolution          | 191        |

PART II: COUNTRY-SPECIFIC ISSUES

|   |            |
|---|------------|
| <b>12 Africa regional transfer pricing</b>          | <b>194</b> |
| 1201 Introduction                                   | 194        |
| SOUTH AFRICA, REPUBLIC OF                           |            |
| 1202 Introduction                                   | 195        |
| 1203 Statutory rules                                | 195        |
| 1204 Controlled foreign companies                   | 197        |
| 1205 Other regulations                              | 197        |
| 1206 Legal cases                                    | 198        |
| 1207 Burden of proof                                | 198        |
| 1208 Tax audit procedures                           | 198        |
| 1209 Resources available to the tax authorities     | 199        |
| 1210 Use and availability of comparable information | 199        |
| 1211 Risk transactions or industries                | 199        |
| 1212 Competent authority                            | 200        |
| 1213 Advance pricing agreements (APAs)              | 200        |
| 1214 Anticipated developments in law and practice   | 200        |
| 1215 Liaison with other authorities                 | 202        |
| 1216 OECD issues                                    | 202        |
| 1217 Joint investigations                           | 202        |
| 1218 Thin capitalisation                            | 202        |
| KENYA   |            |
| 1219 Introduction                                   | 203        |
| 1220 Statutory rules                                | 204        |
| 1221 Controlled foreign companies                   | 205        |
| 1222 Other regulations                              | 205        |
| 1223 Legal cases                                    | 205        |
| 1224 Burden of proof                                | 205        |
| 1225 Tax audit procedures                           | 206        |
| 1226 Resources available to the tax authorities     | 206        |
| 1227 Use and availability of comparable information | 206        |
| 1228 Risk transactions or industries                | 207        |
| 1229 Competent authority                            | 207        |
| 1230 Advance pricing agreements (APAs)              | 207        |
| 1231 Anticipated developments in law and practice   | 207        |
| 1232 Liaison with other authorities                 | 207        |
| 1233 OECD issues                                    | 207        |
| 1234 Joint investigations                           | 207        |
| 1235 Thin capitalisation                            | 208        |
| NAMIBIA   |            |
| 1236 Introduction                                   | 208        |
| 1237 Statutory rules                                | 208        |
| 1238 Controlled foreign companies                   | 209        |
| 1239 Other regulations: Practice Note 2 of 2006     | 209        |

## Contents

|             |   |     |
|-------------|---|-----|
| <b>1240</b> | Legal cases   | 210 |
| <b>1241</b> | Burden of proof   | 210 |
| <b>1242</b> | Tax audit procedures and resources available to the tax authorities | 210 |
| <b>1243</b> | Use and availability of comparable information                      | 211 |
| <b>1244</b> | Risk transactions or industries                                     | 211 |
| <b>1245</b> | Advance pricing agreements (APAs)                                   | 211 |
| <b>1246</b> | Anticipated developments in law and practice                        | 212 |
| <b>1247</b> | Liaison with other authorities                                      | 212 |
| <b>1248</b> | OECD issues   | 212 |
| <b>1249</b> | Joint investigations  | 212 |
| <b>1250</b> | Thin capitalisation   | 212 |

### TANZANIA

|             |  |     |
|-------------|--|-----|
| <b>1251</b> | Introduction                                   | 213 |
| <b>1252</b> | Statutory rules                                | 213 |
| <b>1253</b> | Controlled foreign companies                   | 213 |
| <b>1254</b> | Other regulations                              | 214 |
| <b>1255</b> | Legal cases                                    | 214 |
| <b>1256</b> | Burden of proof                                | 214 |
| <b>1257</b> | Tax audit procedures                           | 214 |
| <b>1258</b> | Resources available to the tax authorities     | 214 |
| <b>1259</b> | Use and availability of comparable information | 214 |
| <b>1260</b> | Risk transactions or industries                | 215 |
| <b>1261</b> | Competent authority                            | 215 |
| <b>1262</b> | Advance pricing agreements (APAs)              | 215 |
| <b>1263</b> | Anticipated developments in law and practice   | 215 |
| <b>1264</b> | Liaison with other authorities                 | 215 |
| <b>1265</b> | OECD issues                                    | 215 |
| <b>1266</b> | Joint investigations                           | 215 |
| <b>1267</b> | Thin capitalisation                            | 215 |

### ZAMBIA

|             |  |     |
|-------------|--|-----|
| <b>1268</b> | Introduction                                   | 216 |
| <b>1269</b> | Statutory rules                                | 216 |
| <b>1270</b> | Controlled foreign companies                   | 218 |
| <b>1271</b> | Other regulations                              | 218 |
| <b>1272</b> | Legal cases                                    | 219 |
| <b>1273</b> | Burden of proof                                | 219 |
| <b>1274</b> | Tax audit procedures                           | 219 |
| <b>1275</b> | Resources available to the tax authorities     | 219 |
| <b>1276</b> | Use and availability of comparable information | 220 |
| <b>1277</b> | Risk transactions or industries                | 220 |
| <b>1278</b> | Competent authority                            | 220 |
| <b>1279</b> | Advance pricing agreements (APAs)              | 220 |
| <b>1280</b> | Anticipated developments in law and practice   | 221 |
| <b>1281</b> | Liaison with other authorities                 | 221 |
| <b>1282</b> | OECD issues                                    | 221 |
| <b>1283</b> | Joint investigations                           | 221 |

|           |   |            |
|-----------|---|------------|
| 1284      | Thin capitalisation   | 221        |
| <b>13</b> | <b>Argentina</b>  | <b>222</b> |
| 1301      | Introduction  | 222        |
| 1302      | Statutory rules   | 223        |
| 1303      | Other regulations   | 226        |
| 1304      | Legal cases   | 228        |
| 1305      | Burden of proof   | 230        |
| 1306      | Tax audit procedures  | 230        |
| 1307      | The audit procedure   | 231        |
| 1308      | Reassessments and the appeals procedure                           | 231        |
| 1309      | Additional tax and penalties                                      | 231        |
| 1310      | Use and availability of comparable information                    | 232        |
| 1311      | Limitation of double taxation and competent authority procedure   | 232        |
| 1312      | Advance pricing agreements (APAs)                                 | 233        |
| 1313      | Anticipated developments in law and practice                      | 233        |
| 1314      | Liaison with customs authorities                                  | 233        |
| 1315      | OECD issues   | 233        |
| 1316      | Joint investigations  | 233        |
| 1317      | Thin capitalisation   | 233        |
| <b>14</b> | <b>Australia</b>  | <b>235</b> |
| 1401      | Introduction  | 235        |
| 1402      | Statutory rules   | 235        |
| 1403      | Other regulations   | 236        |
| 1404      | Legal cases   | 238        |
| 1405      | Burden of proof   | 238        |
| 1406      | Tax audit procedures  | 239        |
| 1407      | The audit procedure   | 240        |
| 1408      | Revised assessments and the appeals procedure                     | 241        |
| 1409      | Additional tax and penalties                                      | 242        |
| 1410      | Resources available to the tax authorities                        | 243        |
| 1411      | Use and availability of comparable information                    | 243        |
| 1412      | Anticipated developments in law and practice                      | 244        |
| 1413      | Risk transactions or industries                                   | 247        |
| 1414      | Limitation of double taxation and competent authority proceedings | 247        |
| 1415      | Advance pricing arrangements (APAs)                               | 248        |
| 1416      | Liaison with customs and other authorities                        | 249        |
| 1417      | OECD issues   | 250        |
| 1418      | Thin capitalisation   | 250        |
| 1419      | Management services and other services                            | 251        |
| 1420      | Marketing and other intangibles                                   | 251        |
| 1421      | Research and development (R&D) tax concession rules               | 252        |
| <b>15</b> | <b>Austria</b>  | <b>253</b> |
| 1501      | Introduction  | 253        |
| 1502      | Statutory rules   | 253        |

|           |   |            |
|-----------|---|------------|
| 1503      | Other regulations   | 253        |
| 1504      | Legal cases   | 253        |
| 1505      | Burden of proof   | 257        |
| 1506      | Tax audit procedures  | 257        |
| 1507      | The audit procedure   | 258        |
| 1508      | Revised assessments and the appeals procedure                     | 258        |
| 1509      | Additional tax and penalties                                      | 258        |
| 1510      | Resources available to the tax authorities                        | 259        |
| 1511      | Use and availability of comparable information                    | 259        |
| 1512      | Risk transactions or industries                                   | 259        |
| 1513      | Limitation of double taxation and competent authority proceedings | 259        |
| 1514      | Advance pricing agreements (APAs)                                 | 260        |
| 1515      | Anticipated developments in law and practice                      | 260        |
| 1516      | Liaison with customs authorities                                  | 260        |
| 1517      | OECD issues   | 261        |
| 1518      | Joint investigations  | 261        |
| 1519      | Thin capitalisation   | 261        |
| 1520      | Management services   | 261        |
| <b>16</b> | <b>Azerbaijan</b>   | <b>262</b> |
| 1601      | Introduction  | 262        |
| 1602      | Statutory rules   | 262        |
| 1603      | Legal cases   | 264        |
| 1604      | Burden of proof   | 264        |
| 1605      | Tax audit procedures  | 264        |
| 1606      | Revised assessments and the appeals procedure                     | 264        |
| 1607      | Additional tax and penalties                                      | 264        |
| 1608      | Resources available to the tax authorities                        | 264        |
| 1609      | Use and availability of comparable information                    | 264        |
| 1610      | Risk transactions or industries                                   | 265        |
| 1611      | Limitation of double taxation and competent authority proceedings | 265        |
| 1612      | Advance pricing agreements (APAs)                                 | 265        |
| 1613      | Anticipated developments in law and practice                      | 265        |
| 1614      | Liaison with customs authorities                                  | 265        |
| 1615      | OECD issues   | 266        |
| 1616      | Joint investigations  | 266        |
| 1617      | Thin capitalisation   | 266        |
| 1618      | Management services   | 266        |
| <b>17</b> | <b>Belgium</b>  | <b>267</b> |
| 1701      | Introduction  | 267        |
| 1702      | Statutory rules   | 267        |
| 1703      | Administrative guidelines   | 270        |
| 1704      | Legal cases   | 272        |
| 1705      | Burden of proof   | 273        |
| 1706      | Tax audit procedures  | 273        |
| 1707      | The audit procedure   | 274        |



## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>1708</b> | Revised assessments and the appeals procedure                     | 274        |
| <b>1709</b> | Additional tax and penalties                                      | 274        |
| <b>1710</b> | Resources available to the tax authorities                        | 275        |
| <b>1711</b> | Use and availability of comparable information                    | 275        |
| <b>1712</b> | Risk transactions or industries                                   | 276        |
| <b>1713</b> | Advance pricing agreements (APAs)                                 | 277        |
| <b>1714</b> | Competent authorities   | 278        |
| <b>1715</b> | Anticipated developments in law and practice                      | 278        |
| <b>1716</b> | Liaison with customs authorities                                  | 278        |
| <b>1717</b> | Joint investigations  | 278        |
| <b>1718</b> | Thin capitalisation   | 278        |
| <b>18</b>   | <b>Brazil</b>   | <b>280</b> |
| <b>1801</b> | Introduction  | 280        |
| <b>1802</b> | Statutory rules   | 280        |
| <b>1803</b> | Other regulations   | 286        |
| <b>1804</b> | Legal cases   | 288        |
| <b>1805</b> | Burden of proof   | 289        |
| <b>1806</b> | Tax audit procedures  | 289        |
| <b>1807</b> | The audit procedure   | 289        |
| <b>1808</b> | Assessments and penalties   | 290        |
| <b>1809</b> | Resources available to the tax authorities                        | 290        |
| <b>1810</b> | Liaison with customs authorities                                  | 291        |
| <b>1811</b> | Limitation of double taxation and competent authority proceedings | 291        |
| <b>1812</b> | Advance pricing agreements (APAs)                                 | 291        |
| <b>1813</b> | OECD issues   | 292        |
| <b>1814</b> | Disguised dividend distributions                                  | 293        |
| <b>1815</b> | Proposal to change Brazilian transfer pricing law                 | 293        |
| <b>19</b>   | <b>Bulgaria</b>   | <b>295</b> |
| <b>1901</b> | Introduction  | 295        |
| <b>1902</b> | Statutory rules   | 295        |
| <b>1903</b> | Other regulations   | 296        |
| <b>1904</b> | Legal cases   | 297        |
| <b>1905</b> | Burden of proof   | 297        |
| <b>1906</b> | Tax audit procedures  | 297        |
| <b>1907</b> | Revised assessments and the appeals procedure                     | 297        |
| <b>1908</b> | Additional tax and penalties                                      | 297        |
| <b>1909</b> | Resources available to the tax authorities                        | 298        |
| <b>1910</b> | Use and availability of comparable information                    | 298        |
| <b>1911</b> | Risk transactions or industries                                   | 298        |
| <b>1912</b> | Limitation of double taxation and competent authority proceedings | 298        |
| <b>1913</b> | Advance pricing agreements (APAs)                                 | 298        |
| <b>1914</b> | Anticipated developments in law and practice                      | 298        |
| <b>1915</b> | Liaison with customs authorities                                  | 299        |

|           |   |            |
|-----------|---|------------|
| 1916      | OECD issues   | 299        |
| 1917      | Joint investigations  | 299        |
| 1918      | Thin capitalisation   | 299        |
| 1919      | Management services   | 299        |
| <b>20</b> | <b>Canada</b>   | <b>300</b> |
| 2001      | Introduction  | 300        |
| 2002      | Statutory rules   | 300        |
| 2003      | Other regulations   | 305        |
| 2004      | Legal cases   | 306        |
| 2005      | Burden of proof   | 315        |
| 2006      | Tax audit procedures  | 315        |
| 2007      | The transfer pricing audit procedure                              | 316        |
| 2008      | Reassessments and the appeals procedure                           | 317        |
| 2009      | Additional tax and penalties                                      | 318        |
| 2010      | Resources available to the tax authorities                        | 319        |
| 2011      | Use and availability of comparable information                    | 319        |
| 2012      | Risk transactions or industries                                   | 319        |
| 2013      | Limitation of double taxation and competent authority proceedings | 320        |
| 2014      | Advance pricing arrangements (APAs)                               | 322        |
| 2015      | Anticipated developments in law and practice                      | 323        |
| 2016      | Liaison with customs authorities                                  | 323        |
| 2017      | OECD issues   | 324        |
| 2018      | Joint investigations  | 324        |
| 2019      | Thin capitalisation   | 324        |
| 2020      | Intra-group services (management fees)                            | 325        |
| 2021      | Qualifying cost-contribution arrangements                         | 326        |
| <b>21</b> | <b>Chile</b>  | <b>327</b> |
| 2101      | Introduction  | 327        |
| 2102      | Statutory rules   | 327        |
| 2103      | Other regulations   | 328        |
| 2104      | Cases   | 328        |
| 2105      | Burden of proof   | 328        |
| 2106      | Tax audit procedures  | 329        |
| 2107      | Advance pricing agreements (APAs)                                 | 329        |
| 2108      | Anticipated developments in law and practice                      | 329        |
| 2109      | Liaison with customs authority and Central Bank of Chile          | 329        |
| 2110      | Tax treaty activities   | 329        |
| 2111      | OECD issues   | 329        |
| <b>22</b> | <b>China</b>  | <b>330</b> |
| 2201      | Introduction  | 330        |
| 2202      | Statutory rules   | 330        |
| 2203      | Other regulations   | 330        |
| 2204      | Legal cases   | 331        |
| 2205      | Burden of proof   | 332        |

## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>2206</b> | Information reporting   | 332        |
| <b>2207</b> | Audit targets   | 334        |
| <b>2208</b> | Audit information requests  | 334        |
| <b>2209</b> | The audit procedure and adjustments                               | 335        |
| <b>2210</b> | Assessments and appeals procedure                                 | 336        |
| <b>2211</b> | Additional tax and penalties                                      | 337        |
| <b>2212</b> | Resources available to the tax authorities                        | 338        |
| <b>2213</b> | Advance pricing arrangements (APAs)                               | 338        |
| <b>2214</b> | Anticipated developments in law and practice                      | 338        |
| <b>2215</b> | OECD issues   | 338        |
| <b>2216</b> | Joint investigations  | 339        |
| <b>2217</b> | Cost sharing  | 339        |
| <b>2218</b> | Anti-avoidance  | 339        |
| <b>2219</b> | Thin capitalisation   | 340        |
| <b>2220</b> | Special features  | 340        |
| <b>23</b>   | <b>Colombia</b>   | <b>341</b> |
| <b>2301</b> | Introduction  | 341        |
| <b>2302</b> | Statutory rules   | 341        |
| <b>2303</b> | Other regulations   | 345        |
| <b>2304</b> | Legal cases   | 346        |
| <b>2305</b> | Burden of proof   | 346        |
| <b>2306</b> | Tax audit procedures  | 346        |
| <b>2307</b> | The audit procedure   | 347        |
| <b>2308</b> | Additional tax and penalties                                      | 347        |
| <b>2309</b> | Use and availability of comparable information                    | 347        |
| <b>2310</b> | Limitation of double taxation and competent authority procedure   | 348        |
| <b>2311</b> | Advance pricing agreements (APAs)                                 | 348        |
| <b>2312</b> | Anticipated developments in law and practice                      | 348        |
| <b>2313</b> | Liaison with customs authorities                                  | 348        |
| <b>2314</b> | OECD issues   | 348        |
| <b>2315</b> | Joint investigations  | 348        |
| <b>24</b>   | <b>Croatia</b>  | <b>349</b> |
| <b>2401</b> | Introduction  | 349        |
| <b>2402</b> | Statutory rules   | 349        |
| <b>2403</b> | Other regulations   | 349        |
| <b>2404</b> | Legal cases   | 349        |
| <b>2405</b> | Burden of proof   | 350        |
| <b>2406</b> | Tax audit procedures  | 350        |
| <b>2407</b> | Revised assessments and the appeals procedure                     | 350        |
| <b>2408</b> | Additional tax and penalties                                      | 351        |
| <b>2409</b> | Resources available to the tax authorities                        | 351        |
| <b>2410</b> | Use and availability of comparable information                    | 351        |
| <b>2411</b> | Risk transactions or industries                                   | 351        |
| <b>2412</b> | Limitation of double taxation and competent authority proceedings | 351        |
| <b>2413</b> | Advance pricing agreements (APAs)                                 | 351        |

|             |   |            |
|-------------|---|------------|
| <b>2414</b> | Anticipated developments in law and practice                      | 351        |
| <b>2415</b> | Liaison with customs authorities                                  | 351        |
| <b>2416</b> | OECD issues   | 351        |
| <b>2417</b> | Joint investigations  | 352        |
| <b>2418</b> | Thin capitalisation   | 352        |
| <b>2419</b> | Management services   | 352        |
| <b>25</b>   | <b>The Czech Republic</b>   | <b>353</b> |
| <b>2501</b> | Introduction  | 353        |
| <b>2502</b> | Statutory rules   | 353        |
| <b>2503</b> | Reporting under the commercial code                               | 354        |
| <b>2504</b> | Penalties and interest on late payments                           | 355        |
| <b>2505</b> | Tax audit procedures  | 355        |
| <b>2506</b> | Transfer pricing practice   | 356        |
| <b>2507</b> | Anticipated developments  | 356        |
| <b>26</b>   | <b>Denmark</b>  | <b>358</b> |
| <b>2601</b> | Introduction  | 358        |
| <b>2602</b> | Statutory rules arm's length principle                            | 358        |
| <b>2603</b> | Legal cases   | 362        |
| <b>2604</b> | Burden of proof   | 363        |
| <b>2605</b> | Tax audits  | 364        |
| <b>2606</b> | Revised assessments and the appeals procedure                     | 365        |
| <b>2607</b> | Resources available to the tax authorities                        | 365        |
| <b>2608</b> | Comparability analysis  | 365        |
| <b>2609</b> | Risk transactions or industries                                   | 367        |
| <b>2610</b> | Limitation of double taxation and competent authority proceedings | 368        |
| <b>2611</b> | Advance pricing agreements (APAs) and Binding Statement           | 368        |
| <b>2612</b> | Thin capitalisation   | 369        |
| <b>2613</b> | Recent developments in Danish law                                 | 370        |
| <b>2614</b> | Liaison with customs authorities                                  | 371        |
| <b>2615</b> | OECD issues   | 371        |
| <b>27</b>   | <b>Dominican Republic</b>   | <b>372</b> |
| <b>2701</b> | Introduction  | 372        |
| <b>2702</b> | Statutory rules   | 372        |
| <b>2703</b> | Legal cases   | 372        |
| <b>2704</b> | Burden of proof   | 373        |
| <b>2705</b> | Tax audit procedures  | 373        |
| <b>2706</b> | Risk transactions or industries                                   | 373        |
| <b>2707</b> | Advanced pricing agreements (APAs)                                | 373        |
| <b>2708</b> | OECD Rules  | 373        |
| <b>28</b>   | <b>Ecuador</b>  | <b>374</b> |
| <b>2801</b> | Introduction  | 374        |
| <b>2802</b> | Statutory rules   | 374        |
| <b>2803</b> | Other regulations   | 377        |

## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>2804</b> | Legal cases   | 377        |
| <b>2805</b> | Burden of proof   | 377        |
| <b>2806</b> | Tax audit procedures  | 377        |
| <b>2807</b> | Revised assessments and the appeals procedure                     | 378        |
| <b>2808</b> | Additional tax and penalties                                      | 378        |
| <b>2809</b> | Resources available to the tax authorities                        | 378        |
| <b>2810</b> | Use and availability of comparable information                    | 378        |
| <b>2811</b> | Limitation of double taxation and competent authority proceedings | 379        |
| <b>2812</b> | Advance pricing agreements (APAs)                                 | 379        |
| <b>2813</b> | Anticipated developments in law and practice                      | 379        |
| <b>2814</b> | Liaison with customs authorities                                  | 379        |
| <b>2815</b> | OECD issues   | 379        |
| <b>2816</b> | Joint investigations  | 380        |
| <b>2817</b> | Thin capitalisation   | 380        |
| <b>2818</b> | Management services   | 380        |
| <b>29</b>   | <b>Estonia</b>  | <b>381</b> |
| <b>2901</b> | Introduction  | 381        |
| <b>2902</b> | Statutory rules   | 381        |
| <b>2903</b> | Other regulations   | 384        |
| <b>2904</b> | Legal cases   | 384        |
| <b>2905</b> | Burden of proof   | 384        |
| <b>2906</b> | Tax audit procedures  | 385        |
| <b>2907</b> | Revised assessments and the appeals procedure                     | 385        |
| <b>2908</b> | Additional tax and penalties                                      | 385        |
| <b>2909</b> | Resources available to the tax authorities                        | 386        |
| <b>2910</b> | Use and availability of comparable information                    | 386        |
| <b>2911</b> | Risk transactions or industries                                   | 386        |
| <b>2912</b> | Limitation of double taxation and competent authority proceedings | 386        |
| <b>2913</b> | Advance pricing agreements (APAs)                                 | 386        |
| <b>2914</b> | Anticipated developments in law and practice                      | 386        |
| <b>2915</b> | Liaison with customs authorities                                  | 386        |
| <b>2916</b> | OECD issues   | 387        |
| <b>2917</b> | Joint investigations  | 387        |
| <b>2918</b> | Thin capitalisation   | 387        |
| <b>2919</b> | Management services   | 387        |
| <b>30</b>   | <b>Finland</b>  | <b>388</b> |
| <b>3001</b> | Introduction  | 388        |
| <b>3002</b> | Statutory rules   | 388        |
| <b>3003</b> | Other regulations   | 390        |
| <b>3004</b> | Legal cases   | 391        |
| <b>3005</b> | Burden of proof   | 393        |
| <b>3006</b> | Tax audit procedures  | 393        |
| <b>3007</b> | Assessments and the appeals procedure                             | 394        |
| <b>3008</b> | Additional tax and penalties                                      | 394        |
| <b>3009</b> | Use and availability of comparable information                    | 394        |

|             |  |            |
|-------------|--|------------|
| <b>3010</b> | Risk transactions or industries  | 395        |
| <b>3011</b> | Limitation of double taxation and competent authority proceedings                | 395        |
| <b>3012</b> | Advance pricing agreements (APAs)  | 395        |
| <b>3013</b> | Anticipated developments in law and practice                                     | 396        |
| <b>3014</b> | Liaison with customs authorities   | 396        |
| <b>3015</b> | OECD issues  | 396        |
| <b>3016</b> | Joint investigations   | 396        |
| <b>31</b>   | <b>France</b>  | <b>397</b> |
| <b>3101</b> | Introduction   | 397        |
| <b>3102</b> | Statutory rules  | 397        |
| <b>3103</b> | Other regulations  | 399        |
| <b>3104</b> | New transfer pricing documentation requirements under consideration<br>in France | 400        |
| <b>3105</b> | Legal cases  | 401        |
| <b>3106</b> | Burden of proof  | 408        |
| <b>3107</b> | Tax audit procedures   | 408        |
| <b>3108</b> | The audit procedure  | 408        |
| <b>3109</b> | Revised assessments and the appeals procedure                                    | 409        |
| <b>3110</b> | Additional tax and penalties   | 409        |
| <b>3111</b> | Resources available to the tax authorities                                       | 410        |
| <b>3112</b> | Use and availability of comparable information                                   | 410        |
| <b>3113</b> | Risk transactions or industries  | 410        |
| <b>3114</b> | Limitation of double taxation and competent authority proceedings                | 410        |
| <b>3115</b> | Advance pricing agreements (APAs)  | 411        |
| <b>3116</b> | Mutual agreement procedure (MAP)   | 412        |
| <b>3117</b> | Binding PE ruling  | 413        |
| <b>3118</b> | Liaison with customs authorities   | 413        |
| <b>3119</b> | OECD issues  | 413        |
| <b>3120</b> | Joint investigations   | 414        |
| <b>3121</b> | Thin capitalisation  | 414        |
| <b>32</b>   | <b>Georgia</b>   | <b>416</b> |
| <b>3201</b> | Introduction   | 416        |
| <b>3202</b> | Statutory rules  | 416        |
| <b>3203</b> | Other regulations  | 417        |
| <b>3204</b> | Legal cases  | 417        |
| <b>3205</b> | Burden of proof  | 417        |
| <b>3206</b> | Tax audit procedures   | 417        |
| <b>3207</b> | Revised assessments and the appeals procedure                                    | 417        |
| <b>3208</b> | Additional tax and penalties   | 418        |
| <b>3209</b> | Resources available to the tax authorities                                       | 418        |
| <b>3210</b> | Use and availability of comparable information                                   | 418        |
| <b>3211</b> | Risk transactions or industries  | 418        |
| <b>3212</b> | Limitation of double taxation and competent authority proceedings                | 418        |
| <b>3213</b> | Advance pricing agreements (APAs)  | 418        |
| <b>3214</b> | Anticipated developments in law and practice                                     | 418        |

## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>3215</b> | Liaison with customs authorities                                  | 418        |
| <b>3216</b> | OECD issues   | 419        |
| <b>3217</b> | Joint investigations  | 419        |
| <b>3218</b> | Thin capitalisation   | 419        |
| <b>3219</b> | Management services   | 419        |
| <b>33</b>   | <b>Germany</b>  | <b>420</b> |
| <b>3301</b> | Introduction  | 420        |
| <b>3302</b> | Statutory rules   | 420        |
| <b>3303</b> | Other regulations   | 422        |
| <b>3304</b> | Legal cases   | 423        |
| <b>3305</b> | Burden of proof   | 424        |
| <b>3306</b> | Tax audit procedures  | 425        |
| <b>3307</b> | Field audits in practice  | 427        |
| <b>3308</b> | Revised assessments and the appeals procedure                     | 427        |
| <b>3309</b> | Additional tax and penalties                                      | 428        |
| <b>3310</b> | Resources available to the tax authorities                        | 428        |
| <b>3311</b> | Use and availability of comparable information                    | 429        |
| <b>3312</b> | Risk transactions or industries                                   | 431        |
| <b>3313</b> | Limitation of double taxation and competent authority proceedings | 431        |
| <b>3314</b> | Advance pricing agreements (APAs)                                 | 432        |
| <b>3315</b> | Anticipated developments in law and practice                      | 433        |
| <b>3316</b> | Liaison with customs authorities                                  | 433        |
| <b>3317</b> | OECD issues   | 433        |
| <b>3318</b> | Joint investigations  | 434        |
| <b>3319</b> | Thin capitalisation / limitations on interest deductions          | 434        |
| <b>34</b>   | <b>Hungary</b>  | <b>435</b> |
| <b>3401</b> | Introduction  | 435        |
| <b>3402</b> | Statutory rules   | 435        |
| <b>3403</b> | Other regulations   | 436        |
| <b>3404</b> | Legal cases   | 436        |
| <b>3405</b> | Burden of proof   | 436        |
| <b>3406</b> | Tax audit procedures  | 437        |
| <b>3407</b> | Revised assessments and the appeals procedure                     | 437        |
| <b>3408</b> | Additional tax and penalties                                      | 438        |
| <b>3409</b> | Resources available to the tax authorities                        | 438        |
| <b>3410</b> | Use and availability of comparable information                    | 438        |
| <b>3411</b> | Risk transactions or industries                                   | 439        |
| <b>3412</b> | Advance pricing agreements (APAs)                                 | 439        |
| <b>3413</b> | Anticipated developments in law and practice                      | 440        |
| <b>3414</b> | OECD issues   | 441        |
| <b>3415</b> | Thin capitalisation   | 441        |
| <b>35</b>   | <b>Iceland</b>  | <b>442</b> |
| <b>3501</b> | Introduction  | 442        |
| <b>3502</b> | Statutory rules   | 442        |

|             |   |            |
|-------------|---|------------|
| <b>3503</b> | Other regulations   | 442        |
| <b>3504</b> | Legal cases   | 443        |
| <b>3505</b> | Burden of proof   | 443        |
| <b>3506</b> | Tax audit procedures  | 443        |
| <b>3507</b> | Revised assessments and the appeals procedure                     | 443        |
| <b>3508</b> | Additional tax and penalties                                      | 443        |
| <b>3509</b> | Resources available to the tax authorities                        | 444        |
| <b>3510</b> | Use and availability of comparable information                    | 444        |
| <b>3511</b> | Risk transaction or industries                                    | 444        |
| <b>3512</b> | Limitation of double taxation and competent authority proceedings | 444        |
| <b>3513</b> | Advance pricing agreements (APAs)                                 | 444        |
| <b>3514</b> | Anticipated developments in law and practice                      | 444        |
| <b>3515</b> | Liaison with customs authorities                                  | 445        |
| <b>3516</b> | OECD issues   | 445        |
| <b>3517</b> | Joint investigations  | 445        |
| <b>3518</b> | Thin capitalisation   | 445        |
| <b>3519</b> | Management services   | 445        |
| <b>36</b>   | <b>India</b>  | <b>446</b> |
| <b>3601</b> | Introduction  | 446        |
| <b>3602</b> | Statutory rules and regulations                                   | 446        |
| <b>3603</b> | Burden of proof   | 449        |
| <b>3604</b> | Tax audit procedure   | 450        |
| <b>3605</b> | Revised assessments and appeals procedure                         | 451        |
| <b>3606</b> | Additional tax and penalties                                      | 451        |
| <b>3607</b> | Legal cases   | 451        |
| <b>3608</b> | Resources available to the tax authorities                        | 455        |
| <b>3609</b> | Use and availability of comparables' information                  | 456        |
| <b>3610</b> | Liaison with customs authorities                                  | 456        |
| <b>3611</b> | Risk transactions or industries                                   | 457        |
| <b>3612</b> | Thin capitalisation   | 457        |
| <b>3613</b> | Management services   | 457        |
| <b>3614</b> | Limitation of double taxation and competent authority proceedings | 457        |
| <b>3615</b> | OECD issues   | 457        |
| <b>3616</b> | Joint investigations  | 458        |
| <b>3617</b> | Anticipated developments in law and practice                      | 458        |
| <b>3618</b> | Advance pricing agreements (APAs)                                 | 458        |
| <b>37</b>   | <b>Indonesia</b>  | <b>459</b> |
| <b>3701</b> | Introduction  | 459        |
| <b>3702</b> | Statutory rules   | 459        |
| <b>3703</b> | Other regulations   | 459        |
| <b>3704</b> | Burden of proof   | 460        |
| <b>3705</b> | Tax audit procedures  | 460        |
| <b>3706</b> | Tax objections and the appeals procedure                          | 460        |



## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>3707</b> | Tax penalties   | 461        |
| <b>3708</b> | Resources available to the tax authorities                        | 461        |
| <b>3709</b> | Use and availability of comparable information                    | 461        |
| <b>3710</b> | Risk transactions or industries                                   | 462        |
| <b>3711</b> | Limitation of double taxation and competent authority proceedings | 463        |
| <b>3712</b> | Advance pricing agreements (APAs)                                 | 463        |
| <b>3713</b> | Anticipated developments in law and practice                      | 463        |
| <b>3714</b> | Liaison with customs authorities                                  | 463        |
| <b>3715</b> | Joint investigations  | 463        |
| <b>38</b>   | <b>Ireland</b>  | <b>464</b> |
| <b>3801</b> | Introduction  | 464        |
| <b>3802</b> | Statutory rules   | 464        |
| <b>3803</b> | Other regulations   | 466        |
| <b>3804</b> | Legal cases   | 466        |
| <b>3805</b> | Burden of proof   | 467        |
| <b>3806</b> | Tax audit procedures  | 468        |
| <b>3807</b> | The audit procedure   | 468        |
| <b>3808</b> | Revised assessments and the appeals procedure                     | 469        |
| <b>3809</b> | Additional tax and penalties                                      | 469        |
| <b>3810</b> | Resources available to the tax authorities                        | 470        |
| <b>3811</b> | Use and availability of comparable information                    | 470        |
| <b>3812</b> | Risk transactions and industries                                  | 470        |
| <b>3813</b> | Limitation of double taxation and competent authority proceedings | 470        |
| <b>3814</b> | Advance pricing agreements (APAs)                                 | 471        |
| <b>3815</b> | Anticipated developments in law and practice                      | 471        |
| <b>3816</b> | Liaison with customs authorities                                  | 472        |
| <b>3817</b> | OECD issues   | 472        |
| <b>3818</b> | Joint investigations  | 472        |
| <b>3819</b> | Thin capitalisation   | 472        |
| <b>3820</b> | Management services   | 472        |
| <b>39</b>   | <b>Israel</b>   | <b>473</b> |
| <b>3901</b> | Introduction  | 473        |
| <b>3902</b> | Statutory rules   | 473        |
| <b>3903</b> | Burden of proof   | 476        |
| <b>40</b>   | <b>Italy</b>  | <b>477</b> |
| <b>4001</b> | Introduction  | 477        |
| <b>4002</b> | Statutory rules   | 477        |
| <b>4003</b> | Other regulations   | 477        |
| <b>4004</b> | Legal cases   | 478        |
| <b>4005</b> | Burden of proof   | 482        |
| <b>4006</b> | Tax audit procedures  | 482        |
| <b>4007</b> | The audit procedure   | 483        |
| <b>4008</b> | Additional tax and penalties                                      | 483        |
| <b>4009</b> | Resources available to the tax authorities                        | 484        |

|             |  |            |
|-------------|--|------------|
| <b>4010</b> | Use and availability of comparable information                     | 484        |
| <b>4011</b> | Risk transactions or industries                                    | 484        |
| <b>4012</b> | Limitation of double taxation and competent authority proceedings  | 484        |
| <b>4013</b> | Advance pricing agreements (APAs)                                  | 485        |
| <b>4014</b> | Anticipated developments in law and practice                       | 485        |
| <b>4015</b> | Liaison with customs authorities                                   | 486        |
| <b>4016</b> | OECD issues  | 486        |
| <b>4017</b> | Joint investigations   | 486        |
| <b>4018</b> | Interest payable deductibility                                     | 486        |
| <b>41</b>   | <b>Japan</b>   | <b>488</b> |
| <b>4101</b> | Introduction   | 488        |
| <b>4102</b> | Statutory rules and other regulations                              | 488        |
| <b>4103</b> | Legal cases  | 493        |
| <b>4104</b> | Burden of proof  | 494        |
| <b>4105</b> | Tax audit procedures   | 494        |
| <b>4106</b> | The audit procedure  | 495        |
| <b>4107</b> | Resource options   | 495        |
| <b>4108</b> | Additional tax and penalties                                       | 496        |
| <b>4109</b> | Resources available to the tax authorities                         | 496        |
| <b>4110</b> | Use and availability of comparable information                     | 496        |
| <b>4111</b> | Limitation of double taxation and competent authority negotiations | 497        |
| <b>4112</b> | Advance pricing agreements (APAs)                                  | 498        |
| <b>4113</b> | OECD issues  | 499        |
| <b>42</b>   | <b>Kazakhstan</b>  | <b>500</b> |
| <b>4201</b> | Introduction   | 500        |
| <b>4202</b> | Statutory rules  | 500        |
| <b>4203</b> | Other regulations  | 501        |
| <b>4204</b> | Legal cases  | 501        |
| <b>4205</b> | Burden of proof  | 501        |
| <b>4206</b> | Tax audit procedures   | 501        |
| <b>4207</b> | Revised assessments and the appeals procedure                      | 502        |
| <b>4208</b> | Additional tax and penalties                                       | 502        |
| <b>4209</b> | Recourses available to the tax authorities                         | 502        |
| <b>4210</b> | Use and availability of comparable information                     | 502        |
| <b>4211</b> | Risk transactions or industries                                    | 503        |
| <b>4212</b> | Limitation of double taxation and competent authority proceedings  | 503        |
| <b>4213</b> | Advance pricing agreements (APAs)                                  | 503        |
| <b>4214</b> | Anticipated developments in law and practice                       | 503        |
| <b>4215</b> | Liaison with customs authorities                                   | 504        |
| <b>4216</b> | OECD issues  | 504        |
| <b>4217</b> | Joint investigations   | 504        |
| <b>4218</b> | Thin capitalisation  | 504        |
| <b>4219</b> | Management services  | 504        |

|           |   |            |
|-----------|---|------------|
| <b>43</b> | <b>Korea</b>  | <b>505</b> |
| 4301      | Introduction  | 505        |
| 4302      | Statutory rules   | 505        |
| 4303      | Other regulations   | 506        |
| 4304      | Legal cases   | 507        |
| 4305      | Burden of proof   | 507        |
| 4306      | Tax audit procedures  | 507        |
| 4307      | Domestic tax appeals procedure and MAPs                           | 508        |
| 4308      | Additional tax and penalties                                      | 508        |
| 4309      | Resources available to the tax authorities                        | 510        |
| 4310      | Use and availability of comparable information                    | 510        |
| 4311      | Risk transactions or industries                                   | 510        |
| 4312      | Limitation of double taxation and MAPs                            | 510        |
| 4313      | Advance pricing agreements (APAs)                                 | 510        |
| 4314      | Anticipated developments in law and practice                      | 511        |
| 4315      | Liaison with customs authorities                                  | 511        |
| 4316      | OECD issues   | 511        |
| 4317      | Joint investigations  | 512        |
| 4318      | Thin capitalisation   | 512        |
| <b>44</b> | <b>Latvia</b>   | <b>513</b> |
| 4401      | Introduction  | 513        |
| 4402      | Statutory rules   | 513        |
| 4403      | Other regulations   | 514        |
| 4404      | Legal cases   | 514        |
| 4405      | Burden of proof   | 515        |
| 4406      | Tax audit procedures  | 515        |
| 4407      | Revised assessments and the appeals procedure                     | 515        |
| 4408      | Additional tax and penalties                                      | 515        |
| 4409      | Resources available to the tax authorities                        | 516        |
| 4410      | Use and availability of comparable information                    | 516        |
| 4411      | Risk transactions or industries                                   | 516        |
| 4412      | Limitation of double taxation and competent authority proceedings | 517        |
| 4413      | Advance pricing agreements (APAs)                                 | 517        |
| 4414      | Anticipated developments in law and practice                      | 517        |
| 4415      | Liaison with customs authorities                                  | 517        |
| 4416      | OECD issues   | 517        |
| 4417      | Joint investigations  | 517        |
| 4418      | Thin capitalisation   | 518        |
| 4419      | Management services   | 518        |
| <b>45</b> | <b>Lithuania</b>  | <b>519</b> |
| 4501      | Introduction  | 519        |
| 4502      | Statutory rules   | 519        |
| 4503      | Other regulations   | 519        |
| 4504      | Legal cases   | 519        |
| 4505      | Burden of proof   | 519        |

|             |   |            |
|-------------|---|------------|
| <b>4506</b> | Tax audit procedures  | 519        |
| <b>4507</b> | Revised assessments and the appeals procedure                     | 520        |
| <b>4508</b> | Additional tax and penalties                                      | 520        |
| <b>4509</b> | Resources available to the tax authorities                        | 520        |
| <b>4510</b> | Use and availability of comparable information                    | 520        |
| <b>4511</b> | Risk transactions or industries                                   | 520        |
| <b>4512</b> | Limitation of double taxation and competent authority proceedings | 520        |
| <b>4513</b> | Advance pricing agreements (APAs)                                 | 520        |
| <b>4514</b> | Anticipated developments in law and practice                      | 520        |
| <b>4515</b> | Liaison with customs authorities                                  | 521        |
| <b>4516</b> | OECD issues   | 521        |
| <b>4517</b> | Joint investigations  | 521        |
| <b>4518</b> | Thin capitalisation   | 521        |
| <b>4519</b> | Management services   | 521        |
| <b>46</b>   | <b>Luxembourg</b>   | <b>523</b> |
| <b>4601</b> | Introduction  | 523        |
| <b>4602</b> | Statutory rules, other guidelines and legal cases                 | 523        |
| <b>4603</b> | Tax audits and resources available to the tax authorities         | 524        |
| <b>4604</b> | Availability of comparable information                            | 524        |
| <b>4605</b> | Advance pricing agreements (APAs)                                 | 524        |
| <b>47</b>   | <b>Malaysia</b>   | <b>525</b> |
| <b>4701</b> | Introduction  | 525        |
| <b>4702</b> | Statutory rules   | 525        |
| <b>4703</b> | Legal cases   | 527        |
| <b>4704</b> | Burden of proof   | 527        |
| <b>4705</b> | Tax audit procedures  | 527        |
| <b>4706</b> | The audit procedure   | 529        |
| <b>4707</b> | Revised assessments and the appeals procedure                     | 532        |
| <b>4708</b> | Additional tax and penalties                                      | 532        |
| <b>4709</b> | Resources available to the tax authorities                        | 533        |
| <b>4710</b> | Use and availability of comparable information                    | 533        |
| <b>4711</b> | Risk transactions or industries                                   | 534        |
| <b>4712</b> | Limitation of double taxation and competent authority proceedings | 535        |
| <b>4713</b> | Advance pricing agreements (APAs)                                 | 535        |
| <b>4714</b> | Liaison with customs authorities                                  | 535        |
| <b>4715</b> | OECD issues   | 535        |
| <b>4716</b> | Joint investigations  | 536        |
| <b>4717</b> | Thin capitalisation   | 536        |
| <b>48</b>   | <b>Mexico</b>   | <b>537</b> |
| <b>4801</b> | Introduction  | 537        |
| <b>4802</b> | Statutory rules   | 537        |
| <b>4803</b> | Other regulations   | 542        |
| <b>4804</b> | Legal cases   | 544        |
| <b>4805</b> | Burden of proof   | 545        |

## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>4806</b> | Tax audit procedures  | 545        |
| <b>4807</b> | The audit procedure   | 546        |
| <b>4808</b> | Revised assessments and the appeals procedure                     | 547        |
| <b>4809</b> | Additional tax and penalties                                      | 548        |
| <b>4810</b> | Resources available to tax authorities                            | 548        |
| <b>4811</b> | Use and availability of comparable information                    | 549        |
| <b>4812</b> | Risk transactions or industries                                   | 549        |
| <b>4813</b> | Limitation of double taxation and competent authority proceedings | 549        |
| <b>4814</b> | Advance pricing agreements (APAs)                                 | 550        |
| <b>4815</b> | Anticipated developments in law and practice                      | 551        |
| <b>4816</b> | Liaison with customs authorities                                  | 553        |
| <b>4817</b> | OECD issues   | 553        |
| <b>4818</b> | Joint investigations  | 554        |
| <b>4819</b> | Thin capitalisation   | 554        |
| <b>49</b>   | <b>The Netherlands</b>  | <b>555</b> |
| <b>4901</b> | Introduction  | 555        |
| <b>4902</b> | Statutory rules   | 555        |
| <b>4903</b> | Other regulations   | 557        |
| <b>4904</b> | Legal cases   | 560        |
| <b>4905</b> | Burden of proof   | 561        |
| <b>4906</b> | Tax audit procedures  | 561        |
| <b>4907</b> | The audit procedure   | 562        |
| <b>4908</b> | Revised assessments and the appeals procedure                     | 563        |
| <b>4909</b> | Additional tax and penalties                                      | 563        |
| <b>4910</b> | Resources available to the tax authorities                        | 564        |
| <b>4911</b> | Use and availability of comparable information                    | 564        |
| <b>4912</b> | Risk transactions or industries                                   | 565        |
| <b>4913</b> | Limitation of double taxation and competent authority proceedings | 565        |
| <b>4914</b> | Advance pricing agreements (APAs)                                 | 566        |
| <b>4915</b> | Anticipated developments in law and practice                      | 567        |
| <b>4916</b> | Liaison with customs authorities                                  | 567        |
| <b>4917</b> | OECD issues   | 569        |
| <b>4918</b> | Joint investigations  | 569        |
| <b>4919</b> | Thin capitalisation   | 569        |
| <b>50</b>   | <b>New Zealand</b>  | <b>570</b> |
| <b>5001</b> | Introduction  | 570        |
| <b>5002</b> | Inland Revenue's current focus                                    | 570        |
| <b>5003</b> | Inland Revenue's review mechanism                                 | 571        |
| <b>5004</b> | Statutory rules   | 572        |
| <b>5005</b> | Guidance on applying New Zealand's transfer pricing rules         | 573        |
| <b>5006</b> | Legal cases   | 576        |
| <b>5007</b> | Burden of proof   | 576        |
| <b>5008</b> | Tax audit procedures  | 577        |
| <b>5009</b> | The audit procedure   | 578        |
| <b>5010</b> | Revised assessments and the appeals procedure                     | 578        |

|             |   |            |
|-------------|---|------------|
| <b>5011</b> | Additional tax and penalties                                      | 579        |
| <b>5012</b> | Resources available to the tax authorities                        | 579        |
| <b>5013</b> | Use and availability of comparable information                    | 579        |
| <b>5014</b> | Risk transactions or industries                                   | 580        |
| <b>5015</b> | Limitation of double taxation and competent authority proceedings | 581        |
| <b>5016</b> | Advance pricing agreements (APAs)                                 | 581        |
| <b>5017</b> | Liaison with customs authorities                                  | 581        |
| <b>5018</b> | OECD issues   | 582        |
| <b>5019</b> | Joint investigations  | 582        |
| <b>5020</b> | Thin capitalisation   | 582        |
| <b>51</b>   | <b>Norway</b>   | <b>583</b> |
| <b>5101</b> | Introduction  | 583        |
| <b>5102</b> | Statutory rules   | 583        |
| <b>5103</b> | Other regulations   | 584        |
| <b>5104</b> | Legal cases   | 585        |
| <b>5105</b> | Burden of proof   | 589        |
| <b>5106</b> | Tax audit procedures  | 590        |
| <b>5107</b> | The audit procedure   | 591        |
| <b>5108</b> | Revised assessments and the appeals procedure                     | 591        |
| <b>5109</b> | Additional tax and penalties                                      | 591        |
| <b>5110</b> | Resources available to the tax authorities                        | 591        |
| <b>5111</b> | Use and availability of comparable information                    | 592        |
| <b>5112</b> | Risk transactions or industries                                   | 593        |
| <b>5113</b> | Limitation of double taxation and competent authority proceedings | 593        |
| <b>5114</b> | Advance pricing agreements (APAs)                                 | 593        |
| <b>5115</b> | Documentation requirements  | 593        |
| <b>5116</b> | Liaison with customs authorities                                  | 594        |
| <b>5117</b> | OECD issues   | 594        |
| <b>5118</b> | Joint investigations  | 595        |
| <b>5119</b> | Thin capitalisation   | 595        |
| <b>52</b>   | <b>Peru</b>   | <b>596</b> |
| <b>5201</b> | Introduction  | 596        |
| <b>5202</b> | Statutory rules   | 596        |
| <b>5203</b> | Other regulations   | 598        |
| <b>5204</b> | Advance pricing agreements (APAs)                                 | 599        |
| <b>5205</b> | Burden of proof   | 599        |
| <b>5206</b> | Tax audit procedures  | 599        |
| <b>5207</b> | Legal cases   | 600        |
| <b>5208</b> | Resources available to the tax authorities                        | 601        |
| <b>5209</b> | Use and availability of comparable information                    | 601        |
| <b>5210</b> | Risk transactions or industries                                   | 602        |
| <b>5211</b> | OECD issues   | 602        |
| <b>5212</b> | Joint investigations  | 602        |

|           |   |            |
|-----------|---|------------|
| <b>53</b> | <b>Philippines</b>  | <b>603</b> |
| 5301      | Introduction  | 603        |
| 5302      | Statutory rules   | 603        |
| 5303      | Other regulations   | 603        |
| 5304      | Legal cases   | 604        |
| 5305      | Anticipated developments  | 604        |
| 5306      | Burden of proof   | 605        |
| 5307      | Tax audit procedures  | 605        |
| 5308      | The audit procedures  | 605        |
| 5309      | Appeals procedures  | 606        |
| 5310      | Additional tax and penalties  | 606        |
| 5311      | Resources available to the tax authorities                            | 606        |
| 5312      | Risk transactions   | 607        |
| 5313      | Thin capitalisation   | 607        |
| 5314      | Advance pricing agreements (APAs)                                     | 608        |
| 5315      | Joint investigations  | 608        |
| 5316      | OECD issues   | 608        |
| <b>54</b> | <b>Poland</b>   | <b>609</b> |
| 5401      | Introduction  | 609        |
| 5402      | Statutory rules, other guidelines                                     | 609        |
| 5403      | Legal cases   | 612        |
| 5404      | Burden of proof   | 612        |
| 5405      | Tax audit procedures  | 612        |
| 5406      | Comparable information  | 613        |
| 5407      | Competent authority proceedings and advance pricing agreements (APAs) | 613        |
| 5408      | Liaison with customs and other tax authorities                        | 615        |
| 5409      | Thin capitalisation   | 615        |
| 5410      | Management services   | 615        |
| <b>55</b> | <b>Portugal</b>   | <b>616</b> |
| 5501      | Introduction  | 616        |
| 5502      | Statutory rules   | 616        |
| 5503      | Other regulations   | 618        |
| 5504      | Legal cases   | 619        |
| 5505      | Burden of proof   | 619        |
| 5506      | Documentation   | 619        |
| 5507      | Tax audit procedures  | 621        |
| 5508      | Revised assessments and the appeals procedure                         | 622        |
| 5509      | Additional tax assessment and penalties                               | 622        |
| 5510      | Resources available to the tax authorities                            | 622        |
| 5511      | Use and availability of comparable information                        | 623        |
| 5512      | Risk transactions or industries                                       | 623        |
| 5513      | Limitation of double taxation and competent authority proceedings     | 623        |
| 5514      | Advance pricing agreements (APAs)                                     | 624        |
| 5515      | Anticipated developments in law and practice                          | 624        |

|             |   |            |
|-------------|---|------------|
| <b>5516</b> | Liaison with customs authorities                                  | 624        |
| <b>5517</b> | OECD issues   | 624        |
| <b>5518</b> | Joint investigations  | 624        |
| <b>5519</b> | Thin capitalisation   | 625        |
| <b>56</b>   | <b>Romania</b>  | <b>626</b> |
| <b>5601</b> | Introduction  | 626        |
| <b>5602</b> | Statutory rules   | 626        |
| <b>5603</b> | Risk transactions or industries and legal cases                   | 628        |
| <b>5604</b> | Burden of proof and tax audit procedures                          | 629        |
| <b>5605</b> | Comparable information  | 629        |
| <b>5606</b> | Additional taxes and penalties                                    | 629        |
| <b>5607</b> | Inter-company loans   | 629        |
| <b>5608</b> | Liaison with customs authorities                                  | 631        |
| <b>57</b>   | <b>Russia</b>   | <b>632</b> |
| <b>5701</b> | Introduction  | 632        |
| <b>5702</b> | Statutory rules   | 633        |
| <b>5703</b> | Other regulations   | 636        |
| <b>5704</b> | Legal cases   | 637        |
| <b>5705</b> | Burden of proof   | 637        |
| <b>5706</b> | Tax audit procedures  | 638        |
| <b>5707</b> | Additional tax and penalties                                      | 639        |
| <b>5708</b> | Resources available to the tax authorities                        | 639        |
| <b>5709</b> | Use and availability of comparable information                    | 640        |
| <b>5710</b> | Limitation of double taxation and competent authority proceedings | 640        |
| <b>5711</b> | Advance pricing agreements (APAs)                                 | 640        |
| <b>5712</b> | Liaison with customs authorities                                  | 641        |
| <b>5713</b> | OECD issues   | 641        |
| <b>5714</b> | Thin capitalisation   | 641        |
| <b>58</b>   | <b>Singapore</b>  | <b>642</b> |
| <b>5801</b> | Introduction  | 642        |
| <b>5802</b> | Statutory rules   | 642        |
| <b>5803</b> | Other regulations   | 646        |
| <b>5804</b> | Legal cases   | 647        |
| <b>5805</b> | Burden of proof   | 647        |
| <b>5806</b> | Tax audit procedures  | 647        |
| <b>5807</b> | Revised assessments and the appeals procedure                     | 647        |
| <b>5808</b> | Additional tax and penalties                                      | 647        |
| <b>5809</b> | Resources available to the tax authorities                        | 648        |
| <b>5810</b> | Use and availability of comparable information                    | 648        |
| <b>5811</b> | Limitation of double taxation and competent authority proceedings | 648        |
| <b>5812</b> | Advance pricing agreements (APAs)                                 | 648        |
| <b>5813</b> | Management services   | 648        |
| <b>5814</b> | Business profits  | 649        |



|           |   |            |
|-----------|---|------------|
| <b>59</b> | <b>Slovakia</b>   | <b>650</b> |
| 5901      | Introduction  | 650        |
| 5902      | Corporate income tax  | 650        |
| 5903      | Value added tax   | 652        |
| 5904      | Other taxes   | 652        |
| 5905      | Customs   | 652        |
| 5906      | Tax inspection procedures   | 652        |
| 5907      | Anticipated developments  | 653        |
| <b>60</b> | <b>Slovenia</b>   | <b>654</b> |
| 6001      | Introduction  | 654        |
| 6002      | Statutory rules   | 654        |
| 6003      | Other regulations   | 656        |
| 6004      | Legal cases   | 657        |
| 6005      | Burden of proof   | 657        |
| 6006      | Tax audit procedures  | 657        |
| 6007      | Additional tax and penalties                                      | 657        |
| 6008      | Resources available to the tax authorities                        | 658        |
| 6009      | Use and availability of comparable information                    | 658        |
| 6010      | Risk transactions or industries                                   | 658        |
| 6011      | Advance pricing agreements (APAs)                                 | 658        |
| 6012      | Anticipated developments in law and practice                      | 658        |
| 6013      | OECD issues   | 659        |
| 6014      | Joint investigations  | 659        |
| 6015      | Thin capitalisation   | 659        |
| 6016      | Management services   | 659        |
| <b>61</b> | <b>Spain</b>  | <b>661</b> |
| 6101      | Introduction  | 661        |
| 6102      | Statutory rules   | 661        |
| 6103      | Documentation   | 662        |
| 6104      | Legal cases   | 663        |
| 6105      | Management services and R&D cost sharing arrangements             | 664        |
| 6106      | Burden of proof   | 665        |
| 6107      | Tax audit procedures  | 666        |
| 6108      | The audit procedure   | 666        |
| 6109      | Revised assessments and the appeals procedure                     | 667        |
| 6110      | Additional tax and penalties                                      | 667        |
| 6111      | Resources available to the tax authorities                        | 668        |
| 6112      | Use and availability of comparable information                    | 668        |
| 6113      | Risk transactions or industries                                   | 668        |
| 6114      | Limitation of double taxation and competent authority proceedings | 669        |
| 6115      | Advance pricing agreements (APAs)                                 | 669        |
| 6116      | Anticipated developments in law and practice                      | 670        |
| 6117      | Liaison with customs authorities                                  | 670        |
| 6118      | OECD issues   | 670        |

|           |   |            |
|-----------|---|------------|
| 6119      | Joint investigations  | 670        |
| 6120      | Thin capitalisation   | 671        |
| <b>62</b> | <b>Sweden</b>   | <b>673</b> |
| 6201      | Introduction  | 673        |
| 6202      | Statutory rules   | 673        |
| 6203      | Other regulations   | 673        |
| 6204      | Legal cases   | 674        |
| 6205      | Burden of proof   | 674        |
| 6206      | Documentation requirements  | 675        |
| 6207      | The audit procedure   | 675        |
| 6208      | Revised assessments and the appeals procedure                     | 676        |
| 6209      | Additional tax and penalties                                      | 676        |
| 6210      | Resources available to the tax authorities                        | 676        |
| 6211      | Use and availability of comparable information                    | 676        |
| 6212      | Risk transactions or industries                                   | 676        |
| 6213      | Limitation of double taxation and competent authority proceedings | 677        |
| 6214      | Advance pricing agreements (APAs)                                 | 677        |
| 6215      | Anticipated developments in law and practice                      | 678        |
| 6216      | Liaison with customs authorities                                  | 678        |
| 6217      | OECD issues   | 678        |
| 6218      | Joint investigations  | 678        |
| 6219      | Thin capitalisation   | 678        |
| <b>63</b> | <b>Switzerland</b>  | <b>679</b> |
| 6301      | Introduction  | 679        |
| 6302      | Statutory rules   | 679        |
| 6303      | Other regulations   | 679        |
| 6304      | Legal cases   | 680        |
| 6305      | Burden of proof   | 680        |
| 6306      | Tax audit procedures  | 680        |
| 6307      | The audit procedure   | 681        |
| 6308      | Revised assessments and the appeals procedure                     | 681        |
| 6309      | Additional tax and penalties                                      | 681        |
| 6310      | Resources available to the tax authorities                        | 681        |
| 6311      | Use and availability of comparable information                    | 681        |
| 6312      | Risk transactions or industries                                   | 682        |
| 6313      | Limitation of double taxation and competent authority proceedings | 682        |
| 6314      | Advance pricing agreements (APAs)                                 | 682        |
| 6315      | Anticipated developments in law and practice                      | 682        |
| 6316      | Liaison with customs authorities                                  | 682        |
| 6317      | OECD issues   | 683        |
| 6318      | Joint investigations  | 683        |
| 6319      | Thin capitalisation   | 683        |
| 6320      | Management services   | 683        |
| <b>64</b> | <b>Taiwan</b>   | <b>684</b> |
| 6401      | Introduction  | 684        |

## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>6402</b> | Statutory rules   | 684        |
| <b>6403</b> | Burden of proof   | 685        |
| <b>6404</b> | Documentation   | 685        |
| <b>6405</b> | Audit targets   | 686        |
| <b>6406</b> | The audit procedure   | 687        |
| <b>6407</b> | Revised assessments and the appeals procedure                     | 688        |
| <b>6409</b> | Advance pricing agreements (APAs)                                 | 689        |
| <b>6410</b> | OECD issues   | 690        |
| <b>6411</b> | Special topics  | 690        |
| <b>65</b>   | <b>Thailand</b>   | <b>692</b> |
| <b>6501</b> | Introduction  | 692        |
| <b>6502</b> | Statutory rules   | 692        |
| <b>6503</b> | Components of the Transfer Pricing Guidelines                     | 693        |
| <b>6504</b> | Legal cases   | 693        |
| <b>6505</b> | Burden of proof   | 694        |
| <b>6506</b> | Tax audit procedures  | 694        |
| <b>6507</b> | Revised assessments and the appeals procedure                     | 695        |
| <b>6508</b> | Additional tax and penalties                                      | 696        |
| <b>6509</b> | Resources available to the tax authorities                        | 696        |
| <b>6510</b> | Use and availability of comparable information                    | 696        |
| <b>6511</b> | Risk transactions or industries                                   | 697        |
| <b>6512</b> | Limitation of double taxation and competent authority proceedings | 697        |
| <b>6513</b> | Advance pricing agreements (APAs)                                 | 697        |
| <b>6514</b> | Liaison with customs authorities                                  | 698        |
| <b>6515</b> | OECD issues   | 698        |
| <b>6516</b> | Joint investigations  | 698        |
| <b>6517</b> | Thin capitalisation   | 698        |
| <b>6518</b> | Management services   | 698        |
| <b>66</b>   | <b>Turkey</b>   | <b>700</b> |
| <b>6601</b> | Introduction  | 700        |
| <b>6602</b> | Statutory rules   | 700        |
| <b>6603</b> | Tax havens  | 702        |
| <b>6604</b> | Deemed dividends  | 703        |
| <b>6605</b> | Adjustments   | 703        |
| <b>6606</b> | Documentation requirements  | 703        |
| <b>6607</b> | Other regulations   | 705        |
| <b>6608</b> | Legal cases   | 705        |
| <b>6609</b> | Burden of proof   | 706        |
| <b>6610</b> | Tax audit procedures  | 706        |
| <b>6611</b> | Revised assessments and the appeals procedure                     | 706        |
| <b>6612</b> | Additional tax and penalties                                      | 706        |
| <b>6613</b> | Resources available to the tax authorities                        | 707        |
| <b>6614</b> | Use and availability of comparable information                    | 707        |
| <b>6615</b> | Risk transactions or industries                                   | 707        |
| <b>6616</b> | Limitation of double taxation and competent authority proceedings | 707        |

|             |   |            |
|-------------|---|------------|
| <b>6617</b> | Advance pricing agreements (APAs)                                 | 707        |
| <b>6618</b> | Anticipated developments in law and practice                      | 708        |
| <b>6619</b> | Liaison with customs authorities                                  | 708        |
| <b>6620</b> | OECD issues   | 708        |
| <b>6621</b> | Thin capitalisation   | 708        |
| <b>6622</b> | Management services   | 709        |
| <b>67</b>   | <b>United Kingdom</b>   | <b>710</b> |
| <b>6701</b> | Introduction  | 710        |
| <b>6702</b> | Statutory rules   | 710        |
| <b>6703</b> | Other regulations and guidance                                    | 714        |
| <b>6704</b> | Legal cases   | 717        |
| <b>6705</b> | Burden of proof   | 718        |
| <b>6706</b> | Tax audits  | 719        |
| <b>6707</b> | Information powers  | 723        |
| <b>6708</b> | Revised assessments and the appeals procedure                     | 724        |
| <b>6709</b> | Additional tax and penalties                                      | 724        |
| <b>6710</b> | Resources available to the tax authorities                        | 728        |
| <b>6711</b> | Use and availability of information on comparables                | 728        |
| <b>6712</b> | Risk transactions or industries                                   | 729        |
| <b>6713</b> | Limitation of double taxation and competent authority proceedings | 729        |
| <b>6714</b> | Advance pricing agreements (APAs)                                 | 731        |
| <b>6715</b> | Anticipated developments in law and practice                      | 734        |
| <b>6716</b> | Liaison with customs authorities                                  | 734        |
| <b>6717</b> | OECD issues   | 734        |
| <b>6718</b> | Joint investigations  | 734        |
| <b>6719</b> | Thin capitalisation   | 734        |
| <b>6720</b> | Management services   | 736        |
| <b>68</b>   | <b>Uruguay</b>  | <b>737</b> |
| <b>6801</b> | Introduction  | 737        |
| <b>6802</b> | Statutory rules   | 737        |
| <b>6803</b> | Other regulations   | 739        |
| <b>6804</b> | Legal cases   | 740        |
| <b>6805</b> | Burden of proof   | 741        |
| <b>6806</b> | Tax audit procedures  | 741        |
| <b>6807</b> | Revised assessments and the appeals procedure                     | 742        |
| <b>6808</b> | Additional tax and penalties                                      | 742        |
| <b>6809</b> | Resources available to the tax authorities                        | 742        |
| <b>6810</b> | Use and availability of comparable information                    | 743        |
| <b>6811</b> | Risk transactions or industries                                   | 743        |
| <b>6812</b> | Limitation of double taxation and competent authority proceedings | 743        |
| <b>6813</b> | Advance pricing agreements (APAs)                                 | 744        |
| <b>6814</b> | Anticipated developments in law and practice                      | 744        |
| <b>6815</b> | Liaison with customs authorities                                  | 744        |
| <b>6816</b> | OECD issues   | 744        |
| <b>6817</b> | Joint investigations  | 744        |

## *International transfer pricing 2009*

|             |   |            |
|-------------|---|------------|
| <b>6818</b> | Thin capitalisation   | 744        |
| <b>6819</b> | Management services   | 745        |
| <b>69</b>   | <b>Uzbekistan</b>   | <b>746</b> |
| <b>6901</b> | Introduction  | 746        |
| <b>6902</b> | Statutory rules   | 746        |
| <b>6903</b> | Other regulations   | 746        |
| <b>6904</b> | Legal cases   | 746        |
| <b>6905</b> | Burden of proof   | 746        |
| <b>6906</b> | Tax audit procedures  | 746        |
| <b>6907</b> | Revised assessments and the appeals procedure                     | 746        |
| <b>6908</b> | Additional tax and penalties                                      | 746        |
| <b>6909</b> | Resources available to the tax authorities                        | 746        |
| <b>6910</b> | Use and availability of comparable information                    | 746        |
| <b>6911</b> | Risk transactions or industries                                   | 747        |
| <b>6912</b> | Limitation of double taxation and competent authority proceedings | 747        |
| <b>6913</b> | Advance pricing agreements (APAs)                                 | 747        |
| <b>6914</b> | Anticipated developments in law and practice                      | 747        |
| <b>6915</b> | Liaison with customs authorities                                  | 747        |
| <b>6916</b> | OECD issues   | 747        |
| <b>6917</b> | Joint investigations  | 747        |
| <b>6918</b> | Thin capitalisation   | 747        |
| <b>6919</b> | Management services   | 747        |
| <b>70</b>   | <b>Venezuela</b>  | <b>748</b> |
| <b>7001</b> | Introduction  | 748        |
| <b>7002</b> | Statutory rules   | 748        |
| <b>7003</b> | Legal cases   | 750        |
| <b>7004</b> | Burden of proof   | 751        |
| <b>7005</b> | Tax audit procedures  | 751        |
| <b>7006</b> | Additional tax and penalties                                      | 752        |
| <b>7007</b> | Resources available to the tax authorities                        | 752        |
| <b>7008</b> | Use and availability of comparable information                    | 752        |
| <b>7009</b> | Risk transactions or industries                                   | 753        |
| <b>7010</b> | Limitation of double taxation and competent authority proceedings | 754        |
| <b>7011</b> | Advanced pricing agreements (APAs)                                | 754        |
| <b>7012</b> | Anticipated developments in law and practice                      | 754        |
| <b>7013</b> | Liaison with customs authorities                                  | 754        |
| <b>7014</b> | OECD issues   | 754        |
| <b>7015</b> | Joint investigations  | 755        |
| <b>7016</b> | Thin capitalisation   | 755        |
| <b>71</b>   | <b>Vietnam</b>  | <b>756</b> |
| <b>7101</b> | Introduction  | 756        |
| <b>7102</b> | Statutory rules   | 757        |
| <b>7103</b> | Other regulations   | 762        |
| <b>7104</b> | Legal cases   | 763        |

|   |   |            |
|---|---|------------|
| <b>7105</b>   | Burden of proof   | 763        |
| <b>7106</b>   | Tax audit procedures  | 763        |
| <b>7107</b>   | The transfer pricing audit procedure                              | 764        |
| <b>7108</b>   | Revised assessments and the appeals procedure                     | 765        |
| <b>7109</b>   | Additional tax and penalties                                      | 765        |
| <b>7110</b>   | Resources available to the tax authorities                        | 765        |
| <b>7111</b>   | Use and availability of comparable information                    | 766        |
| <b>7112</b>   | Risk transactions or industries                                   | 766        |
| <b>7113</b>   | Limitation of double taxation and competent authority proceedings | 766        |
| <b>7114</b>   | Advance pricing agreements (APAs)                                 | 767        |
| <b>7115</b>   | Anticipated developments in law and practice                      | 767        |
| <b>7116</b>   | Liaison with customs authorities                                  | 767        |
| <b>7117</b>   | OECD issues   | 767        |
| <b>7118</b>   | Joint investigations  | 767        |
| <b>7119</b>   | Thin capitalisation   | 767        |
| <br><b>Appendix 1: Functional analysis questions</b>  |   | <b>768</b> |
|   | FUNCTIONS ANALYSIS  | 768        |
|   | RISK ANALYSIS   | 774        |
|   | INTANGIBLE ANALYSIS   | 775        |
| <br><b>Appendix 2: Examples of databases for use in identifying comparative information</b> |   | <b>777</b> |
| <br><b>Appendix 3: US – Proposed service regulations</b>                                    |   | <b>778</b> |
|   | Benefit test  | 778        |
|   | Overview of proposed transfer pricing methods                     | 778        |
|   | The comparable uncontrolled services price method (CUSPM)         | 778        |
|   | The gross services margin method (GSMM)                           | 779        |
|   | The cost of services plus method (CSPM)                           | 779        |
|   | The comparable profits method (CPM)                               | 779        |
|   | The profit split method (PSM)                                     | 779        |
|   | The simplified cost-based method (SCBM)                           | 780        |
|   | Intangibles ownership and enhancements                            | 781        |
|   | Contingent payment contractual terms                              | 781        |
|   | Allocation of costs   | 782        |
|   | Conclusion  | 782        |
| <br><b>INDEX</b>  |   | <b>783</b> |



## PART I

# DEVELOPING DEFENSIBLE TRANSFER PRICING POLICIES





# 1 Introduction

## 101 At the eye of the “perfect storm”

The explosion in volume of international transactions, the growth of national treasury deficits and the frequent use of the phrase *transfer pricing* in the same sentence as *tax shelters* and *tax evasion* on the business pages of newspapers around the world have left multinational enterprises, for whom international transactions are simply an every day business necessity, at the centre of a storm of controversy. Tax authorities have made the regulation and enforcement of the arm’s length standard a top priority (see section 701ff. for commentary on the audit approach to pricing matters in a number of countries). A key incentive for challenging taxpayers on their transfer prices is that the authorities see transfer pricing as a soft target with the potential to produce very large increases in tax revenues. Since there is no absolute rule for determining the right transfer price for any kind of international transaction with associated enterprises, whether it involves tangibles, intangibles, services, financing or cost allocation/sharing arrangements, there is huge potential for disagreement as to whether the correct amount of taxable income has been reported in a particular jurisdiction. While the existence of tax treaties between most of the world’s major trading nations might lead the casual observer to conclude that international transfer pricing is a “zero sum game” where an adjustment in one jurisdiction will be matched by the granting of corresponding relief at the other end of the transaction, the reality is that transfer pricing controversies are expensive and time consuming to deal with, not to mention full of pitfalls for the unwary that frequently result in double taxation of income.

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

- the risk of very large local tax reassessments;
- the potential for double taxation because income has already been taxed elsewhere and relief under tax treaties is not available;
- significant penalties and interest on overdue tax;
- the potential for carry forward of the impact of unfavourable Revenue determinations, creating further liabilities in future periods;
- secondary tax consequences adding further cost – for example the levy of withholding taxes on adjusted amounts treated as constructive dividends;

- uncertainty as to the group's worldwide tax burden, leading to the risk of earnings restatements and investor lawsuits;
- conflicts with customs and indirect tax reporting requirements;
- conflicts with regulatory authorities; and
- damage to reputation and diminution of brand value as a consequence of the perception of being a bad corporate citizen.

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

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

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

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

### **103 Keeping policies and procedures up to date**

A pricing policy cannot be established, set in stone and then ignored. If it is to have any value, the policy must be responsive to an increasingly dynamic and turbulent business environment and must be reviewed on an ongoing basis, at a minimum

whenever the group's business is restructured or new types of transactions are contemplated. This should not be an onerous task if it is performed by appropriate personnel who are well-briefed on the aims of the analysis and any necessary amendments to the policy are implemented quickly. An updating of the transfer pricing policy should form part of the routine process of reviewing the overall business strategy. Regular and as-needed policy updates can help to ensure that the policy continues to cover all inter-company transactions undertaken by the company, as well as produce arm's length results and prevent unwelcome surprises.

#### **104 Theory and practice**

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

#### **105 Transfer pricing is not just about taxation**

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

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

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

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

### 106 The legacy of the 1990s

In 1994-95 timeframe, the US broke new ground with regulations on intangibles, tangibles and cost sharing. These regulations evoked widespread reaction amongst the international community. Many commentators perceived that the US Regulations were a departure from the arm's length standard. The OECD responded by publishing new chapters on the adoption of the arm's length principle in 1995, the provision of standards of comparability emphasising functions performed, risks assumed and assets employed; the need for taxpayer documentation of the arm's length character of its transfer pricing; and the role played by penalties in encouraging tax compliance. The following year, further material was published on '*Special Considerations for Intangible Property*' and '*Special Considerations for Intra-Group Services*'. A chapter on '*Cost Contribution Arrangements*' was released in late 1997. The work of the OECD was a trendsetter for several other countries which introduced transfer pricing legislation revolving around the OECD Guidelines in quick succession.

A decade later, with more concrete Revenue and taxpayer experience behind it, the US is revisiting the regulations pertaining to services, intangibles and cost sharing. New temporary regulations pertaining to services and dealing specifically with the services cost method are presently in force and regulations relating to intangibles and cost sharing have been proposed. In the meanwhile, the OECD is reviewing aspects of comparability and the use of transactional profit methods in more detail. Recently the OECD has also issued revised public discussion drafts of four parts of its '*Report on the Attribution of Profits to Permanent Establishments*' (also referred to herein as PE) and a new discussion draft dealing with '*Transfer Pricing Aspects of Business Restructurings*'.

### 107 The future

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

- corporate restructurings, particularly where there is downsizing of operations in a particular jurisdiction;
- significant inter-company transactions with related parties located in tax havens, low tax jurisdictions or entities that benefit from special tax regimes;
- deductions claimed for inter-company payments of royalties and/or service fees, particularly if this results in losses being claimed on the local tax return;
- royalty rates that appear high in relative percentage terms, especially where intellectual property that is not legally registered may be involved;
- inconsistencies between inter-company contracts, transfer pricing policies and detailed transaction documents such as inter-company invoices and/or customs documentation;
- separation of business functions and related risks that are contractually assigned to a different jurisdiction;

- frequent revisions to transfer pricing policies and procedures;
- recurring year-end pricing adjustments, particularly where they may create book/tax differences;
- failure to adopt a clear defence strategy; and
- simply not paying any taxes.

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

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

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

## **2 Categories of inter-company transfer**

### **201 Introduction**

There are many types of inter-company transactions. These include transfers of tangible and intangible property, the provision of services, as well as inter-company financing, rental and leasing arrangements or even an exchange (of say, property for services or the issue of sweat equity). It is important to note that it is the substance of the situation that will always determine whether or not a transaction has taken place, rather than whether an invoice has been rendered. For instance, management services may be delivered through the medium of a telephone call between executives of a parent company and its subsidiary. In this example, a service has been performed that the provider had to finance in the form of payroll costs, phone charges, overheads, etc, and the service itself will be of value to the recipient in the form of the advice received. Thus, a transaction has taken place for transfer pricing purposes even though, at this stage, no charge has been made for the service. Transfer pricing rules typically require related entities to compensate each other appropriately so as to be commensurate with the value of property transferred or services provided whenever an inter-company transaction takes place. The basis for determining proper compensation is, almost universally, the arm's length principle.

### **202 The arm's length principle**

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

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

### **203 Sales of tangible property – definition**

Tangible property refers to all the physical assets of a business. Sales of raw materials, work in progress and finished goods represent a major portion of the transfers that take place between related parties, typically referred to as sales of inventory (see Section 205). However, it is important to bear in mind that 'sales of tangible property'

can include all the machinery and equipment employed by businesses in their day-to-day activities as well as the goods they produce.

#### **204 Sales of machinery and equipment**

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

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

#### **205 Sales of inventory**

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

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

##### **Example**

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



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

- sale of the testing machine;
- the sale of semiconductor chips; and
- the sale of transistors purchased from unrelated parties.

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

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

## **206 Transfers of intangible property – definition**

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

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

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

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

Those intangibles that produce a monopoly or near-monopoly in their product areas are sometimes referred to as 'super-intangibles' and are the subject of much current interest in the transfer pricing arena. This has been particularly true in the US since the Tax Reform Act of 1986 (reference to more recent temporary and proposed regulations) which, following the subsequent White Paper, temporary regulations and final transfer pricing regulations and penalty rules, attracted attention to the question of the appropriate inter-company royalty rates for these 'super-intangibles' and as a result, highlighted this whole issue of intangible transfers generally. (See Chapter 8 for a detailed discussion of the current US Regulations.) An intangible

asset that does not produce a monopoly, i.e. situations where the product to that the intangible relates is sold in very competitive markets, is sometimes referred to as an 'ordinary' intangible.

### **207 Types of intangibles**

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

### **208 Modes of transfer of intangibles**

Intangibles can be transferred between related entities in four ways:

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

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

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

### **209 Manufacturing intangibles**

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

When transferring patents to affiliates, it is vital to understand the degree of

monopoly power conveyed by the patent. This is critical to the determination of the arm's length compensation due to the transferor because patents that provide more protection to the owner are more valuable than patents that provide less protection.

Technical know-how is the accumulated specific knowledge that gives a manufacturer the ability to produce a product. In some industries, technical know-how is worth very little, so that when it is transferred between unrelated parties the royalty rate is extremely low. In other industries, technical know-how is highly valuable.

### **Example**

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

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

In determining the value of the intangibles in this example, it is important to note the length of time during which the original design created an absolute monopoly for CWL. Intangibles that sustain monopoly positions over long periods are far more valuable than intangibles that create monopoly positions for much shorter periods. The longer the monopoly continues, the more time the owner of the intangible has to exploit the monopoly position and to develop value in the form of technical know-how or selling intangibles such as trademarks, which will protect an imperfectly competitive market position after the expiration of the patent. Furthermore, in this example, the ability to produce a high-quality and low-cost product is extremely valuable in the long run because without this ability, CWL would not be able to compete in the marketplace. There are countless examples of these types of intangibles in the modern world.

## **210 Marketing intangibles**

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

A trademark is a distinctive identification of a manufactured product in the form of a name, logo, etc. A trade name is the name under which an organisation conducts its business. Trademarks and trade names are frequently treated as identical, although one (trademark) is a product-specific intangible, while the other (trade name) is a company-specific intangible. A product-specific intangible applies to a particular product and has zero value at the time the product is marketed for the first time under that name. Its value is developed by the marketing/sales organisation over the life of

the product. This is important for inter-company pricing because trademarks typically have little or no value when a product is first introduced into a new market (even though it may have high value in the markets into which the product is already being sold).

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

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

### **Example**

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

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

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

## **211 Hybrid intangibles**

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

In another example, suppose that corporate reputation of a particular company results from its advertising genius, so that customers and potential customers think

of the corporation as, for example, 'The Golden Arches' (McDonalds) or the company that 'taught the world to sing' (Coca-Cola). In this case, corporate reputation is a very powerful marketing intangible. In such cases, a significant portion of the value of the corporation is attributed to the tradename itself, such as BMW.

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

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

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

## **212 The provision of services – definition**

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

## **213 Examples of types of service**

There are essentially five types of service that may be provided to related parties.

- (1) The service can be a 'routine' service such as accounting or legal services, where no intangible is transferred. In situations such as this, the price charged in arm's length relationships is invariably based on a 'cost plus' formula where the 'plus' element varies greatly with the value added of the service and the extent of competition within the market. In the inter-company context, many countries allow reimbursement on a cost plus basis, albeit with a relatively small and steady uplift for services which are regarded as being low-risk and routine. However, a minority either do not allow the inclusion of a profit or have restrictive rules.
- (2) The service can be technical assistance in connection with the transfer of an intangible, either manufacturing or marketing, but usually a manufacturing intangible. Typically, in arm's length relationships, a certain amount of technical

assistance is provided in connection with a licence agreement (at no extra charge). If services in excess of this level are needed, arm's length agreements usually allow for this at an extra charge, typically a per diem amount (itself determined on a cost plus basis) plus out-of-pocket expenses.

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

#### **214 The problem of 'shareholder' services**

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

can duplicate services performed by the subsidiaries, or can represent shareholder activities and, if so, whether the subsidiary will succeed in obtaining a tax deduction for the expense if a charge is made.

Directly beneficial services are those that provide a benefit to the recipient. For example, if a parent prepares the original books and records for a related company, this accounting service is directly beneficial to the recipient because it allows the recipient to produce its financial statements etc. Whether an intra-group service has been rendered so as to warrant the payment of a inter-company charge depends on whether the activity provides the related entity with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in similar circumstances would have been willing to pay for the activity if it was performed by a third party or would have performed the activity in-house. In the absence of any of these conditions being met, the activity would not be regarded as an intra-group service..

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

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

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

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

**Table 2.1 Costs often incurred by a parent company**

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

**Example**

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

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

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

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

- (1) technical assistance to the Swedish subsidiary in connection with the utilisation of the manufacturing technology;



- (2) marketing assistance to all selling subsidiaries; and
- (3) the President's quarterly review.

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

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

## **215 Financing transactions**

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

There are a number of factors of relevance in the context of related party debt:

- the rate of interest on the loan (including whether or not it is fixed or floating);
- the capital amount of the loan;
- the currency; and
- the credit worthiness of this borrower (including whether or not any guarantees have been provided in connection with the loan).

Tax authorities may review whether a third party would charge the rate of interest set between the related parties or whether that rate is too high or low (see Section 542). Furthermore, the tax authority in the borrower's country may question whether a third party would have been willing to lend the funds at all. In assessing the answer to the latter question, the local Revenue authority will have reference to the debt:equity ratio of the borrower.

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

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

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

If it is considered that an entity has related party debt in excess of the amount that a third party would lend, the borrower is said to be 'thinly capitalised'. Many countries,

particularly the developed nations, have special thin capitalisation rules or practices. A detailed analysis of these rules, as they apply in each jurisdiction, is beyond the scope of this book (although a number of examples are included in the country commentaries). However, it is crucial to review any specific rules and practices (including any 'safe harbour' debt:equity ratios) applicable in the relevant countries before international financing structures are established.

## 216 Financing short-term capital needs

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

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

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

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

### Example

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

#### *(1) Inter-company payables and receivables*

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

#### *(2) Advance of capital*

TLC may loan the funds required to finance the short-term needs of the subsidiary

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

### *(3) Parent guaranteed bank loans*

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

## **217 Market penetration payments**

An alternative to the financing schemes discussed in Sections 215 to 216 is to use a market penetration or market maintenance mechanism. In this situation, the manufacturing company treats the related selling company's market as its own in the sense that the manufacturer wishes to expand its sales into a new market. Because its products have not previously been sold in the new market, it must penetrate the market through marketing, e.g. advertising or through a reduction in price to customers (below the price that is expected to be charged after achieving the desired level of sales). These costs are the costs of the manufacturer rather than the distributor.

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

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

**218 Cost sharing**

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

**219 Financing long-term capital needs**

Long-term capital needs can be financed through:

- mortgages;
- lease financing;
- capital stock;
- long-term debt (either inter-company or third party); or
- the issue of equity to shareholders, and bonds or other financial instruments in the marketplace (this activity with third parties is not covered further).

**220 Mortgages**

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

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

**221 Lease financing**

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

lessee) and pricing the lease rental accordingly.

## **222 Capital stock**

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

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

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

## **223 Long-term inter-company loans**

A parent company will usually have the flexibility to lend funds to subsidiaries directly in the form of loans, whether secured or unsecured. Most parent company jurisdictions require that the parent charge an arm's length rate of interest on the loan based on the term of the loan, the currency involved and the credit risk associated with the subsidiary (see Section 542).

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

## **224 Other financing techniques**

The methods of determining an appropriate 'price' for the financial transactions discussed in Sections 215 to 223 apply equally to the more sophisticated financing techniques, such as deep-discounted loans, hybrid financing arrangements (where the instrument is taxed on an equity basis in one country and as debt in the other), swaps, etc. In all these situations, the correct remuneration for the parties involved can only be determined by a careful analysis of the various obligations and risks of the parties to the transaction and how these would be compensated in an arm's length situation. This analysis is essentially the same as that which a bank does in setting the terms of special arrangements with its customers or the market processes

that eventually determine how a quoted financial instrument is valued on a stock exchange.

**225 Flexibility in managing capital needs**

It is always important to bear in mind that cash is easily moved from one place to another. A multinational will have opportunities to raise external capital from shareholders or from institutional backers and banks, probably in a number of different countries, and will similarly be generating profits across a wide spread of territories. While the remarks in Sections 215 to 224 generally refer to the financing of subsidiaries by the parent, there may well be opportunities to arrange finance between subsidiaries 'across' the group, perhaps through a special entity taxed on a low basis, such as a Belgian Co-ordination Centre. Similar principles will apply in these circumstances.

# 3 The work of the OECD

## 301 Introduction

### *The Formation of the OECD*

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

- (1) achieve the highest maintainable economic growth and employment and a sustained rising standard of living in member countries;
- (2) result in sound economic expansion; and
- (3) contribute to the expansion of world trade through a multilateral, non-discriminatory basis.

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

### *The OECD report and Guidelines on transfer pricing*

The tax authorities in the US and a handful of other countries started to pay considerable attention to transfer pricing in the 1960s and 1970s. As part of their general remit, the OECD member countries recognised that it would be helpful to provide some general guidance on transfer pricing in order to avoid the damaging effects that double taxation would have on international trade. The result was the OECD report on transfer pricing, in which the US experience was extremely influential. (*Transfer Pricing and Multinational Enterprises*, published by the OECD Committee on Fiscal Affairs in 1979. Later reports addressed related issues, in particular *Transfer Pricing and Multinational Enterprises – Three Taxation Issues* (1984) and *Thin Capitalisation* (1987).)

The guidelines contained in the 1979 report (the OECD Guidelines), which were drawn up in consultation with Industrial and Trade Union Committees of the OECD, were based on experience gained over a number of years by experts in this field, supplemented by the experience of tax authorities and multinationals located in the OECD countries. The basic principle reflected in the 1979 Guidelines is that 'arm's length' prices should be used in all inter-company transactions. The tax authorities in virtually all the developed countries have adopted the arm's length standard for transfer pricing between related parties. In some cases, this has been achieved by a simple recognition of the OECD principles. In other countries, detailed legislation and supporting regulations have been promulgated.

### *Revisions to the guidelines*

In the changing environment of international trade and following concerns about early drafts of the US transfer pricing regulations (following the 1986 Tax Reform Act), the committee of key OECD member countries began the work needed to update the 1979 report *Transfer Pricing and Multinational Enterprises*. (See the *OECD report*,

*Tax Aspects of Transfer Pricing within Multinational Enterprises: the United States* proposed regulations, published in 1993.) In the absence of agreement on the underlying principles as to how the arm's length standard should be interpreted, there was a great degree of potential for disagreement on transfer pricing matters between the tax administrations of major developed countries which would have been bound to result in an increased incidence of double taxation.

The OECD published the first chapters of the revised guidelines in July 1995 but because this is such a complex area, the committee was unable to reach agreement on all aspects. It published chapters on intangible property and intra-group services in 1996 and in 1997 published a chapter on cost contribution arrangements and a draft discussion paper on the taxation of global trading of financial instruments. In February 1998 the OECD released two new annexes and a revised glossary to the Guidelines. The annexes include guidelines for monitoring procedures on the OECD Transfer Pricing Guidelines and the involvement of the business community and examples to illustrate the Transfer Pricing Guidelines. In 1999, the OECD issued a new annex to the Guidelines on conducting Advance Pricing Agreements under the Mutual Agreement Procedure of tax treaties.

#### *New OECD initiatives*

More recently a number of new OECD initiatives have resulted in pronouncements that potentially have significant impact on transfer pricing matters. In December 2006 final versions of Parts I, II and III of the Report on Attribution of Profits to Permanent Establishments dealing with general considerations in relation to the taxation of permanent establishments and application of these principles to banks and in the context of global trading were issued. This was followed on 22 August 2007 by a revised Part IV dealing with Insurance. On 25 January 2008 a series of draft issues notes were issued for comment in respect of Transactional Profits Methods. On 7 July 2008, the OECD released for comment a discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention and related commentary changes. Finally on 19 September 2008 the OECD released its discussion draft on the Transfer Pricing Aspects of Business Restructurings.

#### *The main points of the guidelines*

To summarise the main points, the 1995 OECD Guidelines:

- (1) adopt the arm's length principle and express a strong preference for the use of traditional transaction-based methods;
- (2) set out the levels of comparability that emphasise functions performed, risks assumed and assets employed;
- (3) introduce a profit-based method, called the 'transactional net margin method'; and
- (4) acknowledge the need for taxpayer documentation of the arm's length character of its transfer pricing and role played by penalties in encouraging compliance.

### **302 The arm's length principle**

Under the arm's length principle, related taxpayers must set transfer prices for any



inter-company transaction as if they were unrelated entities but all other aspects of the relationship were unchanged. That is, the transfer price should equal a price determined by reference to the interaction of unrelated firms in the marketplace.

This concept is set out definitively in art. 9 of the OECD Model Tax Convention, which forms the basis of many bilateral tax treaties. The OECD Guidelines acknowledge that it is often difficult to obtain sufficient information to verify application of the arm's length principle in practice but state that it is the best theory available to replicate the conditions of the open market.

The problem then arises as to how to determine the market price for inter-company transactions.

### *Guidance for applying the arm's length principle*

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

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

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

### *Analysis of transactions*

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

- (1) The tax authorities should review the actual transaction as structured by the related parties.
- (2) Although the Guidelines prefer a review of transfer pricing on a transaction-by-transaction basis, they acknowledge that this is not often practical, and so a combination of transactions may be examined.
- (3) It is not always possible to use a single figure, for example, as a price or margin; instead, a range of prices may be more appropriate.

- (4) The Guidelines suggest examining data from both the year in question and previous years.

### *Transfer pricing methods*

The Guidelines study various pricing methodologies, with examples of their application, under a number of headings, the first being 'traditional transaction methods'. They prefer these methods as they are the most direct. However, under the Guidelines, a taxpayer must select the method that provides 'the best estimation of an arm's length price'. To do this, the tax authorities or taxpayer only need to analyse one method in depth.

### **303 Comparable uncontrolled price method**

The comparable uncontrolled price (CUP) method offers the most direct way of determining an arm's length price. It compares the price charged for goods or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction. The OECD report states that, if it can be used, 'the CUP method is preferable over all other methods'. In practice, this method is often very difficult to apply as it is unusual for multinationals to have access to sufficient details of appropriately comparable third party transactions. In response to this, the OECD report suggests that multinationals and tax authorities should take a more adaptable approach to the use of this method, possibly working with data prepared for CUP purposes supplemented by other appropriate methods. The extent of the OECD's support for the CUP method can be seen from the comment that 'every effort should be made to adjust the data so that it may be used appropriately in a CUP method'.

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

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

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

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

- quality of the products;
- geographic markets;
- level of the market; and

- amount and type of intangible property involved in the sale.

**Example**

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

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

**Example**

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

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

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

**304 Resale price method**

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

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

**Example**

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

**305 Cost plus method**

The cost plus method is one of the methods typically applied in analysing the activities of a contract manufacturer (see 409) or when determining the arm's length charge for services. It can also be applied to fully-fledged manufacturers although the mark-up, as well as the cost base, may be different from that utilised in the case of a contract manufacturer.

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

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

When determining arm's length mark-ups for fully-fledged manufacturers, i.e. manufacturers that operate with a greater degree of independence and which carry out more sophisticated activities, the nature of the product that is manufactured will probably be of much greater significance to the analysis. Mark-ups earned by manufacturers could vary considerably from one product to another because of manufacturing intangibles that may have been developed by the fully-fledged

manufacturer. As a result, identifying a comparable for the fully-fledged manufacturer may be extremely difficult unless the company manufactures and sells the products in question to unrelated companies at the same level of the market as the affiliates to which the related party sales are made (i.e. an internal comparable exists).

### **Example**

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

In this case, the Irish affiliate is a contract manufacturer. It performs limited manufacturing activities and engages in no production scheduling, materials purchasing, or technical service. Moreover, it bears no raw material or market risk. When the shaping process is complete, the Irish affiliate ships the completed products to the UK parent for sale in the UK market. In addition to this service provided to the UK parent, the Irish affiliate also provides similar services to unrelated companies.

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

### **306 Cost plus method – capacity adjustments**

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

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

**Example**

As an example, if we take the facts of GSL from 305 but change the assumption such that the Irish affiliate dedicates 100% capacity to GSL through a long-term contract, then the fee for charges to GSL must take account of all the overhead accruing on a long-term basis. As a result, GSL and its Irish affiliate must budget to maintain the subsidiary in an appropriately profitable position.

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

**307 Other methods**

Situations sometimes arise where there is no satisfactory evidence of a CUP and where it is not possible to apply the resale price or cost plus methods. In these situations it is necessary to apply an appropriate alternative method to determine arm's length transfer prices. Such methods, often known as 'fourth' methods, include the rate of return (see Section 308), profit split (see Section 309), transactional net margin (see Section 310) and the Berry ratio (see Section 311).

Chapter III of the OECD Guidelines considers other methods, referred to as 'transactional profit methods', as they deal with the profits that arise from particular transactions. These methods can be used to approximate arm's length conditions when the traditional transaction methods cannot reliably be applied on their own, or – in the opinion of the OECD – exceptionally, cannot be applied at all. The extent to which there is a significant difference in the results of traditional methods as compared to profit-based methods has led to extensive international debate. A careful reading of the Guidelines will reveal that the authors did not believe that there would be a great divergence of outcomes from different methods of analysis in practice. For example, in the definition of the resale price method in Chapter II of the Guidelines it is noted that, in addition to covering the selling costs of the distribution company concerned, the gross margin earned by the company is required to cover 'other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit'.

Each of these other methods compares some financial measure of the related parties to the same measure for similar firms in the same industry. The need to base the financial measure used to determine transfer prices on a measure for similar unrelated firms underscores the fact that all transfer pricing methods have to refer to external comparable data to be defensible. Standard operating practices in competitive industrial situations indicate that third parties often determine market prices through resale price or cost plus methods. Rarely do third parties negotiate prices based on any of the alternative methods. Therefore, when they are used to establish transfer prices, there are few, if any, reasons to argue for the use of one method over another as a matter of principle. However the choice of a confirming method is more likely to be determined by practical considerations such as the availability of third party comparable data in order to demonstrate that the result of the internal policy is arm's length in nature. This is why alternative transfer pricing methods, especially profit based methods, are commonly used to provide a test of the reasonableness of a transfer pricing policy determined by using one of the first three methods. For instance,

if a resale price margin is used to determine the appropriate transfer price between a manufacturer and its related distributor, an analysis of the profit split between these parties can give some indication of the reasonableness of that transfer price.

### **Example**

The Loveable Bear Company (LBC), a Canadian company, manufactures and sells teddy bears. The parent company develops and manufactures the bears and sells completed products to subsidiaries in the US, Japan and France. After a complete functional analysis (see 402), it is determined that the subsidiaries function as marketer distributors that operate with a fairly high degree of independence and a search is conducted for comparable distributors purchasing completed products from unrelated manufacturers.

No comparable businesses are identified that distribute only teddy bears. Several comparables that distribute children's toys are identified and their gross margins are used to derive an arm's length range expressed as a percentage of their sales. Thus a resale price method is used to determine transfer prices such that the subsidiaries' gross margins, approximately 15% of their net sales, fall within the range established by reference to the third party transactions. Because these comparables are not 'perfect', in that their product lines are broader than the subsidiaries' product lines, the results are tested to make certain that they are reasonable. The test that is selected is a profit split.

The income statement for the manufacture and sale of teddy bears in the US market is prepared. The Canadian parent's revenues and costs with respect to sales to its US subsidiary are computed, as also are the revenues and costs of the US subsidiary (using consistent accounting policies). Using a residual profit split approach, arm's length rates of profitability are established by reference to a group of external comparables for the routine manufacturing activities of the Canadian parent and the routine distribution activities of the US subsidiary, and the residual profit attributable to intangible assets owned by each party are split based on an appropriate formula reflecting the relative contributions made by each party. The result indicates that 60% of the consolidated operating profit should be reported in the Canadian parent and 40% is reported in the US subsidiary. Notice that the operating profit used here is the consolidated operating profit earned on products that are sold in the US market (any other revenues, costs and profits of the Canadian parent are ignored). This finding is compared to the actual results achieved under the group policy of pricing of tangible goods based on the Resale Price Method target of 15% gross profit.

A similar analysis is prepared for the Japanese and French subsidiaries with similar results. Based on the supporting profit split analysis, the results of the Resale Price Method analysis is confirmed and the transfer prices are judged to be defensible arm's length prices.

### **308 Rate-of-return method**

Return on equity is generally the economist's preferred rate-of-return measure but it is not normally possible to use this measure directly in an inter-company pricing framework, and it is not a specified transfer pricing method under the OECD Guidelines. This is because the capitalisation of a subsidiary will usually be determined by the

parent company in the light of internal group financing requirements and not by the market forces of banks, shareholders and bond holders, who effectively control the capitalisation of a quoted company. The overall capitalisation of a wholly owned subsidiary is therefore not necessarily arm's length.

As a substitute for return on equity, return on assets (ROA) is frequently used. In the US ROA is frequently selected as an appropriate 'profit level indicator' in an analysis that applies the Comparable Profits Method, and in many other countries it may be similarly applied as part of a Transactional Net Margin or Cost Plus Method analysis.

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

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

### **Example**

Clipco SA, a Belgian company, manufactures and sells razors. Its R&D activity is conducted at the parent company in Belgium; its manufacturing is done by a subsidiary in Ireland and its distribution is done by a subsidiary in Germany. No publicly available information exists, which can be used to apply the CUP, resale price or cost plus methods to determine transfer prices between the Irish and German subsidiaries. Financial statements are available, however, which allow a typical ROA to be computed for the manufacturing activities. Specifically, financial statements for manufacturing companies that produce razors for sale to unrelated distributors are available.

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

### **309 Profit split method**

This method establishes transfer pricing by dividing the profits of a multinational enterprise in a way that would be expected of independent enterprises in a joint-venture relationship. It might be appropriate to use this method where transactions are so interdependent that it is not possible to identify closely comparable



transactions, particularly in circumstances where both parties in a related party transaction have contributed valuable intellectual property. The OECD Guidelines state that expected profits should be used rather than actual profits, in order to avoid the use of hindsight. Many MNEs have responded to this by including a year-end 'true up' calculation as part of their inter-company agreements.

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

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

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

### **Example**

Wheels AG (WAG) is a German company that manufactures luggage carriers that are lighter than those sold by its competitors and which fold into a small package for use by airline passengers. Key parts are manufactured at the parent company and sold to a subsidiary located in the UK. The UK subsidiary assembles the finished luggage carriers and markets and distributes the products in the UK market. It has been in existence for 15 years. No comparables are available that would allow the application of the CUP, resale price or cost plus methods; so WAG has decided to utilise a profit split method to determine transfer prices.

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

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

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

### **310 Transactional net margin method (TNMM)**

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

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

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

Although such profit based methods are supposed to be 'methods of last resort' under the OECD Guidelines, in practice they are widely used. The reason for this is the paucity of accessible data about independent comparable transactions or about gross margins. Where financial information is made available publicly, it is often only the operating income that can be defined with sufficient clarity to be useful in making comparisons from one company to another.

### **311 Berry ratio compared to return on sales (ROS)**

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

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

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

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

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

### **Example**

US Pills Inc. (USP) is a US pharmaceutical company that has begun to manufacture a new drug in a subsidiary located in Sweden. The parent developed and patented the drug in the US and has licensed the Swedish subsidiary to manufacture it. The parent purchases the drug from its subsidiary and distributes it in the US. The final sales price for the drug in the US is USD2 per tablet. Sales of the drug are expected to be 600 million tablets per year. The distributor's operating costs are USD14.4 million per year.

To determine the transfer price, the Berry ratio for distributors in the US is computed. It is found to be 125%. This means that the operating costs of the distributor are marked up by 25% to determine transfer prices, i.e. the distributor's gross margin is USD18 million per year. Using this gross margin, the price of the tablets to the distributor is USD1.97 per tablet.

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

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

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

### **312 Non-arm's length approach: global formulary apportionment**

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

### **313 OECD commentary on other matters impacting transfer pricing**

#### *Safe harbours*

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

- a risk of double taxation and mutual agreement procedure difficulties;
- tax planning opportunities for taxpayers; and
- potential discrimination and distortion of competition.

On balance, the OECD does not recommend the use of safe harbours.

#### *Advance pricing agreements (APAs)*

An advance pricing agreement (APA) sets out appropriate criteria (for example, a method, comparables and critical assumptions) for determining transfer pricing over

a fixed period. APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure (MAP) under art. 25 of the OECD Model Tax Convention. An APA can help taxpayers by providing certainty through the establishment of the tax treatment of their international transactions. Until recently, relatively few OECD member countries have used APAs, and therefore the Committee on Fiscal Affairs intends to monitor any expanded use of APAs. APAs are discussed in some detail in Chapter V of the Guidelines. This intention to monitor use of APAs gave rise to the Guidelines annex on APAs, issued by the OECD in 1999.

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

### *Documentation*

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

### *The mutual agreement procedure and corresponding adjustments*

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

- (1) extending domestic time-limits for the purposes of making corresponding adjustments;
- (2) reducing the time taken for mutual agreement proceedings;
- (3) increasing taxpayer participation;
- (4) the publication of domestic rules or procedures; and
- (5) the suspension of collection of tax during the procedure.

### *Secondary adjustments*

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

### *Authority of the OECD Guidelines*

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

- (1) tax administrations follow the Guidelines when determining taxable income;
- (2) tax authorities should encourage taxpayers to follow the Guidelines; and
- (3) governments should further develop co-operation between the tax authorities.

### *Increased co-operation between tax authorities*

One result from the process of agreeing the OECD Guidelines has been the increasing internationalisation of the review of multinationals' transfer pricing. This is because the tax authorities have improved their communication procedures through having more discussions in the forum of the OECD, which in turn has resulted in a significant increase in the use of the exchange of information article included in most bilateral tax treaties. Clearly it can no longer be assumed that tax authorities will act in isolation.

### *Member countries of the OECD*

The countries subscribing to the OECD at the time the new transfer pricing guidelines were issued were Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Czech Republic, Hungary, Korea, Poland and the Slovak Republic have been subsequently admitted and have embraced the OECD's Guidelines.

## **314 Recent developments at the OECD**

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

### *Discussion draft on transactional profits methods*

On 25 January 2008 the OECD issued a Discussion Draft on Transactional Profits Methods. A change in the status of profit based methods under which they would rank equal with "traditional" transaction based methods is proposed. Guidance is also given on the application of profits based methods in practice, as follows:

- (1) the use of a secondary confirming transfer pricing method is encouraged;
- (2) the lack of significant intangible assets in a tested party does not imply that application of the TNMM is automatically valid since there may be other unique contributions that would entitle the entity to a share of the residual income or loss;

- (3) the draft suggests a more disciplined approach to segregation of financial data and the issue of aggregation of transactions for the purposes of analysis;
- (4) there is a discussion of the selection of an appropriate profit level indicator; and
- (5) it is suggested that impact of interest expenses on the level of net income should be determined.

*Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention and Report on Attribution of Profits to Permanent Establishments*

On 7 July 2008, the OECD released for comment a discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention and related commentary changes. Together with the OECD's issue of new parts of the Report on the Attribution of Profits to Permanent Establishments the intention is to reflect on an interim basis certain changes and clarifications in the interpretation of Article 7 pending a more fundamental redrafting of the language of the Model Convention expected in 2010. In April 2007, the OECD released an open invitation to comment on the first part of the implementation package, i.e. a draft of the revised Commentary on the current Article 7 of the OECD Model Tax Convention, which was subsequently revised and incorporated in the 2008 update to the OECD Model Tax Convention.

With these changes, the OECD intends to achieve greater consensus in terms of interpretation and application of the guidance on the attribution of profits to PEs in practice among OECD and non-OECD countries. The revised Commentary describes the "central directive" of Article 7 as being the separate entity approach under which the profits attributed to a PE should be those that it would have realised if it had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and dealings wholly independently from the rest of the enterprise. The Commentary embodies the two stage approach set out in the Report, firstly identification of the activities carried on through the PE, and secondly determination of the appropriate compensation by applying the principles set out in the OECD Transfer Pricing Guidelines. In a non-financial services business, risks and assets are allocated between the home office and the PE based on the location of "significant people functions". In a financial services business the location of "key entrepreneurial risk taking functions" will be determinative. The "force of attraction" principle under which income arising in the territory may be fully taxable even if it is not attributable to the PE is rejected.

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

- (1) the calculation of profits attributable to a dependent agent should be consistent with the two stage approach described above;
- (2) the deduction of expenses incurred in the operation of a PE should be allowed;
- (3) recognition of the attribution of an arm's length amount of interest to a PE based on attributing an appropriate amount of "free" capital in order to support the functions; and
- (4) encouragement of taxpayers to produce contemporaneous documentation in order to reduce the potential for controversies

*Discussion Draft on the Transfer Pricing Aspects of Business Restructurings*

On 19 September 2008 the OECD released a Discussion Draft on the Transfer Pricing Aspects of Business Restructurings. This document contains four draft issues notes including coverage of specifically internal business reorganisations designed to shift risks, intangible property and income among members of a multinational group of corporations. The four issues notes address the following subjects:

- (1) Special considerations for risks;
- (2) Arm's length compensation for the restructuring itself;
- (3) Remuneration of post-restructuring controlled transactions; and
- (4) Recognition of the actual transactions undertaken.

In several respects the draft significantly widens government authority to challenge business restructuring transactions under the OECD's existing guidelines. The most significant of these are a number of exceptions to the general rule that governments should base transfer pricing analysis on the transactions and agreements as structured and adopted by the taxpayer. The draft allows for piecemeal re-characterisation of individual contract terms where substance is found to differ from form, or where the terms are not arm's length. This appears to mark a significant departure from current practice. The current commentary on Article 9 in the model treaty deals with any such discrepancies via pricing adjustments, not by adjusting contractual terms or re-characterising transactions. The issues surrounding 'substance over form' adjustments and 'non-arm's length terms' adjustments are treated in slightly different ways. Where substance differs from the discussion draft requires the use of hindsight. That is, if the parties to the agreement did not do what they originally contracted to do, then the suggestion is to change the relevant contractual terms. This does not appear to be an arm's length remedy and the OECD has not previously endorsed the use of hindsight in this manner. In addition it is suggested that adjustments to contractual terms are to be allowed where the terms would not have been agreed by third parties in similar circumstances. This is despite the fact that the Discussion Draft reiterates that associated enterprises may engage in transactions that independent enterprises would not undertake. The Draft does not state what would be interposed if terms were found not to be arm's length. Overall the draft makes it clear that companies adopting transactions or assigning risks in ways that would not be commercially sensible in unrelated party dealings may have those transactions challenged.

The discussion draft suggests that in a reorganisation exit taxes should be imposed at the time of a restructuring only if valuable intangible assets are in fact transferred. However, the Draft takes a broad view of what constitutes a valuable intangible asset for this purpose. It suggests that whether a change in the entity entitled to recognise a future profit should give rise to current tax will turn on the specific facts, including actual and implied expectations under contracts. This discussion of transfers of "profit potential" has created significant concern that countries will try to use the Discussion Draft to impose exit taxes in the context of a business restructuring even in the absence of a transfer of readily discernable assets.



*Other major issues raised by the discussion draft include:*

- (1) whether assets are relegated into a position of secondary importance relative to functions in analysing the impact of a particular transaction;
- (2) whether transactions which are commercially rational at multinational company (MNC) level can be disregarded at the subsidiary level;
- (3) whether the strong emphasis on high standards of comparability with the inference that if unique functions exist they are unlikely to be capable of being benchmarked may lead to increased use of profit split methods; and
- (3) whether these interpretations should have retrospective effect.

## 4 Establishing a transfer pricing policy: practical considerations

### 401 Arm's length pricing: market prices

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

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

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

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

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

in three categories: functions (see Section 405), risks (see Section 406), and intangible and tangible assets (see Section 407).

#### **402 Functional analysis**

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

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

#### **403 Interviews**

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

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

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

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

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

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

#### **404 Other information or documents required**

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

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

#### **405 Functions**

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

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

the chemical industry, where the company's name may be of limited importance compared with the specific chemical properties of the product.

Several functions are particularly important in the context of a manufacturing company. The first is the materials purchasing function. For instance, does the parent corporation purchase raw materials on behalf of its manufacturing subsidiary and then consign those materials to its subsidiary, or does the subsidiary purchase its own raw materials? The selection of materials will naturally have a significant impact on the price and quality of the finished goods, the reliability of supply and other areas of the business process.

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

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

#### **Table 4.1 Typical business functions**

---

- Product research, design and development
- Purchasing materials, supplies and equipment
- Controlling stocks of raw materials and finished goods
- Developing and administering budgets
- Quality control
- Production of finished goods
- Packaging and labelling of products
- Sales
- Marketing
- Shipping of products to customer
- Facilities engineering
- Personnel
- Manufacturing engineering
- Maintenance: building, grounds and equipment
- Electronic data processing
- Public relations
- Production planning and scheduling
- Industrial engineering
- Management and supervision of offshore operations
- Manufacturing site selection

- Administrative services
  - Government affairs
  - Finance and control
  - Accounting services
  - Arranging product liability insurance
  - Establishing and controlling pricing policy
  - Technical service
- 

#### 406 Risks

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

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

#### Table 4.2 Typical business risks

---

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

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

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

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

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

Inventory risk is another factor that should be investigated in every transfer pricing study. Both raw materials and finished products inventory risk are particularly important but work in progress may also be material (for instance, the value of 'work in progress' for a whisky distiller, which needs to age the stock for many years before it can be sold as premium aged Scotch).

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

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

It is also important to consider how contract law might be used to deal with the location of risk in this area. For instance, it might be that a manufacturing operation

is obliged by local law to be responsible for all environmental risks associated with its activities. However, its parent company might be able to establish indemnity arrangements to cover this risk, effectively shifting the local, legally imposed risk to another jurisdiction.

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

#### **407 Intangibles**

Table 4.3 provides a list of typical intangible assets.

---

#### **Table 4.3 Typical intangible assets**

---

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

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

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

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



might, in reality, be an appreciating asset.

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

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

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

#### **408 Characterisation of businesses**

Characterisation of the related parties is an important component to a transfer pricing analysis and is typically used as the foundation in developing the economic analysis. Characterisation of businesses means making comparisons of the functions and risks of the related entities under review and comparing those to uncontrolled entities that exist in the same or similar industry. Such characterisation involves using information from the functional analysis and information about the industry.

#### **409 Contract manufacturers and fully-fledged manufacturers**

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

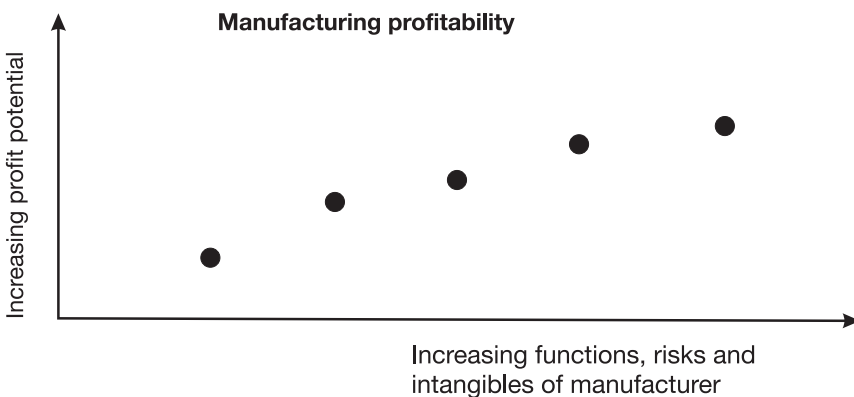
Contract manufacturers provide manufacturing services to fully-fledged manufacturers. They do not develop their own product lines but offer expertise in performing certain manufacturing functions only. They may or may not perform such functions as materials purchasing and production scheduling or own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

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

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

**Table 4.4 Characterisation of manufacturing entities**

| <i>Contract manufacturer</i>   | <i>Fully-fledged manufacturer</i>   |
|--|---|
| <ul style="list-style-type: none"> <li>● Does not own technology</li> <li>● Little risk</li> </ul>   | <ul style="list-style-type: none"> <li>● Owns technology</li> <li>● Full of risk</li> </ul>   |
| <ul style="list-style-type: none"> <li>● Little discretion in production scheduling</li> <li>● Does not totally control equipment</li> <li>● Scheduling</li> <li>● Quality control usually dictated</li> </ul> | <ul style="list-style-type: none"> <li>● Purchasing</li> <li>● Production scheduling</li> <li>● Select own equipment scheduling</li> </ul>  |
| <ul style="list-style-type: none"> <li>● Usually manufacturing high volume, high volume mature products</li> </ul>   | <ul style="list-style-type: none"> <li>● Direct control over quality by customer</li> <li>● Manufacturing products at all high volume mature products stages of product life cycle</li> </ul> |



It should be noted in the diagram above that greater functions/risks may not only have greater profit potential but may also have greater loss potential.

#### **410 Characterisation of distribution/selling companies**

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

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

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

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

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

Table 4.5, after 411, summarises the salient characteristics of each of these types of sales entity and indicates their relative profitability.

#### **411 Goals of the multinational corporation**

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

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

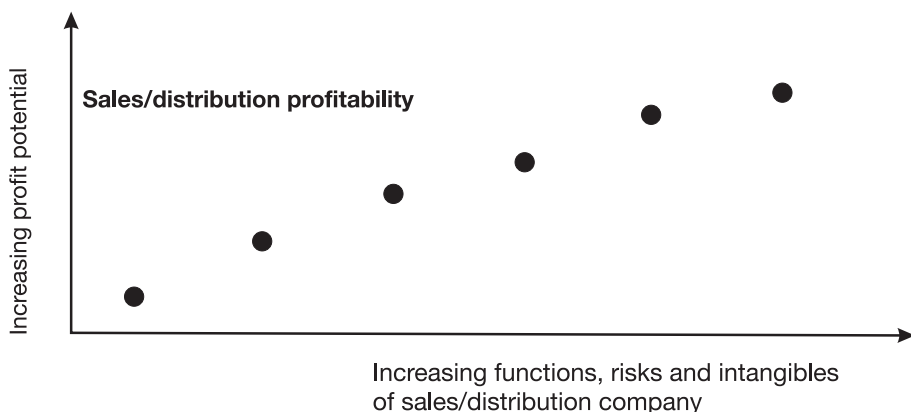
A company may have overriding business reasons for wanting to place functions, risks and intangibles in certain locations. For example, the goal may be to rationalise global production, or centralise management, financial and marketing functions to improve efficiency and reduce costs, or it may be necessary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

A key goal of most multinationals is to minimise the global tax charge. Corporate

income tax rates vary across countries and form an important consideration in establishing a transfer pricing policy. Because the arm's length standard for transfer pricing requires that pricing, and thus profit, be based on the substance of a transaction, corporate restructuring, which places important functions, risks and intangibles in jurisdictions that have lower tax rates will result in a lower overall tax rate for the group, maximising earnings per share. Some examples of these possible restructuring techniques are set out in Sections 412–419.

**Table 4.5 Characterisation of distribution/selling companies Sales/ Distribution profitability**

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



It should be noted in the diagram above that greater functions/risks may not only have greater profit potential but may also have greater loss potential.

#### **412 Manufacturing opportunities**

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

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

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

#### **413 Centralised support activities**

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

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

#### **414 Selling companies**

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

#### **415 Contract service providers**

In addition to contract manufacturers (see Section 409), there are other types of contract service companies. These include contract R&D and contract marketing. Such entities are typically established for commercial reasons and can be structured as service providers to minimise tax or to place ownership of valuable intangibles created by the R&D or marketing activity in a central location.

#### **416 Contract research and development**

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

This construction is useful in the inter-company pricing context when the parent wishes to conduct R&D in several countries but wishes to retain legal ownership of the intangibles (and therefore the profit created by the R&D) in a single country. Contract R&D places the risk in the country that will ultimately own the technology.

#### **Example**

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

conduct all the research and development activities for these raw materials.

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

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

#### **417 Other reasons for establishing contract research and development**

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

##### **Example**

Semi-Chips, Inc. (a US company) has been manufacturing and selling custom-designed semi-conductor equipment for Semiconductor original equipment manufacturers (OEMs) in the US for ten years. It recognises that a vast majority of Semiconductor OEMs (its direct customers) have moved operations to Asia. As such, the Company has determined to establish a subsidiary in Taiwan to be closer to its customers. At the same time, the Company has noticed that because of the large amount of semiconductor manufacturing activities in Asia, there exists a great deal of technical expertise in Taiwan. Due to this fact, the Company determines that it is more efficient for the Taiwanese subsidiary to also conduct R&D activities for products on its behalf.

The new Taiwanese subsidiary is capitalised by Semi-Chips, Inc. with USD1 million and sets about hiring Taiwanese scientists to conduct the R&D. The subsidiary does not have the cash to pay these scientists; therefore, the parent establishes a contract R&D arrangement and pays the Taiwanese subsidiary its costs plus an arm's length mark-up for its services.

**418 Contract maintenance**

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

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

**419 Contract marketing**

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

**Example**

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

**420 The evaluation of pricing options**

This chapter has examined the way in which functional analysis can be used to characterise a business and has looked at some examples of particular ways in



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

#### **421 The search for comparables**

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

##### **Example**

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

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

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

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

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

- (1) the Japanese parent may have sold the same fishing equipment to an unrelated distributor in the US; or
- (2) the US subsidiary may have purchased the same fishing equipment from an unrelated manufacturer; or

- (3) an entirely separate operation, Company A, may have manufactured identical fishing equipment and sold it to Company B (unrelated to Company A), which serves as its distributor in the US.

Rarely do transactions such as these exist due to the stringent product comparability requirements. However, if it is possible to identify such transactions, it would be necessary to determine whether they could be applied directly or whether adjustments must be made to the CUP to account for elements of the CUP that differ from the related party transactions (see Section 304).

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

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

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

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

When these obstacles to using the resale price-method cannot be overcome, as is often the case, the Transactional Net Margin Method (TNMM) under the OECD Guidelines or the Comparable Profits Method (CPM) in the US transfer pricing regulations, discussed in Chapter 3 would most likely be applied. When using the CPM/TNMM, the degree of functional comparability between the tested party and the uncontrolled distributors is less than that required under the resale price method to obtain a reliable result. To search for comparables under the CPM/TNMM, a search for external comparable independent distributors with broadly similar functions as the tested party, i.e. Fishy US, using information obtained from the functional analysis, is conducted. Once this set of comparable companies is established, the profitability results of the distribution business of Fishy US are benchmarked against the profitability results of the uncontrolled distributors. If Fishy US' profitability results fall within the range of profitability results established by independent distributors, Fishy Fish should be treated as having reasonably concluded that its transactions with Fishy US were at arm's length.

#### **422 Identifying appropriate comparables**

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

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

#### **423 Internal comparables**

It is advisable to perform a thorough analysis of group transactions to ascertain whether any comparable transactions with third parties exist. There are a number of reasons why internal comparables may be preferable to external comparables:

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

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

#### **Example**

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

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

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

Identification of internal comparables may be made through:

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

#### **424 External comparables**

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

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

- (1) government sources, e.g. statutory public filing requirements and government trade department publications;
- (2) commercial databases;
- (3) industry associations; and
- (4) knowledge of employees.

There are many sources of information for conducting a search for comparable transactions. The most important include the operating personnel, who know their industry and the characteristics of competitors, and can frequently provide valuable sources of information about competitors and potential comparables.

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

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

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

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

The test of reasonableness should be based on a financial analysis of the projected results on applying the comparative information (see Section 428).

#### **425 Functional analysis and comparable information – an overview**

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

**Example**

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

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

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

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

**426 Documentation**

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

**427 How to document a policy**

In the past there was little guidance on the appropriate level of documentation needed to support a transfer pricing policy. In many countries, the fact that the burden of proof lay largely with the tax authority gave little incentive for work in this area. However, the US provided a lead at the start of the 1990s, culminating in regulations that impose heavy penalties for transfer pricing adjustments unless the taxpayer holds contemporaneous documentary evidence that it was reasonable to believe that the policy was in fact arm's length (see Chapter 8 for a detailed discussion of the US position). As more tax authorities began to take transfer pricing matters seriously, it was recognised that documentation standards were important and new regulations have now emerged in many countries. The OECD also devoted attention to the matter in Chapter V of the Guidelines, which was part of the work published in 1995. As a

general guide, however, a defensible transfer pricing policy will require documentation covering the following areas in order to demonstrate how the policy complies with the arm's length principle:

- (1) a description of the transfer pricing methodology used to test the arm's length nature of the inter-company transactions;
- (2) guidelines interpreting the choice of the methodology;
- (3) inter-company legal agreements;
- (4) functional analysis of the entities involved;
- (5) comparables supporting the policy;
- (6) financial analyses of the comparables as well as the tested party; and
- (7) industry evidence required to substantiate the decisions made.

#### **428 Financial analyses**

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

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

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

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

To the extent possible, the chosen allocation method should first make direct allocations where particular expenses can be definitely and accurately matched to a specific business line. Then, indirect allocations of other expenses may be made on a reasonable basis. (Examples of allocation bases for this purpose include sales, gross profit, volume and head-count ratios.)

The aim of this exercise is to produce an income statement that reflects what the company's results would be if a particular business line grouping were its only

business. (One of the reasons for constructing such a statement is that, when comparables are found, the results of one line of business may be compared with the results of independent companies that operate only that line of business.)

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

### Example

Continuing with the example in Section 421, income statements for Fishy US are constructed. In 2007, sales to Fishy US are 80. Assume that Fishy US's sales to its customers during this period are 100. The following income statement reflects these transactions:

|  | Fishy Fish | Fishy US | Consolidated |
|--|------------|----------|--------------|
| Net Sales                                    | \$ 80      | \$ 100   | \$ 100       |
| Cost of Sales                                | 56         | 80       | 56           |
| Gross Income                                 | \$ 24      | \$ 20    | \$ 44        |
| Gross Margin %                               | 30.0%      | 20.0%    | 44.0%        |
| Selling, General and Administrative Expenses | 21         | 18       | 39           |
| Operating Income (Loss)                      | \$ 3       | \$ 2     | \$ 5         |
| Operating Margin                             | 3.8%       | 2.0%     | 5.0%         |

## 429 Evaluation of financial analyses

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

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

### Example

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

The gross margin for the manufacturer is 30% and the gross margin for the distributor is 20%. As previously mentioned Fishy US is the tested party in our transaction since it is the less complex party and does not possess valuable intangible assets. Comparable manufacturing margins are much harder to judge, primarily because of the return on intangible assets that they reflect.

Fishy US's gross margin is 20% and other comparable distributors of similar

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

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

#### **430 Transfer pricing policy**

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

#### **431 Transfer pricing guidelines**

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

#### **432 Inter-company agreements**

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

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

#### **433 Documentation of the functional analysis**

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

#### **434 Documenting the comparables**

All information gathered about the comparables, e.g. financial statements and functional analyses, should be retained in a useful form so that it can be referred to in



presenting explanations to the tax authorities. Updates of financial statements from those comparables should be collected annually to be sure that the prices applied continue to reflect the arm's length standard. It will also be important to update the search for comparables on a regular basis (as independent companies enter or leave the market) to ensure that the sample used for analysis remains as complete as possible.

### **435 Income statements**

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

### **436 Industry evidence**

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

### **437 Implementing a transfer pricing policy**

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

The implementation process itself will depend upon the nature of the business and the pricing structure but in all cases implementation is more likely to be successfully achieved if employee politics and sensitivities are fully considered. In particular, relocation of functions and adjustments to employee pay or bonus schemes (see Section 623) require careful handling.

### **438 Monitoring the application of the policy**

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

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

The policy should be examined quarterly until it is clear that it is working. After that, semi-annual examinations are usually sufficient unless the industry is inordinately volatile. The evaluation should include an examination of the financial results realised under the policy. That is, financial ratios and profit splits should be calculated and examined to ensure the policy is producing the anticipated results. If it is not, the

reasons for this should be determined and appropriate adjustments made.

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

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

#### **439 Compensation of management**

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

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

# 5 Specific issues in transfer pricing

## MANAGEMENT SERVICES

### 501 Management fees – introduction

The term 'management fee' is often used rather loosely to describe any inter-company charge for a transaction that is not clearly either a transfer of tangible property or the right to use an intangible property. In this chapter, the term is used to describe charges paid for general administrative or technical services or payments for commercial services that are provided intra-group from one or more providers to one or more recipients. Chapter 2 considered the types of services that might be provided between related companies. This chapter focuses in more detail on some of the problem areas, on the methods of determining arm's length charges for the services and the documentation needed to support the arrangements.

### 502 The importance of management fees

For many years it has been recognised that multinationals find it necessary to provide certain services from a central point to one or more affiliates and that for many such services it will be appropriate for a charge to be made. The 'central point' for service rendering is often the parent company itself, although this is by no means always the case. It is becoming common for one affiliate to provide services on a central basis to several other affiliates. Examples include company HQs located in Europe to provide centralised marketing, management and accounting assistance to all European entities in a non-European group. In these situations, cost contribution (or shared-service) arrangements can be constructed to charge the costs of the service providers to the affiliates that benefit from the services they provide.

Whatever the detailed arrangements in any particular group, it is usually relatively difficult either to find a comparable price for such services or to evaluate the benefit received. Because of this difficulty, rightly or wrongly, many tax authorities regard the area of management fees as particularly prone to potential abuse and are therefore devoting increasing resources to auditing such transactions as these charges are considered the 'low-hanging fruits' and support for them are oftentimes lax. At the same time, the increasingly competitive global marketplace is demanding greater efficiency from multinational businesses. They must take every opportunity to minimise costs down, so there is an ever-greater need to arrange for the centralisation of business functions where possible.

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

expenses to the 'correct' companies, ensuring that tax deductions are obtained for these costs.

### **503 The tax treatment of management fees – an overview**

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

### **504 Management fees in the developed world**

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

- the exact nature of the services that are to be performed;
- which entities are to render the services;
- which entities are to receive the services; and
- what costs are involved in providing the services.

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

### **505 Dealing with shareholder costs**

Central services include services provided to:

- (1) one or more specific companies (perhaps including the parent company), for the specific purposes of their trading activities (e.g. marketing advice);

- (2) a range of companies (perhaps including the parent), for the general benefit of their businesses (e.g. accounting services); and
- (3) the parent company, in its capacity as shareholder of one or more subsidiaries. The costs in the last category are generally known as shareholder costs. They are the responsibility of the parent company and should not be borne by other group members. If incurred by the parent, the cost should remain with the parent. If incurred elsewhere, the expense should be recharged to the parent, possibly at a mark-up. Once costs for shareholder functions have been dealt with, it is necessary to consider charging for other services. Recent developments in the United States (i.e., the Temporary and Proposed Service Regulations) have put a renewed emphasis on the evaluation of inter-company service transactions dealing with a plethora of issues in this area. Of the many services considered, these new regulations have re-defined, or narrowed the definition of 'shareholder' expenses to those expenses that 'solely' benefit the parent company. The focus of the new US Regulations was to be more consistent with the OECD Guidelines; however, the new definition in the context of shareholder expenses may prove problematic because of its restrictiveness. This creates a new aspect that multinationals (particularly US-based companies) must now consider as the potential for challenges of deductibility for non-shareholder costs may be initiated by the provider country. (See Chapter 9)

### **506 Analysing the services**

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

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

#### **Example**

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

- accounting assistance was provided to the subsidiaries by the parent to assist them in keeping their local accounts;
- management of the group's internal IT system, which the group members use to track its customer accounts;
- marketing assistance was provided by EM in the form of recommendations for advertisements and promotional campaigns; and
- provision of marketing assistance by EM in the form of sales brochures that have been localised to the local customer base. These brochures are used by the foreign affiliates in their distribution operations.

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

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

The remaining matters to be considered are whether or not a mark-up can be applied and whether it makes sense to make a charge to Bermuda, given that no effective tax relief will be obtained.

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

The reports of the OECD (see Section 301) state that there may be circumstances in which comparable data may be available, for instance where a multinational establishes its own banking, insurance, legal or financial services operations. Even here, however, great care is needed in comparing group activity with third party businesses. Third parties face the challenge of the real market whereas group

companies are often forced to buy the internal services when available. A group insurance company will be dealing with the risks of one business only, rather than a multitude of different customers. These examples merely illustrate that comparables will be hard to find for group service activities, even where similar services appear to be offered by third parties.

### **507 The cost base for service charges**

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

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

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

### **508 The cost-accounting method**

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

### **509 The computation on a full cost basis**

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

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

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

supplier on some reasonable basis would be accepted in most countries.

The US Temporary and Proposed Service Regulations, effective for tax years commencing after 31 December 2006, require the inclusion of stock-based compensation in the costs associated with a particular service. This change has proven controversial as third party dealings typically do not include such costs in their service cost base nor does stock-based compensation ever enter into consideration in third party negotiations. Nevertheless, the inclusion of stock-based compensation is part of the new regulations and hence companies should consider the impact of these regulations on their inter-company service transactions. There will undoubtedly be controversy related to this issue in the recipient jurisdictions as US multinationals are 'forced' to comply with these new rules; especially in those jurisdictions where stock-based compensation are non-deductible, or if deductible, subject to stringent policies in non-US jurisdictions. (See Chapter 9)

### **510 When should a profit margin be added to cost?**

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

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

- (1) where the service company's only business activity is rendering services;
- (2) where service costs are a material element in the cost structure of the service provider; or
- (3) where the service costs represent a material part of the cost structure of the service recipient. Most tax authorities in developed countries accept these conditions as relevant in reviewing the application of a mark-up to service costs. However, a more formalised approach is taken in certain instances, particularly in the US. As noted in section 923 of this book, the US Temporary Regulations on services require the addition of profit margin to the intra-group charge for services rendered where the services provided are not considered 'low margin' services, or the median arm's length mark-up for such services exceeds seven percent.

When it is appropriate to include a profit element on service charges, arm's length mark-ups are determined by reference to comparables where possible. Once the service is identified, the cost of providing the service is determined and comparables are sought to determine the arm's length mark-up for those costs. In practice, many tax authorities expect to see certain levels of profit margin as the norm, typically between 5 - 10% of costs for most support services. However, as global competition gears up, companies should take care to ensure that the higher historical norms are



not allowed to prevail in inappropriate circumstances, or the internal service provider may prove to be a cost-creating mechanism rather than a vehicle to enhance efficiency. Furthermore, great care must be taken in deciding which costs should be marked up. It is the service function for which a charge is being made. If the service provider incurs third party expense (for instance arranging for advertising space to be made available for its client), then it may well be correct to evaluate the advertising costs as an expense reimbursement (covering disbursements, financing and handling charges). It will invoice for the service of arranging it (labour, phone, office costs, etc) on a cost plus basis. The total costs recharged would be the same but the profit recognised in the service provider would differ significantly.

### **511 The determination of an arm's length service charge**

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

#### **Example**

Continuing the example in Section 506, it has been determined that three services have been provided for which it is appropriate to make inter-company charges:

- (1) assistance with the determination of arm's length service fees;
- (2) provision of marketing assistance in the form of sales brochures; and
- (3) accounting assistance.

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

in the developing the brochures as well as any external printing costs. The charges could be allocated on the relative basis of brochures shipped or other allocation keys deemed more appropriate.

## **512 Documentation**

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

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

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

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

### *Contract services and shared service centres*

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

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

Finally, the search for access to the best resources for a task at the lowest price is leading to the creation of contract research and development (R&D) centres and contract manufacturing activities. The idea here is that the multinational can tap into what it requires without impacting its strategy for managing intellectual property or manufacturing, while tightly controlling the costs. The best known example of contract R&D comes from the US case, Westreco, in which the Swiss group Nestlè was involved. Nestlè wanted to conduct research into the US market in order to design successful products for that market. If this research had been financed by Nestlè's US operation, any intangibles created would have belonged in the US and subsequent profits derived would have been taxable there. Instead, Nestlè established a contract research operation that sold its services to the Swiss operation, which thereby owned the resultant intangibles. Subsequent exploitation by way of licence was therefore possible.

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

## **TRANSFER OF INTANGIBLE PROPERTY**

### **513 Transfer of intangibles – introduction**

Generally, intangible assets can be transferred between related parties in three ways:

contribution to capital, sale, or licence. In addition, the parties may have agreed to share the costs and risks of the development of an intangible through a cost sharing arrangement or otherwise referred to in the OECD Guidelines as a cost contribution arrangement.

#### **514 Sale for consideration**

When intangibles are sold, tax laws in most countries require that the developer/owner receive the fair market value of the intangible at the time of transfer (see Chapter 9 for a detailed discussion of the US perspective on this issue). The geographic rights to the property that is sold can be broad or narrow. For example, the developer may sell the North American rights to the property. Alternatively, the developer may sell the worldwide rights for uses other than for the use that it wishes to keep for itself. For example, in the pharmaceutical industry, the developer may keep the rights for human use while selling the rights for animal use.

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

#### **515 Licence**

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

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

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

### **516 Determination of arm's length royalty rates**

Determining the proper compensation due to the developer/owner of intangible property can be difficult. In setting an arm's length royalty rate it is important to distinguish, as precisely as possible, what property is to be licensed. Once the property is identified, the rights granted to the licensee and their relative value is determined. The property may be an 'ordinary' intangible in that it provides some, though not complete, protection from competitors (this type of intangible is sometimes referred to as a 'typical' or a 'routine' intangible). Alternatively it may constitute a 'super'-intangible, which effectively gives the licensee a monopoly or near-monopoly over the market in question. There is no difference in the approach to setting an arm's length royalty, however. The concept of 'super-intangibles' is mentioned here for completeness only. It arose following the 1986 Tax Reform Act in the US. One of the key issues included was a requirement that the licence income to be enjoyed by a licensor in the US from an overseas affiliate, should be 'commensurate with the income' associated with the intangible. There was concern that insufficient royalty income was being derived from US intangibles that proved to be valuable after being licensed overseas. There was considerable concern outside the US that excessive use has to be made of hindsight in this area (see Chapter 9 for further details).

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

#### **Example**

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

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

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

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

the rights within North America and the related party licence grants the licensee the rights to European markets.

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

### **517 Determining an arm's length royalty rate in the absence of perfect comparables**

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

#### **Example**

Assume that the ZapAway agreement (see Section 516) does not exist, i.e. ACAG does not licence the property to any third party. However, another competitor licences a similar product (another grass stain remover) to a third party. This licence agreement is subjected to the same analysis discussed in Section 516. If the differences either do not affect the royalty rate or can be valued, then this third party licence arrangement can be used as a basis for the determination of the arm's length royalty between ACAG and its Irish subsidiary.

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

- (1) the expected profits attributable to the technology;
- (2) the cost of developing the technology;
- (3) the degree of protection provided under the terms of the licence as well as the length of time the protection is expected to exist;
- (4) the terms of the transfer, including limitations on geographic area covered; and
- (5) the uniqueness of the property.

### **518 Super-intangibles**

Super-intangibles are those that give the owner a monopoly or a near-monopoly in its product class for a significant period of time. It is unlikely, due to their nature, that close comparables exist for these intangibles. However, occasionally a developer may not wish to market the product resulting from an invention (or does not have the

capital required to exploit the invention) and chooses to licence it to a third party. Even in the case of super-intangibles, a comparables search should be completed to ascertain whether or not comparables exist.

### **519 Valuation of royalty rates for super-intangibles**

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

#### **Example**

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

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

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

**US PARENT****Functions**

- Research and development
- Marketing (on royalty)
- Technical assistance

**Risks**

- Foreign exchange (on royalty)
- Trademark

**Intangibles**

- Patent
- Unpatented know-how

**IRISH SUBSIDIARY****Functions**

- Manufacturing

**Risks**

- Warranty
- Obsolete Products

**Intangibles**

- None

**Table 5.1 Functional analysis**

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

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

**COST SHARING****520 Cost sharing – introduction**

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



allocation under a CCA is consistent with the arm's length principle is whether the allocation of costs among the CCA participants is consistent with the parties' proportionate share of the overall expected benefits to be received under the CCA.

Cost sharing is based on the idea that a group of companies may gather together and share the expenditure involved in researching and developing new technologies or know-how. By sharing the costs, each participant in the arrangement obtains rights to all the R&D, although it funds only a small part of the expense. As soon as a viable commercial opportunity arises from the R&D, all contributors to the cost sharing arrangement are free to exploit it as they see fit, subject to any constraints laid down by the agreement (see Sections 522 and 523). Such constraints typically include territorial restrictions on each participant regarding sales to customers.

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

### **521 Advantages of cost sharing**

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

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

### **522 Cost sharing arrangements**

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

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

All participants in a cost sharing arrangement must be involved in the decision-

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

### **523 Cost sharing agreements**

Because cost sharing is a method of sharing the costs and risks of the development of intangibles, the key to cost sharing is that the agreement exists prior to the development of the intangibles so that all parties share the risk of development, i.e. cost sharing is a method of funding the development process. Each participant in the cost sharing arrangement must bear its share of the costs and risks and in return will own whatever results from the arrangement. For a description of cost sharing after the development of the intangible has already begun, see Section 529, 'Establishing cost sharing arrangements in mid-stream.'

### **524 Allocation of costs among participants**

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

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

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

in the context of the relevant provisions of the Australian income tax law.

The most notable exception from following the OECD Guidelines is the US. The US has issued final regulations in 1995 (the 1995 US final cost sharing regulations), and new proposed regulations in 2005 (the 2005 US proposed cost sharing regulations) which at the time of this writing are expected to be finalised in 2007. Where authorities do have rules, such as the US rules on cost sharing arrangements, there is a growing tendency for the rules to be complex and restrictive. Furthermore, prior to the issue of Chapter VIII of the OECD Guidelines, there was some variation between different taxing authorities as to whether or not profit margins are acceptable within cost sharing arrangements. As noted above, Chapter VIII of the Guidelines now focuses upon whether the allocation of costs among the participants reflects the relative benefits inuring to the parties. This point can be illustrated by considering a cost sharing arrangement.

### **Example**

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

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

## **525 Deductibility of cost sharing payments**

As noted in Section 522, cost sharing arrangements may be entered into by third parties and it follows, therefore, that similar arrangements should be regarded as, *prima facie*, arm's length where entered into by related companies. However, a key issue as far as each taxation authority is concerned, is whether or not the net costs borne by the entity under their jurisdiction are deductible for tax purposes on a revenue basis. In order to determine the deductibility of these costs, there will need to be reference to the tax treatment of specific types of expenditure under local law and practice. Thus, it will be decided whether the costs incurred qualify as a revenue deduction or whether they should, for example, be treated as capital (in whole or part) and therefore subject to different rules.

The more fundamental question, however, is whether the proportion of cost allocated to the company under review is reasonable. This necessarily requires a review of the total cost sharing arrangement. It is not uncommon for a tax authority to require a detailed examination of the cost sharing arrangement at group level and not just at the level of the company they are looking at. Thus they will need to see the cost

sharing agreement in writing and be convinced that it was entered into in advance and that the basis on which costs are allocated is reasonable. They will require convincing that the costs being accumulated are in accordance with the agreement and do not include costs not covered by the agreement. They will wish to see that the company they are auditing has a reasonable expectation that proportionate benefits will accrue from the cost sharing payments.

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

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

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

Local country laws vary as to whether any particular item of expenditure is deductible or not. If the amount being charged under the cost sharing arrangement is the proportionate share of assets of a capital nature such as machines, buildings, etc, questions may arise as to whether the cost will be treated as revenue or capital, both for accounting purposes and tax purposes.

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

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

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

Looking at the question of whether or not a profit margin should be added to the pool of costs allocated among the sharers, an earlier report of the OECD concluded that it would normally be appropriate for some kind of profit element to be included but that it should relate only to the organisation and management of R&D and not the general investment risk of undertaking it, as that risk is being borne by the participants.

As noted above, however, Chapter VIII of the OECD Guidelines now focuses upon whether the allocation of costs among the participants reflects the relative benefits inuring to the parties. A profit element is thus no longer to be allocated among the participants in the cost sharing arrangements.

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

### **526 Cost sharing adjustments**

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

### **527 Cost sharing and risk**

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

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

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

when tax authorities might identify an area as worthwhile for investigation.

Once implemented, it is imperative that all parties are actively involved in monitoring the cost sharing arrangement. Care should be taken to ensure that the legal form of the cost sharing agreement reflects its substance. In addition, the documentation of the active involvement of the members in policy setting, monitoring and controlling the cost sharing agreement on a current basis is indispensable.

### **528 The participants**

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

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

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

### **529 Establishing cost sharing arrangements in mid-stream**

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

- (1) buy-in payments; and
- (2) the business issue regarding the location of ownership of intangible property. That is, which entity or entities is/are characterised as the developer of the intangible. Under the OECD Guidelines, the developer is the entity that acquires legal and economic ownership of the intangible property.

### **530 Buy-in arrangements**

When a group decides to form a cost sharing arrangement to fund the 'development' phase, as opposed to the 'research' phase of R&D, an important issue arises. It

concerns whether or not a payment should be made by a company entering into a cost sharing arrangement with the owner of existing technology. This concept, known as 'buy-in', has been under debate for some time but came under widespread review following the publication of a White Paper by the Internal Revenue Service (IRS) in the US in 1988. This White Paper interpreted the transfer pricing proposals contained in the Tax Reform Act of 1986 in the US, which obtained widespread publicity. Most tax authorities are now aware of the concept of 'buy-in' and are in the process of considering the issues raised by this concept.

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

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

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

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

The 2005 US proposed cost sharing regulations refer to 'buy-in' payments as preliminary or contemporaneous transactions (PCTs) and expand the definition of intangible property subject to a PCT payment to potentially include workforce, business opportunity and goodwill. Under this new definition, the contribution of an experienced research team in place would require adequate consideration in the buy-in payment. Furthermore, the 2005 US proposed cost sharing regulations expand the rights required to be transferred in order to eliminate a perceived abuse where the transfer of limited rights could result in lower PCT payments. Therefore, under these proposed regulations, the PCT payment must account for the transfer of exclusive, perpetual and territorial rights to the intangible property. Finally, the 2005 US proposed cost sharing regulations do not allow a reduction in the PCT for the transfer of existing 'make or sell' rights by any participant that has already paid for these rights.

In addition, the 2005 US proposed cost sharing regulations introduce the 'investor model' approach which provides that the amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participants'

aggregate net investment in developing cost shared intangibles pursuant to a CCA, attributable to both external contributions and cost contributions, is reasonably anticipated to earn a rate of return equal to the appropriate discount rate. These new proposed rules are discussed in more detail in Sections 915 – 922.

Chapter VIII of the OECD Guidelines supports the use of buy-in payments as the incoming entity becomes entitled to a beneficial interest in intangibles (whether or not fully developed), which it had no rights in before. As such, the buy-in would represent the purchase of a bundle of intangibles and would need to be valued in that way (i.e. by applying the provisions of the Guidelines for determining an arm's length consideration for the transfers of intangible property.)

It should be noted that the terminology employed in Chapter VIII of the Guidelines, the 1995 US final cost sharing regulations and the 2005 US proposed cost sharing regulations with respect to this concept is somewhat different. Under Chapter VIII, a 'buy-in' is limited to a payment made by a new entrant to an existing cost sharing arrangement for acquiring an interest in the results of prior activities of the cost sharing arrangement. Similarly, a 'buy-out' refers only to a payment made to a departing member of an existing cost sharing arrangement. Chapter VIII refers to any payment that does not qualify as a buy-in or a buy-out payment (for example, a payment made to adjust participants' proportionate shares of contributions in an existing cost sharing arrangement) as a 'balancing payment'. In contrast, the 1995 US final cost sharing regulations use the terms more broadly. Buy-in and buy-out payments refer to payments made in the context of new, as well as existing, cost sharing arrangements under these regulations. There is no such thing as a balancing payment in the 1995 US final cost sharing regulations. In further contrast, the 2005 US proposed cost sharing regulations refer to 'buy-in' payments as PCTs for which the controlled participants compensate one another for their external contributions to the CCA. In addition, post formation acquisitions (PFAs) occur after the formation of a CCA and include external contributions representing resources or capabilities acquired by a controlled participant in an uncontrolled transaction.

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

### **531 Ownership of intangibles**

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



**Example**

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

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

In order to implement the cost sharing arrangement, BU must address the following issues:

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

Because the Irish subsidiary has been paying for the pre-existing technology through the licence agreement, it is determined that this arm's length royalty rate is sufficient under Chapter VIII of the OECD Guidelines to compensate BU for the existing technology. However, under the 1995 US final cost sharing regulations, the buy-in payment is required to be the arm's length charge for the use of the intangible under the pertinent provisions of the US transfer pricing regulations, multiplied by the Irish subsidiary's anticipated share of reasonably anticipated benefits. The prior royalty payments will likely be insufficient and the Irish subsidiary will have to pay a buy-in payment to the parent to the extent that the royalty payments made are less than the required buy-in payment amount. In further contrast, under the 2005 US proposed cost sharing regulations, the prior royalty payments would be considered 'make or sell' rights which can not reduce the amount of the buy-in for the existing technology.

Under Chapter VIII of the OECD Guidelines, the cost of the R&D is calculated by aggregating the direct and indirect costs of the R&D activities; this is divided between BU and its Irish subsidiary, based on the relative sales of both entities. Under the 1995 US final cost sharing regulations and 2005 US proposed cost sharing regulations, the cost of the R&D is calculated by aggregating certain operating expenses other than depreciation or amortisation charges (i.e. expenses other than cost of goods sold, such as advertising, promotion, sales administration, etc), charges for the use of any tangible property (to the extent such charges are not already included in operating expenses) plus charges for use of tangible property made available by a controlled party. Costs do not include consideration for the use of any intangible property made available to the cost sharing arrangement. Under the 1995 US final cost sharing regulations, 2005 US proposed cost sharing regulations and Chapter VIII of the OECD Guidelines, these costs are

allocated between BU and its Irish subsidiary in proportion to their shares of reasonable anticipated benefits from the developed R&D.

The rights that will be granted to the Irish subsidiary under the agreement are the use of the technology in respect of sales outside North America. Under the 2005 US proposed cost sharing regulations, the rights granted to the Irish subsidiary must be the exclusive and perpetual use of the technology in respect of sales outside North America.

### **532 Other types of cost sharing agreements**

There are costs other than those involving R&D, which can also be shared through a cost sharing arrangement. For example, common costs such as accounting, management, marketing, etc, can be the subject of a cost sharing agreement among the affiliates that benefit from the services offered. (See sections 501–511 for further discussion of this type of cost sharing arrangement.)

## **FOREIGN EXCHANGE AND FINANCE**

### **533 Foreign exchange risk – introduction**

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

### **534 The arm's length standard**

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

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

**535 Types of exchange rate exposure**

The exchange rate exposures of a multinational enterprise can be categorised as translation (see Section 536), transaction (see Section 537) and economic (see Section 538) exposure.

**536 Translation exposure**

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

**537 Transaction exposure**

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

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

**538 Economic exposure**

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

- market structure;
- the nature of competition;
- general business conditions; and
- government policies.

**Example**

USM, a US-based manufacturer of auto parts, exports its product to UKD, its UK-based distribution subsidiary. UKD sells parts to unrelated retailers throughout

the UK. USM denominates the transfer price in pounds and converts its pound receipts into dollars. USM has adopted a resale price approach to set its transfer price for goods sold to UKD. The resale price method calculates the transfer price by deducting an arm's length mark-up percentage for UKD's distribution activities from the resale price.

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

### **539 Planning opportunities**

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

#### **Example**

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

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

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

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

to handle the invoicing and the collection activity plus foreign exchange managers to deal with hedging etc.

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

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

#### **540 Loans and advances**

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

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

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

- demand loans;
- term loans;
- temporary advances;
- open trading accounts; and
- cross-border guarantees or other collateralisation of an affiliate's outstanding debt.

#### **541 Characterisation of loans**

The issue of the characterisation, for tax purposes, of funds placed with a subsidiary as debt or equity was considered at Section 215. In summary, many countries have specific rules and/or practices that restrict the permissible level of related party debt and it is crucial to review these before adopting any amendments to the group's international financial structure.

#### **542 Interest on loans**

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

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

- the repayment terms, i.e. demand, short-term, long-term;
- covenants;
- collateralisation;
- guarantees;
- informal and temporary advances;
- open lines of credit;
- leasing arrangements that are not bona fide leases;
- trading accounts;
- the credit risk of the debtor, i.e. debt to equity ratio;
- volatility of the business;
- reliance on R&D or other high-risk investments such as oil and gas exploration;
- track record of affiliate;
- location of exchange risk; and
- the market – differences may exist among the markets of various countries, the regional market such as the European market or the Eurodollar market.

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

### **543 Loan guarantees**

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

### **544 Bona fide leases**

Leasing as a form of loan financing is discussed at Section 221. The use of a bona

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

#### **545 Establishing an arm's length rental rate**

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

- a comparable uncontrolled price;
- pricing based on economic depreciation of the leased asset;
- pricing based on interest and a profit mark-up for risk; or
- pricing based on any other method for establishing a reasonable rent.

## **E-BUSINESS**

### **546 Introduction**

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

Instantaneous transactions across international boundaries – which are quicker, more frequent, often highly automated and involve the greater integration of functions within a multinational group – potentially make it harder to perform a traditional analysis of functions, assets and risks. What is it that creates value, for instance, where huge costs may be taken out of the supply chain by the use of a software platform that links the whole chain from raw materials supplier to ultimate customer? Can one readily ascertain which party performs which specific function, and where? Given that current tax regimes work within international boundaries, and transfer pricing rules require one to attribute value to location, has it become even more difficult to establish where profit is made? And if one can successfully identify the transaction and its essential attributes, is there a readily available comparable transaction given the unique factual circumstances which, for now, may relate to certain e-business activities?

### **547 Transfer pricing issues for the business community**

If one looks at the new business models that are emerging, one begins to realise that there are opportunities to reduce the tax burden. Let us start with electronic marketplaces. These are the online exchanges and networked business communities,

usually involving established businesses, that allow these businesses to buy and sell products and services. These exchanges are often multi-member joint ventures with geographically diverse investors and newly hired management and staff. They are lean operations with high potential value and no loyalty to any particular geographical or business location. Despite the deflation of the dot.com bubble, interest in such business models continues, with some caution over the measure of benefits expected.

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

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

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

#### **548 Issues for tax authorities**

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

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

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



# 6 Managing changes to a transfer pricing policy

## 601 Introduction

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

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

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

## 602 Transfer pricing committee

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

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

The responsibility of the committee is to advise on whether or not the arm's length transfer pricing policy that the group has adopted is properly and efficiently implemented and continues to work effectively. It must recommend that appropriate transfer pricing policies are implemented for new products, new geographic markets, etc. The committee's brief will be to monitor changes in the business, whether they be major restructurings made for operational reasons, intended acquisitions, new product lines, changes in operations, etc and to determine whether the policy is effective or recommend changes that need to be made to correct any deficiencies.

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

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

The transfer pricing committee will be responsible for policy but may delegate various detailed activities to finance personnel, sales managers, plant managers, etc as required. The committee should meet, as required, if major operating changes are envisaged but otherwise a regular meeting every quarter would be advisable.

### **603 Setting the group's initial pricing policy**

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

### **604 Active planning of the global tax charge**

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

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

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

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

### **605 Change in the operating structure of the company**

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

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

### **606 Parent company pressure**

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

the arm's length principle by a taxing authority, indirect tax issues may crop up.

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

### **607 Tax audit settlements**

When resolving disputes with a tax authority, it is good practice, where possible, to ensure that the methodology agreed between the company and the authority for settling the current year's tax position is also determined as acceptable for some period into the future. This may necessitate an amendment to the existing transfer pricing policy. It is important to consider both sides of the transaction. In settling a tax audit, a competent authority claim (see Chapter 11) may be necessary to involve the authorities of the other state. In going through this claim with them, proposals for the future should be addressed at the same time, if possible. If both countries agree on the approach to be adopted, a change to the transfer pricing policy should be uncontroversial. However, where different positions are adopted, great care will need to be exercised. In circumstances such as these, the company may wish to consider alternate measures to address the forward looking issues by means of an advance pricing agreement (see Chapter 11).

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

For further discussion of tax audits, see Chapter 7.

### **608 Problems with current policy**

It is often the case that a group will find that an existing inter-company pricing policy will cease to provide the results it requires. This is usually caused by one or more of the following factors:

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

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

### **609 Making corrections through fine-tuning**

In this paragraph, it is assumed that the change needed to rectify the situation is fairly limited and represents 'fine-tuning'. The situation where the current transfer pricing policy must be changed in a material way is dealt with in Section 610.

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

It is important to be aware of pressures in some countries to bring transfer prices up to date on as regular a basis as possible. For instance, while minor 'cut-off errors' are likely to be fitted into the acceptable arm's length range of transfer prices for US purposes, 'errors' that mean that US profits cease to meet the arm's length test will require adjustment for that year (see Chapter 9).

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

### **610 Massive change: alteration to business reality**

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

problem for transfer pricing, as well as for the business generally.

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

### **611 Changes in law**

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

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

#### **Example**

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

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

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

service fees could exceed 80% in certain circumstances, in addition to causing cash-flow problems.

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

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

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

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

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

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

## **612 Dealing with major changes**

Occasionally, a transfer pricing policy will not be arm's length at all and will require major changes. For example, it is not unusual for a parent company to establish transfer prices from its own manufacturing plant to related parties in high-tax jurisdictions using a cost plus approach. Often, the cost base is standard manufacturing cost. The 'plus' is frequently quite low, e.g. 5 or 10%. If the result of a policy such as this is to produce recurring losses in the manufacturing entity, after deducting overheads and general and administrative expenses, while the sales affiliate is making large profits, it is clear that the transfer pricing policy is not arm's length; no independent manufacturer would tolerate manufacturing at a loss in this way. If such a policy has been in operation for a number of years and has not created problems with the tax authorities in the manufacturer's country, changing the policy is problematic – particularly so because the need for change usually emerges as a result of a crisis. For example, a manufacturing company may experience recurring losses and consequent cash-flow problems. When this happens, the result is a critical need to change the policy to rectify the problem. The issue that must then be addressed is the reaction of the tax authorities involved.

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

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

## **613 Year-end adjustment**

Towards the end of the fiscal year, a group usually examines the forecasted final income statements of the various legal entities within the group and it is often the case that the results will not be acceptable for companies that have failed to plan their transfer pricing policies carefully. The reaction in these groups is often to process a lump-sum payment at the end of the year to 'make things right'. Determining the amount to put on these invoices is generally not difficult. It is deciding what to call the payment and how to justify it that is problematic. If it is described as a retroactive price change, it has the implications discussed in Section 614. If it is termed a royalty, it will be necessary to show what intangible property has been provided to the licensee and why this was not recognised and formalised in a licence agreement at the beginning of the year. If it is called a management fee, the problem is how to demonstrate what services were provided, their cost and why the services were not



formalised in a management service agreement at the beginning of the year.

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

#### **614 Retroactive price changes**

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

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

Companies should not be complacent, however, even where it is unlikely that the direct tax authorities will be able to identify a year-end adjustment. The interest of indirect tax authorities must also be considered, as there will probably be duty and value added/consumption tax implications of a retroactive price change (see Chapter 9).

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

#### **615 Defensible late adjustments**

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

validity of the charge. However, an invoice rendered for work carried out without prior authorisation of that work by the client will often result in a dispute and possibly non-payment for the consultant.

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

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

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

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

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

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

exchange, etc, particularly on long-term contracts but care must be taken to ensure that indirect taxes and customs duties are handled appropriately.

### **616 Timing of changes**

The timing of a change in transfer pricing policy, particularly if it corrects an error in a prior policy, is crucial. If an income tax audit is ongoing at the time the policy change is made, knowledge of the change might come into the hands of the tax authority and it could be alleged that the prior policy was incorrect. This type of evidence is not helpful in settling the audit favourably. It is, therefore, imperative to plan carefully the timing of the implementation of a policy change, in order to minimise the impact on the tax liability for previous years. This involves weighing the risks for prior years against the potential cost to the company of inaction, in the form of possibly higher tax rates in the future and/or possible penalties. This analysis is detailed and must be done on a case-by-case basis to arrive at a defensible answer.

### **617 'Big bang' or gradual**

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

### **618 Communicating the changes to the tax authorities**

For certain changes in transfer pricing policies it may be important to obtain local government approval. In some countries (e.g., Korea and China), for instance, royalty payments must be approved by foreign exchange control authorities. This is especially true when dealing with the developing countries in general and countries that are heavy importers of technology of all kinds. Tax authority clearances may also be required to avoid withholding taxes or in order to benefit from the lower rates offered by a double tax treaty. In other situations, it may be useful to approach the authority concerned for a ruling on the policy under review. Such an advance pricing agreement offers certainty to the multinational, albeit at the price of higher levels of disclosure than might otherwise be the case (see Section 707). Sometimes, in the course of a previous year's transfer pricing audit, the tax authorities may also seek the financial statements of the succeeding years. A change in transfer pricing policy would then come to light earlier than expected and hence the taxpayer should be prepared to explain the rationale for the variance in advance.

**619 Tax return disclosure**

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

**620 Accounting disclosure**

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

**621 Impact on banks and other users of the financial statements**

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

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

**622 Communicating the changes to employees**

Changes to the transfer pricing policy of a multinational will have an impact on numerous people and organisations. There will be an immediate effect on the employees involved in the transactions, for there may be completely new procedures for them to follow and they need to be directed exactly how to proceed. The reasons underlying the change and the technical justification for it need to be recorded as part of the group's overall documentation of its transfer pricing policy. It may be useful, however, to produce a short note containing the key reasons for the change, to be

communicated to employees to explain what has happened and why. This will assist in making them more supportive of the change and may well be of value in future years when those same employees may be questioned by tax authorities on the reasons why changes were made.

For instance, in the area of management services rendered by a parent company to its subsidiaries, the parent company executives may be quite clear about the nature of the services they carry out for subsidiaries and will also have ideas about the value to the subsidiary of their work. However, executives at the subsidiary company may well feel overawed by the parent company or, alternatively, feel that the parent company does not understand their position. Their view of the benefit of the services they receive will therefore be a different one and in such circumstances it would be enormously helpful for both sides to be clear about what is being provided and why and how the services will be priced. The work involved in documenting these points would follow the course of an ordinary negotiation between parties at arm's length and, if followed, should produce a result that will be fully justifiable and properly understood by all those involved. At the same time, it is not always appropriate to let too many employees know about tax planning initiatives that the parent company is using to manage the worldwide tax burden of the group. 'Loose lips sink ships' is an old adage that applies in this area. There are numerous examples of disgruntled former employees who knew only enough about a transfer pricing policy to suggest to the tax authority that a fraud might exist. In such cases, the employee is rarely in a position to know the whole story and, thus, to understand that no fraud existed at all. The end result can be an awkward situation for the group in dealing with the tax authority. Subject to compliance with local laws that may govern disclosures to employees or trade unions, employees should be told only what they need to know to do their jobs properly and to support policies that directly affect them.

### **623 Impact on management/employee bonus schemes**

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

### **624 Accounting systems**

All changes to a group's transfer pricing policies will affect the way in which transactions are accounted for, if only to the extent of their value. There may, however, be more significant implications. For instance, where a management services agreement is established for the first time, there will be an entirely new set of transactions to be dealt with, both in the company rendering the service and in the company receiving it and paying the fees. It may necessitate new account codes and

possibly new procedures for authorising such payments. Furthermore, in order to render a charge for the management services, the price of those services has to be determined. Very often this will involve an evaluation of the time spent by the executives performing the services, plus an analysis of the direct expenses incurred in providing them. The analysis of the charging company accounts in order to produce the basic information necessary to calculate the management fee can be time-consuming and new accounting procedures may be necessary to ensure that these invoices can be produced quickly and efficiently. New computer reports and procedures are likely to be required and the information systems department of the group will therefore need to be involved in the implementation of any changes to transfer pricing procedures. There will also have to be training imparted to the employees recording transactions so that the cutover to the new policy is error-free and transaction reversals and rectification entries are minimised.

### **625 The audit trail**

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

### **626 Documenting the changes**

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

# 7 Dealing with an audit of transfer pricing by a tax authority

## 701 Introduction

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

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

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

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

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

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

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

## **702 Establishing control of the audit process**

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

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

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

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

- (1) management support is obtained for the endeavour;



- (2) a team of appropriate and highly competent individuals, consisting of tax and operational staff, are assigned to manage the audit process (this team should include non-local personnel and external advisers as appropriate), and are allowed to devote a sufficient time to the task;
- (3) all the information required by the team is made available to it on a timely basis; and
- (4) a careful plan is established that sets out protocols on how the audit should progress and how liaison with the local tax authority (and overseas authorities) should be handled.

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

### **703 Minimising the exposure**

There are a number of ways in which tax exposure may be limited in the context of an imminent or ongoing transfer pricing audit. For example:

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

### **704 Settling the matter – negotiation, litigation and arbitration**

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

- (1) a capable, confident negotiating team;
- (2) full and up-to-date information on the issues under discussion;
- (3) an understanding of local statutes, case law and practice;
- (4) a well laid-out strategy concerning the issues at hand, identifying what positions could be compromised and others on which the company would not budge;
- (5) experience of the general attitude of the local tax authority towards the type of issues under consideration; and
- (6) a clear view of the financial risks of reaching or not reaching agreement.

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

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

When negotiation or litigation has resulted in a tax adjustment, the company must consider whether an offsetting adjustment can be made in the other country involved. This may be through the Mutual Agreement Procedures of the relevant income tax convention, or, alternatively, a special purpose arbitration vehicle such as the European Arbitration Convention for countries that are part of the European Union (see Chapter 11). Considering all the avenues that are available to a taxpayer, it is critical to consider the appropriate timing of when to invoke one avenue versus the another, i.e., should the taxpayer pursue a Mutual Agreement Procedure process if negotiations with the local inspectors fail, should litigation be pursued instead, or should both processes be initiated at the same time. The decision on these matters hinges on where the taxpayer believes it will be able to reach the best solution given the factors previously discussed.

### **705 Preparation**

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

The taxpayer's audit team must research the powers of the local tax authority and plan to meet its likely requirements. For example, the local tax authority may have the power to require the provision of substantial amounts of information about the group's transactions within a short time frame. Further, in view of protracted Revenue audit or litigation proceedings, which may take place long after the transactions in question

have occurred, the importance of documentation at every step (by way of work papers, notices, hearing memos, submissions and rejoinders) cannot be overemphasised.

Any information that is to be provided to the local tax authority (verbal or documented) must be carefully reviewed by the audit team to ensure the following:

- (1) all of the information is correct;
- (2) all of the information is consistent with the tax returns and accounts of the relevant entities and other information which may be available to the local tax authority;
- (3) the positive or negative implications of the information have been fully considered (i.e. does it support the existing pricing structure, and the functional analysis of the relevant entities' activities or does it identify a tax exposure?); and
- (4) proper consideration has been given to the possibility both that the information will be made available to other tax authorities and that the local tax authority may have sought information of other authorities under the exchange of information procedure in income tax conventions.

#### **706 Dealing with adjustments to existing pricing arrangements**

If an adjustment to the existing transfer pricing arrangement is agreed with the tax authority, it will be necessary to consider what impact this has or will have on the commercial and tax positions of the relevant entities in past and future periods. The discussion in Section 607 and Sections 613–615 is relevant here.

In respect of past periods, the company must decide whether or not it can or should reflect the tax adjustment in commercial terms by raising appropriate invoices (although commercially desirable, this may not be possible in practice, demanding recourse to the dispute retention procedures in bilateral tax treaties to seek to achieve relief – see also Chapter 11 for notes on the arbitration procedure in the EU). Similarly, with regard to the future, it must decide whether to amend the transfer pricing arrangement to take the tax adjustment into account. A key factor in each of these decisions will be the attitude of the tax authority in the country where the other affiliate is located: double taxation is a risk that most taxpayers are anxious to avoid. In addition to the direct tax issues, the company will need to consider whether the adjustments need to be reflected in tax returns for indirect taxes and customs duties. This may well be the case where the transfer pricing adjustments are related directly to particular shipments of goods. Further, there are accounting and regulatory considerations that must be taken note of.

If the tax authority that would bear the cost of any simple adjustment refuses to accept its validity, it may be necessary to invoke competent authority procedures under a tax treaty or some other form of resolution (e.g. the European Union arbitration procedure – see Sections 1103–1115) in order to reach a satisfactory conclusion. Such processes are unfortunately very lengthy but some form of negotiation or arbitration may be the only way to ensure the agreement of all the relevant tax authorities to the pricing policy on an ongoing basis.

#### **707 Advance rulings**

It may be possible to request an advance ruling on an acceptable pricing structure (an

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

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

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

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

# 8 Financial services

## 801 Introduction

Transfer pricing within the financial services industry raises some of the most complex issues in the transfer pricing arena. The industry covers a wide range of business activities. It is not possible, in this chapter, to explore all of these in depth. Therefore, this chapter considers the main issues associated with banking and capital markets, insurance and investment management activities are not mutually exclusive; a multinational group's activities may well span two or more of these sectors, and also that this chapter is not exhaustive, rather a taste of the main issues and approaches to common types of transactions.

Some of the features of the financial services industry which, in part, contribute to its complexity from a transfer pricing perspective, are explored below, after which issues specific to each of the three sectors identified above are discussed. Perhaps one feature that, while not wholly restricted to the financial services industry, is more prevalent in this industry, is the impact that regulation, global integration and the other factors mentioned below tend to have commercially, and the limits that they place on businesses and their ability to structure their operations to deal with pricing challenges.

## 802 Regulation

Most parts of the financial services industry are subject to significant levels of government regulation, for example to protect the integrity of the financial system globally or to protect consumers. Historically, the regulation has involved a myriad of different rules and regulators at the local country level, although more recently there has been a move towards more consistency at the international level, for example through the Bank for International Settlements (BIS) and within the European Union (EU). Regulation often imposes restrictions on the types of business that can be conducted and the corporate and operating structures that can be employed and any analysis of the transfer pricing position should be mindful of this. Conversely operating structures accepted by the regulators may provide evidence that the arrangements should also be accepted for transfer pricing purposes.

## 803 Global integration

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

While these observations are true for many other industries, the challenges are greater for a sector such as the financial services sector where capital is tangible, is

not dependent on major plant or factories and which does not involve the flow of tangible products.

#### **804 Complexity and speed**

Parts of the financial services industry are also highly innovative, both in their development and use of new and complex products and also in the speed with which they have exploited, and come to rely on, new technology. One of the features of the industry is that a relatively small number of individuals based in a few countries across the globe may be largely responsible for managing substantial assets and risks with increasingly complex interactions with other teams, products and countries. Any analysis of the transfer pricing position should reflect not only an understanding of the products involved but also of the overall businesses and the systems used to manage them.

#### **805 Capital**

The availability of capital is critical to the success of all businesses. It allows key investments to be made and ensures cash is available when needed to keep the business going. However, for many businesses within the financial services industry, capital plays a more fundamental role. Without the required level of capital a business may be prevented from establishing itself or continuing to operate in its current form by regulators. The nature and level of capital held may affect both the extent to which other businesses will transact with it and the prices at which they are prepared to do so. The level of capital to be held by banks, for example, is currently one element of a major review by the BIS.

#### **806 Branch profit allocation**

While transfer pricing has traditionally concerned itself with cross-border transactions between separate legal entities, the financial services industry, particularly in the banking and insurance sectors, has historically often operated through branches. Attributing the profits or losses of branches raises issues similar to those in traditional transfer pricing. The OECD reviewed how profits and losses of branches should be determined and the extent to which branches should be treated as if they were separate legal entities. In December 2006, the OECD published final reports (Parts I, II and III) on the attribution of profits to permanent establishments, as well as a draft Part IV for the insurance industry in August 2007. For a fuller discussion of this complex and challenging area see the OECD's papers on the attribution of profits to permanent establishments available on the OECD website.

#### **807 Economic analysis**

The economic analysis of transactions within the financial services industry is perhaps unique in that for certain types of transactions, such as foreign currency trades, there are highly liquid and relatively transparent markets from which to obtain pricing. However, it is also an industry with some of the most globally integrated businesses that publish few, if any, comparable transactions and also one in which great care is required to avoid the use of data that do not represent reliable comparables.

## **BANKING AND CAPITAL MARKETS**

### **808 Introduction**

The word bank is derived from a medieval expression for bench – the place of business of a moneychanger. The functions of banking institutions have grown considerably since the era when they were discharged over a table in the town square. From the traditional lending of funds and financing of trade flows, banks' activities have extended to retail deposit-taking, lending, credit cards and mortgages to private client wealth management, commercial loans, asset-backed financing and financial risk management products and into capital markets activities including equity brokerage, bond dealing, corporate finance advisory services and the underwriting of securities. Over the last century, banks and capital markets groups have expanded across the globe in part to service their internationally active commercial clients and in part to track the flow of capital from developed countries to newer markets in search of higher returns.

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

The banking sector is one of the more regulated of the financial services sectors and banking and capital markets groups have become some of the most globally integrated and dynamic in the industry. It is also one in which there can be a significant range of operating structures between different products and business lines within a group and between the same products and business lines between different groups.

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

### **809 Global trading**

A global trading operation involves the execution of customer transactions in financial products where part of the business takes place in more than one jurisdiction or the operation is conducted on a 24 hour basis. A simple example would be where a salesperson in one country introduces a customer to the trader located in another country who is responsible for trading the relevant financial product followed by the execution of the customer transaction by the trader.

Transfer pricing in respect of global trading operations has been an acute issue for many years. The OECD has eventually provided its most extensive and detailed review in Part III of its report on the attribution of profits to permanent establishments. The report, however, does not address whether a PE exists given a specific global trading activity. Part I of the report merely sets out how the profits should be attributed allocated given the PE already exists.

Moreover, the report seems more open to the use of hedge fund comparables in appropriate circumstances. A difficulty would be whether it is possible to make reliable adjustments for better comparability purposes.

In a profit split context, the report emphasises that where associated enterprises are involved, the reward for capital inures to enterprise(s) that have the capital. However, the OECD report has not commented on how to handle practical issues which may arise from this approach.

Historically, and considering the large amounts at stake, many multinational banks have resorted to advance pricing agreements (APAs) as a way of addressing the uncertainty resulting from the often judgmental and subjective nature of pricing this type of activity. Adopting an APA approach has its own disadvantages including the speed with which global trading businesses develop (potentially rendering an APA out of date before it is even finalised), the time-consuming and expensive nature of APAs, and the practical difficulty of negotiating APAs for more than a few jurisdictions.

### **810 Fee-based businesses**

Fee-based businesses range from relatively high-volume, low-fee-based businesses such as equity brokerage to the relatively low-volume, high-fee-based businesses such as corporate finance advisory activities and the management, underwriting and distribution of new issues of securities for clients.

Even within such well-established businesses as equity brokerage, there can be a wide range of operating structures within a group and a significant variety of products and services provided to clients. Substantial differences may also exist between the products, markets and exchanges of different countries, including not only in the volatility and liquidity of products but also for example in the settlement risks and costs involved. Difficulties can also arise in extrapolating from data on relatively small trading volumes to potentially much larger volumes handled within a group.

The relatively low-volume, high-fee-based businesses can be particularly challenging from a transfer pricing perspective, particularly as many of the transactions are unique; several years may have been spent investing in a client relationship before a structured transaction emerges and when it does, specialists from several countries with different expertise may be involved in the final transaction.

### **811 Treasury and funding**

The funding of a bank, both on a short-term basis, for example to meet withdrawals by depositors and to fund new loans, and on a longer term basis as part of the overall management of the capital of a bank, is an intrinsic part of the activities of a bank. Although many of the transfer pricing issues surrounding financing transactions identified in Sections 215 to 225 apply equally to intra-group funding within banking groups, the nature, amount and term of internal funding may be significantly affected by regulatory requirements and by pressures in the market to raise and use funds efficiently within a group. Operating structures for raising and managing funds within banking groups vary and even for relatively straightforward money market transactions care may be required to ensure that each party to the transaction is adequately remunerated.

### **812 Cross-border services**

Banking and capital markets groups generally undertake many of the same types of centralised activities that are considered in the management services chapter (Sections 501–512), including *inter alia* the provision of central human resources, legal,



accounting, internal communications and public relations activities. The same considerations relating to the identification of the services provided and benefits conferred, the entities providing the services, the entities receiving the services, the costs involved and the application of a mark-up apply equally here.

Other activities that are largely unique to the banking sector and increasingly centralised within a banking group include credit and market risk management and regulatory compliance and reporting. Banks are also often heavily reliant on IT systems, communication links and external data feeds. While tracking and pricing the use of externally developed software is in principle no different from other industries, identifying the role and pricing of internally developed proprietary software can be especially challenging, particularly in view of the amounts involved.

### **813 Other issues in banking and capital markets**

The above comments are by no means exhaustive. Other important but difficult issues, include the transfer pricing treatment of relationship managers. Developments in the banking sector have resulted in an increasing focus on trading and fee-based activities leading to corresponding changes in the perception of the role of general banking relationship managers. This in turn leads to a more difficult question of whether the relationship management function remains an originator of wealth or whether it has perhaps become merely a consumer of cost.

Similarly, research has historically been treated as an overall cost to a business. Developments since the late 1990s suggest that the role of research may need to be reassessed as the market for research becomes increasingly sophisticated and independent from the multinational group; leading in some cases perhaps to a potential comparable uncontrolled price (CUP) approach.

Credit derivatives is another area where there have been significant developments recently, not only in the trading area where customers have been increasingly willing to purchase protection or take on credit exposure but also in the use of credit derivatives internally by banking groups, for example as part of the centralised management of credit risks associated with loan portfolios.

## **INSURANCE**

### **814 Introduction**

In general, an insurance policy is a contract that binds an insurer to indemnify an insured against a specified loss in exchange for a set payment, or premium. An insurance company is a financial entity that sells these policies.

Insurance policies cover a wide range of risks. Broadly, these can be classified as:

- general insurance: e.g. motor, weather, nuclear, credit; and
- life insurance: e.g. pension, term

The major operations of an insurance company are underwriting, the determination of which risks the insurer can take on; and rate making, the decisions regarding necessary prices for such risks, claims management and appropriate investment of the sizeable assets that an insurer holds. By investing premium payments in a wide range of revenue producing projects, insurance companies have become major suppliers of capital, and they rank among the largest institutional investors.

## 815 Reinsurance

Reinsurance is insurance purchased by insurers. Under a reinsurance arrangement, the reinsurer agrees to indemnify an insurer (known as the cedant under a reinsurance contract) against part, or all, of the liabilities assumed by the cedant under one, or more, insurance or reinsurance contracts.

In consideration for reinsuring risks, the ceding insurance company pays a premium to the reinsurer. Although reinsurance does not legally discharge the primary insurer from its liability for the coverage provided by its policies, it does make the reinsurer liable to the primary insurer with respect to losses sustained under the policy or policies issued by the primary insurer that are covered by the reinsurance transaction.

Reinsurance is generally purchased for any of the following reasons:

- For an insurer to accept risk, the number of insured must be large enough and diverse enough for the law of large numbers to operate and thereby enable the insurer to conclude that the risk of loss is acceptable. Frequently, however, an insurer may accept, for business reasons, insurance of a class or amount that does not permit the law of large numbers to operate or that could result in claims the insurer does not have the financial capacity to absorb. Such risks can be diversified, transferred to or shared with a reinsurer.
- An insurance company can reduce the volatility in its annual results by purchasing reinsurance coverage for those losses. However, even with reinsurance in place to help stabilise loss experience, a man-made or natural catastrophe could occur that could have a significant impact on a company's capital. Catastrophe reinsurance can provide financial protection against such disasters at a cost to the primary insurer.
- Reinsurance may be used to help increase premium writing capacity on existing business. An insurer's gross underwriting capacity (i.e., its ability to write business) is limited by law or regulation based on the amount of its statutory surplus. The greater the ratio of premiums written or liabilities to such surplus (i.e., its leverage ratio), the less likely it is that the regulator will consider the surplus to be sufficient to withstand adverse claims experience on business written. Through reinsurance, an insurer can increase its gross volume of business written, while maintaining a healthy ratio between risk retained and surplus.
- Reinsurance also may be used to facilitate the growth of an insurer's new products or aid its entry into new lines of business. For example, a quota share contract with the assuming company may call for the payment by the reinsurance company to the insurer of an upfront commission (ceding allowance) which could fund a portion of the insurer's development and acquisition expenses and thereby reduce its upfront cash requirements and the resulting statutory surplus strain from entering a new product line. As noted above, the reinsurance also provides additional gross premium writing capacity. Reinsurance can also provide the insurer access to the reinsurer's expertise in the new line of business.
- The terms of reinsurance contracts reflect a consideration of the general economic environment of the insurance industry, both recent and projected,

and the risks perceived by both the buyer and seller of the reinsurance. Many reinsurance contracts contain terms that are intended to limit to some degree the variability in underwriting results in order to limit business risks to the assuming reinsurer associated with the reinsurance contract.

- Common risk limiting features include sliding scale and other adjustable commissions that depend on the level of ceded losses, profit sharing formulas, retrospective premium adjustments, and mandatory reinstatement premiums and limits (caps). Sliding scale commissions and profit sharing formulas typically adjust cash flows between the ceding and assuming company based on loss experience (e.g., increasing payments back to the ceding company as losses decrease and decreasing payments back to the ceding company as losses increase, subject to maximum and minimum limits).

### *Forms of reinsurance*

There are two methods by which risk is ceded through reinsurance contracts:

- Treaty reinsurance – a contractual arrangement that provides for the automatic placement of a specific type or category of risk underwritten by the primary insurer.
- Facultative reinsurance – the reinsurance of individual risks whereby the insurer separately rates and underwrites each risk. Facultative reinsurance is typically purchased by primary insurers for individual risks not covered by their reinsurance treaties, for excess losses on risks covered by their reinsurance treaties, and for 'unusual' risks.

The two major forms of reinsurance are proportional reinsurance and excess of loss reinsurance. Premiums received from both treaty and facultative reinsurance agreements vary according to, among other things, whether the reinsurance is on an excess of loss or on a proportional basis.

(1) Proportional reinsurance – there are two types of proportional insurance:

- Quota share – the risk is shared according to pre-agreed percentages.
- Surplus share agreement – the primary insurer selects the amount of liability it wishes to retain on the policy and then cedes multiples, known as 'lines', of its retention to the insurer. Losses and premiums are divided between the company and the reinsurer proportionally with respect to the portion of risk undertaken. Surplus shares agreements are generally only issued on a treaty basis and allow the primary insurer greater flexibility than quota shares in ceding risk to the reinsurer.

(2) Excess of loss reinsurance – the reinsurer indemnifies the primary insurer for all covered losses incurred on underlying insurance policies in excess of a specified retention. Premiums that the primary insurer pays to the insurer for excess of loss coverage are not directly proportional to the premiums that the primary insurer receives because the reinsurer does not assume a proportional risk. Furthermore, the reinsurer generally does not pay any ceding commissions to the primary insurer in connection with excess of loss reinsurance. Large amounts of coverage typically are written layers, with each layer being an excess policy, taking effect once losses exceed some 'attachment point'. This layering could

result from placement activities of a broker, who may be unable to place the entire amount of coverage with a single insurer or reinsurer.

A company that provides reinsurance can, in its turn, engage in an activity known as retrocession. Retrocession is defined as a transaction in which a reinsurer cedes to another reinsurer all or part of the reinsurance it has previously assumed. The ceding reinsurer in a retrocession is known as the 'retrocedent' while the assuming reinsurer is known as the 'retrocessionaire'.

Intra-group reinsurance arrangements are typically the most material transfer pricing transactions for most insurance groups. As many group reinsurance companies are resident in jurisdictions with benign tax and regulatory regimes, such as Bermuda, revenue authorities have increased transfer pricing scrutiny, a trend which has gained significant momentum following the OECD's work on the attribution of profits to permanent establishments of insurance companies, Part IV which was published in draft form in 2007.

As described above, reinsurance transactions are generally complex in nature and many contracts will be bespoke to address the particular requirements of both the reinsured and the reinsurer. Transfer pricing support will typically comprise a combination of the following approaches:

**Commercial rationale:** The first requirement in support of a reinsurance arrangement is to demonstrate the commercial rationale behind the transaction. Tax authorities can seek to recharacterise the transaction if it would clearly not have been entered into with a third party. This is particularly critical given the OECD members' current focus on an anti-avoidance agenda in respect of reinsurance transactions and business restructuring.

**Internal CUPs:** In some cases, a group will reinsure portions of the same business to both related and unrelated parties, which may provide a strong CUP. In other cases, a group may have previously reinsured with an external reinsurer before establishing a group reinsurer. Care needs to be taken to demonstrate that the contracts are comparable taking into account the mix of business, layers of risk, volume, expected loss ratios, reinsurance capacity, etc.

**Pricing process:** For complex non-proportional reinsurance, the most appropriate transfer pricing support may often be derived from being able to demonstrate that the pricing process for internal reinsurance contracts is exactly the same as that for external reinsurance. This will involve due diligence on the actuarial modelling and underlying assumptions, as well as the underwriting decision, which evidences the process of negotiation, challenge and agreement on the final price. The use of this approach has been strengthened by the new US temporary services regulations, which expanded the indirect evidence rule by reference to an insurance specific example.

**Cost of capital:** Many large proportional reinsurance contracts are difficult to price using either of the above methods as they often involve multiple classes of business which are not commonly found in the market place. In such cases it is often necessary to return to first principles and address the capital requirements and appropriate return on capital based on the expected volatility and loss ratios of the portfolio of business, as well as the cost of acquiring and supporting the business, thereby addressing the pricing from both the cedant's and reinsurer's perspectives. Additionally, ratings agencies may provide guidance and support for the pricing process through the benefits in the sources and uses ratio due to capital relief obtained through reinsurance transactions.

### **816 Centralisation**

Insurance groups will generally undertake many of the same types of centralised activities that are considered in the management services chapter (Sections 501–512), including *inter alia* the provision of central human resources, legal, accounting, internal communications and public relations activities. The same considerations relating to the identification of the services provided, the entities providing the services, the entities receiving the services, the costs involved and the application of a mark-up apply equally here. Certain aspects of centralisation, which are unique to the insurance industry are discussed further below.

Most multinational insurance groups will have formulated a group strategy to manage their risks in one or more centralised locations. It is critical to understand the group strategy in terms of the layering and location of risks, as well as the objectives behind risk centralisation, in order to develop a coherent transfer pricing strategy. Such centralisation of risk may allow a group to purchase cover on a global basis, thereby gaining advantages of economies of scale. Consideration should be given to how this benefit is shared between the participants.

Specific centralisation issues will also arise when global insurance policies are sold to multinationals where negotiation, agreement and management of risk occur at the global or regional head office level. In such cases, even where the local insurance company/branch is required to book the premium, the reality may be that the local entity is bearing little or no risk. Alternatively, where risk is shared among the participants, consideration needs to be given to how the central costs of negotiation should be shared.

### **817 Investment and asset management**

The return earned from investing the premium collected contributes to the ability of insurance companies to meet their claims obligations. To the extent that such investment and asset management capabilities are concentrated in certain parts of the overall group, a charge will be made for the services provided to other members of the group. Specific factors that may influence the pricing of such services include the type of assets managed, level of activities carried out, risk involved, volume of transactions, expected returns and expenses of providing such services.

The specific issues to be considered are described in more detail in the Investment Management section below. However, it is worth noting here that, as insurance groups often have very large sums to manage and the level of funds under management represents a key business factor in pricing investment management services, comparables used in the broader investment management sector may well need to be adjusted for the sale of invested assets before being applied within an insurance group.

### **818 Financing and financial guarantees**

As with banking, many of the issues surrounding financing transactions identified in Sections 215 to 225 apply equally to intra-group financing within insurance institutions. These include intra-group loans and loan guarantees. However, there are certain financing issues that are specific to the insurance sector.

The provision of financial guarantees is an important aspect of insurance transfer pricing. Such guarantees can include claims guarantees, net worth maintenance

agreements and keep well arrangements. Pertinent factors that need to be considered include the type of security or collateral involved, the differential credit ratings between guarantee providers and recipients, market conditions, and type and timing of the guarantee.

### **819 Brokerage and agency activities**

With the increasing internationalisation and consolidation in the insurance sector, insurance brokers and agents are becoming increasingly integrated. As such brokerage/commission sharing becomes increasingly complicated resulting in the use of the profit split method either as a primary or secondary supporting method.

### **820 Other issues in insurance**

Insurance companies are increasingly expanding into new areas of business with a view to diversifying the risks associated with the modern insurance industry. As a result, we are seeing insurance groups undertaking many of the activities that have traditionally been associated with the banking and capital markets industry. Hurricane Katrina and the fears of avian flu have brought new attention to ways of transferring risk to the capital markets. The resurgence of insurance derivatives is part of the general trend of using capital markets solutions to solve insurance industry problems. Transfer pricing associated with the trading of insurance derivatives often raises similar issues described above for global trading within banks, as discussed above.

One specific issue that arises reflects the history of insurance groups. As insurance groups have grown, typically through acquisition, complicated group structures and non-standard transactions have arisen as a result of both regulatory restrictions and historical accident. Understanding the history behind such transactions often plays an important part in explaining how the transfer pricing approach must be evaluated within an appropriate commercial context.

## **INVESTMENT MANAGEMENT**

### **821 Introduction**

Investment management activity permeates the entire financial services industry. Insurance companies have a core need to manage the funds generated through their insurance premiums, and banks may manage investments either on a proprietary basis or on behalf of their customers. Many investment management businesses are therefore part of a wider banking or insurance operation but there are also a significant number of independent investment management firms, whose sole business it is to manage assets on behalf of their clients. In all cases, assets are reinvested either on a segregated basis or, more commonly, on a pooled basis through the medium of a notional or legally distinct investment fund.

The diverse and global nature of the investment management industry gives rise to a huge variety of investment fund types. Fund types include securities or bond funds, hedge funds, property funds, private equity funds, futures and options funds, trading funds, guaranteed funds, warrant funds and funds-of-funds. These funds can be further sub-divided into different share or unit classes incorporating different charges, rights and currency classes.

Within these types of funds there are different strategies of asset management. Investors will select funds based on performance and their aversion to risk. Funds can either passively track an index or be actively managed. Indexed funds or trackers are benchmarked to a defined market index. The fund manager is passive insofar as she/he does not attempt to outperform the index through stock selection. This contrasts with the actively managed fund where the manager selects assets with the aim of outperforming either the market or the benchmark.

Factors such as the increasing mobility of capital and technical advances in the field of communications have contributed to the large number of jurisdictions with thriving investment management industries. In many cases, investment managers offer services from offshore domiciles to investors in selected target countries for certain legal, regulatory, or tax requirements. Investment advisory, marketing and fund-accounting services are often then delegated to onshore subsidiaries, which benefit from better access to a skilled workforce.

Fees for managing assets are typically charged on an *ad valorem* basis (i.e. as a percentage of assets under management). However, charges and charging structures vary depending on the nature of the funds in which the investment is made, the investment profile of the fund and the investment objectives themselves. Private equity and venture capital vehicles may charge investors based on the committed capital pledged to the investment vehicle over time.

Investment funds can give rise to a number of different charges for investors:

**Front-end loads:** a charge made on the monies committed by an individual investor on entering the fund and paid by the investor. This is common in retail funds where independent financial adviser (IFA) brings clients' monies to the fund and in return will expect a proportion of the load.

**Management fees:** a charge (usually a fixed percentage) made on the net asset value of the fund and paid directly by the fund to the fund manager.

**Trailer fees:** a fee payable to distributors, for example, IFAs, by the fund manager from the gross management fee for the referral of clients' monies. The fee is normally calculated as a proportion of the net assets referred by the distributor and is usually payable by the fund manager until the investor withdraws their monies.

**Performance fees:** These are typically paid in addition to a base management fee by niche market funds (e.g. hedge funds and private equity funds) as well as for the management of large segregated funds. The industry recognises three broad classes of investors: institutional, retail and private client.

**Institutional:** Institutional money is that made available by institutions, typically pension funds and life companies, which may outsource the actual management of the whole or a part of their assets. These monies are often managed on a segregated basis (i.e. each client's assets are managed separately) due to their tightly defined objectives but may also be managed on a pooled basis (i.e. together with other clients with similar investment objectives).

**Retail:** Retail money is essentially money invested in collective investment vehicles by smaller investors and members of the general public. Such monies are by definition pooled and it is the overall pool of funds that is managed rather than the monies of each individual investor.

**Private client:** Private client business is less transparent than institutional or retail. The business deals with high net worth individuals (HNWI) to whom a manager may offer a portfolio of services. Confidentiality is usually at a premium and very little market data is available. Client service is a major factor in the private client sector since most clients will put a premium on personal contact and the prompt and reliable handling of instructions, requests for information and reporting. HNWI are often prepared to accept a higher level of risk in return for a better absolute rate of return. Their higher level of financial sophistication and requirement for confidentiality means that they are prepared to invest large sums offshore in a broad spectrum of jurisdictions.

Below, the main areas involving significant cross-border flows of products and services are considered in more detail.

## **822 Asset management**

Asset management, in the round, typically comprises overall asset allocation, and the asset research, selection and management of individual securities, with a view to meeting the objectives of the portfolio or fund. It is not uncommon for these functions to be segregated to take advantage of local/specialist knowledge and expertise (commonly referred to as sub-advisers).

Investment management groups may have potential internal comparables relating to institutional mandates. In addition, there is some publicly available information in respect of both investment management and sub-advisory fees. These should be used carefully, since specific factors influence the pricing of such services, including the type of assets managed, scope of activities carried out, risk involved, volume of transactions, expected returns and expenses of providing such services.

Recent developments in alternative investment funds and the corresponding increase in performance fees has raised the additional consideration of how such a fee should be split between the various functions and jurisdictions within the investment management business.

## **823 Marketing, distribution and client servicing**

In considering appropriate arm's length fees for marketing, distribution and client servicing, one of the most important considerations is the type of customer. For example, fees are usually higher for retail investors than for institutional investors. This reflects both the additional costs associated with attracting funds for retail investors and also the greater bargaining power of institutional investors, due to their larger size of investment. Again, owing to the different business models applicable to different types of customer, funds and investment strategy, great care needs to be taken in attempting to make use of potential comparables, both internal and external. Industry intelligence and anecdotal evidence could outweigh the publicly available data, as financial arrangements for distribution and capital raising services are often highly discrete, or depend on the type of client and asset class managed.

## **824 Administration and other centralised activities**

As for banking and insurance, investment management groups or sub-groups will generally undertake many of the same types of centralised activities that are considered



in the management services chapter (Sections 501–512), including *inter alia* the provision of central human resources, legal, accounting, internal communications and public relations activities. The same considerations relating to the identification of the services provided, the entities providing the services, the entities receiving the services, the costs involved and the application of a mark-up apply equally here. Certain aspects of centralisation that are unique to the investment management industry are discussed further below.

The administration of funds covers a wide variety of activities, for example the preparation of reports for investors, custody, transfer agency, fund accounting, compliance and regulatory, investor protection, regulatory and compliance execution/settlement. Any or all of these functions might be centralised or outsourced to specialist service providers to take advantage of economies of scale and local expertise. In particular, investments in information technology (IT) are a hallmark of the industry.

Consideration needs also to be given to the development of bespoke investment technologies, which act to enhance investment performance or to centralise risk and decision making.

The track record and skills of the portfolio managers are highly important in the investment management business, while the ownership and development of brand and other intangible assets feature prominently in any transfer pricing analysis.

# 9 US transfer pricing rules

## INTRODUCTION

### 901 The importance of the US rules on transfer pricing

This chapter is devoted to a broad outline of US transfer pricing rules and the accompanying penalty regulations. Also covered is the US competent authority procedures, including the Advance Pricing Agreement (APA) programme, and the interaction of the US rules with the OECD Guidelines. The US regulatory environment is of great significance for a number of reasons:

- (1) The US is a significant market for the majority of multinational enterprises, and therefore compliance with US rules, which remain arguably the toughest and most comprehensive in the world, is a significant issue in international business.
- (2) The process of reform of the US transfer pricing regulations in the 1990s, and more recently with changes in the cost sharing, services, and intangible property transfer areas, broke new ground – these developments tended to influence other countries in subsequently increasing the stringency of their own rules. An understanding of developments in the US and the controversies surrounding them are thus a good indicator of likely areas of contention in other countries.
- (3) The actions of the US have caused controversy with the country's trading partners, not all of whom have entirely agreed with the US interpretation of the arm's length standard. The regulations, together with a greater level of enforcement activity, have resulted in an increasing number of transfer pricing issues being considered through the competent authority process under the mutual agreement Article of tax treaties concluded between the US and most of its major trading partners.
- (4) The competent authority process also forms the basis for the APA programme, which has become an increasingly important mechanism for multinational enterprises to obtain prospective reassurance that their transfer pricing policies and procedures meet the requirements of the arm's length standard as well as an additional mechanism for resolving tax audits involving transfer pricing issues.

Non-US tax authorities and practitioners alike have tended to be critical of the level of detail included in the US Regulations and procedures. However, in considering the US regime, it is important to bear in mind that unlike many of its major trading partners, the US corporate tax system is a self assessment system where the burden of proof is generally placed on the taxpayer, and where there is an adversarial relationship between the government and the taxpayer. This additional compliance burden is not unique to the field of transfer pricing.

### 902 The rationale underlying the US Regulations

In 1986, the US Congress ordered a comprehensive study of inter-company pricing

and directed the Internal Revenue Service (IRS) to consider whether the regulations should be modified. This focus on transfer pricing reflected a widespread belief that multinational enterprises operating in the US were often setting their transfer prices in an arbitrary manner with the result that taxable income in the US may be misstated, and that the lack of documentation on how the pricing was set made it extremely difficult for the IRS to conduct retrospective audits to determine whether the arm's length standard had been applied in practice.

### **903 The history of the US reform process**

Since 1934, the arm's length standard has been used to determine whether cross-border, inter-company transfer pricing produces a clear reflection of income for US federal income tax purposes. The arm's length standard has become the internationally accepted norm for evaluating inter-company pricing.

In 1968, the IRS issued regulations that provided procedural rules for applying the arm's length standard and specific pricing methods for testing the arm's length character of transfer pricing results. These transaction-based methods, the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method, have gained broad international acceptance.

Congress amended § 482 in 1986, by adding the commensurate with income standard for the transfer of intangible property. At the same time, Congress directed the IRS to conduct a comprehensive study of inter-company transfer pricing, the applicable regulations under § 482 of the Code, and the need for new enforcement tools and strategies. The IRS responded to that directive by issuing the White Paper in 1988.

Between 1988 and 1992, Congress added or amended §§ 482, 6038A, 6038C, and 6503(k) to impose on taxpayers new information reporting and record-keeping requirements and to provide IRS Revenue agents with greater access to that information. In addition, Congress added § 6662(e) and (h) to impose penalties for significant transfer pricing adjustments. In 1992, the IRS issued new proposed regulations under § 482. Those regulations implemented the commensurate with income standard and introduced significant new procedural rules and pricing methods. These proposed regulations also included significant new rules for cost sharing arrangements. (Discussed in 915 to 922.)

In 1993, the IRS issued temporary regulations that were effective for taxable years beginning after 21 April 1993, and before 6 October 1994. These regulations emphasised the use of comparable transactions between unrelated parties, and a flexible application of pricing methods to reflect specific facts and circumstances. The IRS also issued proposed regulations under § 6662(e) and (h), which conditioned the avoidance of penalties upon the maintenance of contemporaneous documentation of how the pricing methods specified in the § 482 regulations had been applied.

In 1994, the IRS issued temporary and proposed regulations under § 6662(e) and (h), applicable to all tax years beginning after 31 December 1993. The IRS also issued final regulations under § 482, effective for tax years beginning after 6 October 1994 and amended the temporary and proposed § 6662(e) and (h) regulations, retroactive to 1 January 1994.

Also in 1994, final § 482 regulations were issued, which are generally effective for tax years beginning after 6 October 1994. However, taxpayers may elect to apply the

final regulations to any open year and to all subsequent years.

In 1995, final regulations on cost sharing were issued (which were subject to minor modification in 1996). These regulations are effective for taxable years beginning on or after 1 January 1996. Existing cost sharing arrangements were not grandfathered and had to be amended to conform to the final regulations. If an existing cost sharing arrangement met all of the requirements of the 1968 cost sharing regulations, participants had until 31 December 1996 to make the required amendments. Significant changes to the rules governing cost sharing transactions were recommended on 22 August 2005, when the IRS issued proposed cost sharing regulations. These proposed regulations focus on three new specified methods of valuation for determining the arm's length buy-in amount and are described later in this chapter. At the writing of this chapter, the proposed regulations have not been finalised.

In 1996, final transfer pricing penalty regulations under § 6662 were issued on 9 February, with effect from that date subject to a taxpayer's election to apply them to all open tax years beginning after 31 December 1993. Revised procedures for APAs were also issued in 1996. In 1998 the IRS simplified and streamlined procedures for APAs for small-business taxpayers.

In 2003, regulations that were proposed in 2002 dealing with the treatment of costs associated with stock options in the context of qualifying cost sharing arrangements (see below) were finalised, and regulations governing the provision of intra-group services were proposed. The proposed services regulations were replaced by temporary and proposed regulations (Temporary Regulations) issued on 31 July 2006, and these Temporary Regulations are described in this chapter. The commentary in this chapter refers to the final transfer pricing regulations unless otherwise stated.

Global dealing regulations were expected to be released in the near future, and the rules are expected to clarify how to attribute profits consistent with the transfer pricing rules when a permanent establishment exists. At the writing of this chapter, these regulations have not been finalised.

#### **904 Consistency between the US Regulations and the OECD Guidelines**

At the same time as the reform process was progressing in the US, the OECD was also revising its guidelines on transfer pricing (see Chapter 3). The OECD Guidelines are a significant point of reference for many of the major trading partners of the US in dealing with transfer pricing issues. The extent to which the Guidelines are consistent with the US approach is thus a critical issue for all multinational enterprises that wish to be in full compliance with local laws in all the jurisdictions in which they operate but at the same time not be exposed to the risk of double taxation and penalties. The substantive provisions of the US Regulations are compared to the OECD Guidelines in this chapter (see Sections 959-970).

#### **905 Transfer pricing audits in the US**

The IRS has extensive resources available to pursue field audits, at the appellate level and in competent authority procedures, including agents specially trained in economic analysis. Transfer pricing audits are not limited to cases where avoidance is suspected.

Multinational entities should expect to be called upon to affirmatively demonstrate

how they set their inter-company prices and why the result is arm's length as part of the standard review of their US tax returns; and these requests to produce supporting documentation within 30 days has become a standard feature of the commencement of such examinations.

## **THE US TRANSFER PRICING REGULATIONS**

### **906 The best method rule**

A taxpayer must select one of the pricing methods specified in the regulations to test the arm's length character of its transfer pricing. Under the Best Method Rule, the pricing method selected, under the facts and circumstances of the transactions under review should provide the most reliable measure of an arm's length result, relative to the reliability of the other potentially applicable methods. The relative reliability of the various transaction based pricing methods depends primarily upon:

- (1) the use of comparable uncontrolled transactions and the degree of comparability between those transactions and the taxpayer's transactions under review; and
- (2) the completeness and accuracy of the underlying data, and the reliability of the assumptions made and the adjustments required to improve comparability.

Adjustments must be made to the uncontrolled comparables if such adjustments will improve the reliability of the results obtained under the selected pricing method. Determination of the degree of comparability will be based on a functional analysis made to identify the economically significant functions performed, assets used, and risks assumed by the controlled and uncontrolled parties involved in the transactions under review.

Industry average returns cannot be used to establish an arm's length result, except in rare instances where it can be demonstrated that the taxpayer establishes its inter-company prices based on such market or industry indices and that other requirements are complied with. Unspecified methods may be used if it can be shown that they produce the most reliable measure of an arm's length result. A strong preference is given to methods that rely on external data and comparable uncontrolled transactions. When using a specified method, a taxpayer is not required to demonstrate the inapplicability of other methods before selecting its preferred method. However, in order to avoid potential penalties, a taxpayer must demonstrate with contemporaneous documentation that it has made a reasonable effort to evaluate the potential applicability of other methods before selecting its best method (see Section 939).

### **907 The arm's length range**

No adjustment will be made to a taxpayer's transfer pricing results if those results are within an arm's length range derived from two or more comparable uncontrolled transactions. This concept of a range of acceptable outcomes rather than a single arm's length answer is the key to understanding the flexible application of the arm's length standard that underlies the US Regulations.

Under the regulations, the arm's length range will be based on all of the comparables only if each comparable meets a fairly high standard of comparability. If inexact comparables are used, the range ordinarily will be based only on those comparables that are between the 25th and 75th percentile of results. However, other statistical

methods may be used to improve the reliability of the range analysis.

If a taxpayer's transfer pricing results are outside the arm's length range, the IRS may adjust those results to any point within the range. Such an adjustment will ordinarily be to the median of all the results.

The regulations permit comparisons of controlled and uncontrolled transactions, based upon average results over an appropriate multiple-year period. If taxpayer's results are not within the arm's length range calculated using multiple-year data, the adjustment for a year may be based on the arm's length range calculated using data from only that year.

### **908 Collateral adjustments and set-offs**

A taxpayer are required to report an arm's length result on its tax return, even if those results reflect transfer prices that are different from the prices originally set out on invoices and in the taxpayer's books and records, and may be subjected to substantial penalties if they fail to do so. This provision has no direct equivalent in the tax codes of most of the US major trading partners, and may result in double taxation of income.

In the event of an income adjustment under § 482, the IRS is required to take into account any appropriate collateral adjustment. Should the income of one member of the controlled group be increased under § 482, the other members must recognise a corresponding decrease in income.

Taxpayers may also claim set-offs for any non-arm's length transactions within the controlled group. The regulations limit such set-offs to transactions between the same two taxpayers within the same taxable year. Further, set-offs are strictly applied in accordance with revenue procedures issued by the IRS.

### **909 Impact of foreign legal restrictions**

The regulations include provisions that attempt to limit the effect of foreign legal restrictions on the determination of an arm's length price. In general, such restrictions will be taken into account only if those restrictions are publicly promulgated, affect uncontrolled taxpayers under comparable circumstances, the taxpayer must demonstrate that it has exhausted all remedies prescribed by foreign law, the restrictions expressly prevent the payment or receipt of the arm's length amount, and the taxpayer (or the related party) did not enter into arrangements with other parties that had the effect of circumventing the restriction. The regulations also attempt to force the use of the deferred income method of accounting where foreign legal restrictions do limit the ability to charge an arm's length price.

### **910 Transfers of tangible property**

The regulations governing the transfer of tangible property have not changed substantially since 1992. They continue to focus on comparability of products under the CUP method, and the comparability of functions under the resale price and cost plus methods. Comparability adjustments under the regulations must consider potential differences in quality of the product, contractual terms, level of the market, geographic market, date of the transaction and other issues. In addition, the regulations require consideration of potential differences in business experience and management efficiency.

### **911 Transfers of intangible property**

The implementation of the commensurate with income standard has been a considerable source of controversy with US trading partners. Some have interpreted the intent of the regulations to be the consideration for the transfer of an intangible asset, which is subject to adjustment long after the transfer takes place. This has been viewed as inconsistent with the way unrelated parties would contract. The primary objective of this provision is to ensure that the IRS has the right to audit the reliability of the assumptions used in setting the transfer price for an intangible asset as part of an examination as to whether the transfer had been made at arm's length. As such, the regulations provide a detailed description of how the consideration paid for an intangible asset will be evaluated in consistency with the statutory requirement that the consideration be commensurate with the income derived from exploitation of the intangible.

In general terms, the need for periodic adjustment to transfer prices for intangible property depends upon whether the transfer pricing method used to set the transfer price relies on projected results (projected profit or cost savings). No periodic adjustments will be required if the actual cumulative benefits realised from exploitation of the intangible are within a range of plus or minus 20% of the forecast. If the actual benefits realised fall outside this range, the assumption is that the transfer price will be re-evaluated, unless any of the further extraordinary event exceptions detailed in the regulations are satisfied. The intent behind these regulations is to replicate what would occur in a true unrelated party relationship if, for example, one party to a licence arrangement found that unanticipated business events made the level of royalty payments economically not viable. It also prevents a taxpayer from manipulating a forecast of benefits that would result in a significantly different purchase price for the intangible.

If no adjustment is warranted for each of the five consecutive years following the transfer, the transfer will be considered to be at arm's length, and consequently no periodic adjustments will be required in any subsequent year. If an adjustment is warranted, there have been recent debates as to whether a taxpayer can affirmatively invoke the commensurate with income standard. The IRS posits that only the commissioner has the right to invoke the commensurate with income standard and not the taxpayer in the 2003 proposed cost sharing regulations.

All prior regulations (including those issued in 1968, 1992 and 1993) provided that, for transfer pricing purposes, intangible property generally would be treated as being owned by the taxpayer that bore the greatest share of the costs of development of the intangible. In contrast, the 1994 final regulations provide that if an intangible is legally protected (e.g. patents, trademarks, and copyrights), the legal owner of the right to exploit an intangible ordinarily will be considered the owner for transfer pricing purposes. In the case of intangible property that is not legally protected (e.g. know-how) the owner continues to be the party that bears the greatest share of the costs of development.

The regulations provide that legal ownership of an intangible is determined either by operation of law or by contractual agreements under which the legal owner has transferred all or part of its rights in the intangible to another party. In determining legal ownership of the intangible, the final regulations provide that the IRS may impute an agreement to convey ownership of the intangible if the parties' conduct

indicates that, in substance, the parties have already entered into an agreement to convey legal ownership of the intangible.

The Temporary Regulations issued on 1 July 2006 maintained the 1994 final regulations' treatment for legally protected intangibles, i.e., the legal owner of the rights to exploit an intangible ordinarily will be considered the owner for transfer pricing purposes. However, the Temporary Regulations redefined the definition of 'owner' (for transfer pricing purposes) of intangible property rights that are not legally protected. Unlike the existing regulations which assigns ownership of such intangibles to the party that bears the largest portion of the costs of development, the Temporary Regulations redefine the owner of such intangibles as the party that has the 'practical control' over the intangibles. Therefore, eliminating the old 'developer-assister' rule altogether.

Given this position, the possibility still exists that there may be a difference of opinion between the US and other taxing jurisdictions as to who is the primary owner of some categories of intangible assets for transfer pricing purposes. For example, taxpayers may find that because proprietary rights strategies can vary from country to country, the treatment of intangibles may not be consistent across countries, even though the economic circumstances are the same. Taxpayers may also find that trademarks are deemed owned by one party, while the underlying product design and specifications are deemed owned by a different party. This is something that all multinational corporations should take into account in planning their pricing policies and procedures.

The IRS has provided rules for determining how the commensurate with income standard should be applied to lump-sum payments. Such payments will be arm's length and commensurate with income if they are equal to the present value of a stream of royalty payments where those royalty payments can be shown to be both arm's length and commensurate with income.

In February 2007, the IRS issued an Industry Directive that is expected to indicate the direction that future IRS audits will take with regard to migrations of intangible property. The Industry Directive primarily targets pharmaceutical and other life sciences companies that transferred the operations of former section 936 possessions corporations to controlled foreign corporations, or CFCs. More broadly, the Industry Directive underscores the attention that the IRS has been paying to issues surrounding intangible migration transactions. On 27 September 2007, the IRS issued Coordinated Issue Paper (LMSB-04-0907-62) addressing buy-in payments associated with cost sharing arrangements. The Paper covers all industries, suggesting that the IRS is preparing to more rigorously analyse and examine the key operations and risks related to the migration of intangible assets in the future.

## **912 Provision of intra-group services, use of intangible property and the GlaxoSmithKline case**

In July 2006, the Treasury Department and IRS issued temporary and proposed regulations governing the provision of intra-group services. These regulations follow the pattern established for transfers of tangible and intangible property by specifying methods that reference prices and margins earned through transactions with unrelated parties, or by reference to profits earned by parties performing comparable services for unrelated parties. While the 1968 regulations allowed for an intra-group



charge equal to cost for non-integral services, the Temporary Regulations set forth a method that allows a taxpayer to charge cost, without a mark-up, for certain low-margin services specified on a 'good list' or for services where comparable transactions between unrelated parties are performed at prices that yield a median mark-up on total costs that is less than or equal to 7%. For more detail regarding the proposed services regulations, please refer to Sections 923-937.

The Temporary Regulations also emphasise the interaction between intra-group services and the use of intangible property. The Temporary Regulations provide numerous examples of situations where a provider of intra-group services would earn higher margins, or could be expected to share in the profits of the development of intangible property that is jointly developed by the owner of the property and the service provider. Research and development (R&D), and the development of marketing intangible assets in a local market, are examples of high-value services provided in conjunction with intangible property.

The issue of development of marketing intangibles is at the core of the GlaxoSmithKline Plc (Glaxo) Tax Court case. In September 2006, the IRS announced the resolution of the case, the largest tax dispute in the agency's history. The parties reached a settlement under which Glaxo agreed to pay the IRS approximately USD3.4 billion. According to the IRS claims, drugs marketed by the UK multinational Glaxo through a US affiliate derived their primary value from marketing efforts in the US rather than from R&D owned in the UK. The IRS's position is that the unique nature of the R&D may explain the success of the first drug of its kind; however, subsequent market entrants are successful primarily because of the marketing acumen of the US affiliate. Consequently, the IRS asserted that the rate Glaxo's US affiliate charged to its UK parent for marketing services was too low. Furthermore, it argues that the 'embedded' marketing intangibles, trademarks, and trade names existed and were economically owned by the US affiliate. The IRS adjusted the transfer prices paid by the US affiliate to its parent to a contract manufacturing mark-up on costs and reduced the royalties paid by the US affiliate for the right to sell the product. Emphasising the US affiliate's contribution to enhancing the value of the intangibles, the IRS applied the residual profit split method, resulting in a majority of the US affiliate's profits being allocated to the US.

Some tentative observations may be made as to what the implications of both the Glaxo case and the Temporary Regulations may be in the analysis of the use of marketing intangibles for transfer pricing purposes. The approach proposed by the IRS under the Temporary Regulations, as well as in the Glaxo case, might in the future suggest greater reliance by the IRS on profit split methods where a high value could arguably be attached to marketing services. With the heightened importance of these issues arising from a US perspective, tax authorities from other countries may also seek to employ a similar approach in determining the appropriate return for marketing and distribution functions performed by affiliates of foreign companies, especially where these issues are not contractually addressed by the parties. Multinational corporations marketing similar categories of products in other jurisdictions, including those based in the US, will be wise to follow the progress of the Temporary Regulations towards finalisation and the effects of the Glaxo settlement closely as they may have very wide-ranging implications.

### **913 The comparable profits method**

The comparable profits method (CPM) may be used to test the arm's length character of transfers of both tangible and intangible property. Differences in functions performed, resources used, and risks assumed between the tested party and the comparables should be taken into account in applying this method.

### **914 Profit split methods**

Profit split methods are specified methods for testing the arm's length character of transfers of both tangible and intangible property. The emphasis on comparable transactions throughout the regulations, however, is intended to limit the use of profit split methods to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable uncontrolled comparables under some other method. Profit split methods are appropriate when both parties to a transaction own valuable non-routine intangible assets.

Specified profit split methods are limited to either (1) the comparable profit split method, which makes reference to the combined operating profit of two uncontrolled taxpayers dealing with each other and whose transactions are similar to those of the controlled taxpayer, or (2) the residual profit split method, which allocates income first to routine activities using any of the other methods available, and then allocates the residual income, based upon the relative value of intangible property contributed by the parties. No other profit split methods are treated as specified methods under the final regulations (although other forms of profit splits might be used, if necessary, as unspecified methods). The Temporary Regulations expanded the potential applications of the residual profit split method. Whereas under the existing regulations, the residual profit is split between the parties that contribute valuable non-routine intangibles, the Temporary Regulations suggests the residual profits can be split between parties that provide non-routine contributions (not necessarily intangibles) to the commercial venture.

## **COST SHARING**

### **915 The US cost sharing regulations**

The general principles underlying cost sharing are set out in Chapter 5. The US cost sharing regulations (the 1995 US final cost sharing regulations) were issued in 1995 and became effective on 1 January 1996. New proposed US cost sharing regulations (the 2005 US proposed cost sharing regulations) were issued on 29 August 2005, and, at the time of this writing, are expected to be issued in final form in 2008. The 1995 US final cost sharing regulations replaced prior cost sharing regulations issued in 1968 (the 1968 cost sharing regulations). The 1995 US final cost sharing regulations and 2005 US proposed cost sharing regulations provide detailed rules for the use of cost sharing in the US which:

- (1) permit unrelated parties to participate in a cost sharing arrangement and exclude all such unrelated parties for purposes of determining whether the arrangement meets the essential requirements of the regulations;
- (2) define the 'intangible development area' that may be covered by a cost sharing arrangement to include all activities related to the development of intangibles

that are actually undertaken pursuant to the terms of the cost sharing arrangement;

- (3) permit the determination of a participant's proportionate share of R&D costs to be based on any factor that can reasonably be expected to reflect the participant's proportionate share of anticipated benefits from the use of intangibles developed under the cost sharing arrangement (covered intangibles);
- (4) permit the use of projections to estimate anticipated benefits, provided any divergence between projected and actual benefits does not exceed 20%;
- (5) require that any IRS adjustments to the allocation of costs under a cost sharing arrangement be made in the tax year in which the costs were incurred;
- (6) do not provide safe harbour rules for determining buy-in and buy-out payments but do limit the application of these rules to situations where a covered intangible has been made available to another party; and
- (7) provide that a cost sharing arrangement will not be treated as a partnership, and a foreign participant will not be treated as engaged in a US trade or business solely by virtue of its participation in the arrangement.

In addition to describing the 1995 US final cost sharing regulations, the following Sections include significant changes that may occur as a result of the 2005 US proposed cost sharing regulations.

### **916 A qualified cost sharing arrangement in the US**

To constitute a qualified cost sharing arrangement (a CSA), the terms of an arrangement to share R&D costs must be set out in a written document that is contemporaneous with the formation of the arrangement. Under the 1995 US final cost sharing regulations, the essential terms of that written agreement must include:

- (1) a list of the participants;
- (2) a description of the scope of R&D to be undertaken (the intangible development area);
- (3) a description of each participant's interest in any intangibles developed under the arrangement (covered intangibles);
- (4) a method for determining each related party participant's share of intangible development costs based on factors that can reasonably be expected to reflect the participant's proportionate share of anticipated benefits;
- (5) the duration of the arrangement;
- (6) the conditions under which the agreement may be modified or terminated; and
- (7) provision for adjustments to participants' cost-shares to reflect material changes in economic conditions and/or business operations.

The 2005 US proposed cost sharing regulations define contemporaneous as recording the written document in its entirety, signed and dated by all participants, no later than 60 days after the first occurrence of any intangible development cost to which the CSA is to apply. In addition, the 2005 US proposed cost sharing regulations require all of the essential terms listed above for the 1995 US final cost sharing regulation

except for (5) and (6). Finally, the 2005 US proposed cost sharing regulations require the following additional essential terms in the written agreement:

- (1) Specify the functions and risks that each controlled participant will undertake in connection with the CSA;
- (2) Enumerate all categories of intangible development costs (IDCs) to be shared under the CSA;
- (3) Specify that the controlled participants must use a consistent method of accounting to determine the IDCs and reasonably anticipated benefit (RAB) shares as described in the 2005 US proposed cost sharing regulations, and must translate foreign currencies on a consistent basis;
- (4) Require the controlled participants to enter into cost sharing transactions (CSTs) covering all IDCs as described in the 2005 US proposed cost sharing regulations, in connection with the CSA;
- (5) Require, when applicable, the controlled participants to enter into preliminary or contemporaneous transactions (PCTs) covering all external contributions as described in the 2005 US proposed cost sharing regulations, in connection with the CSA.

A related party that only provides R&D services under contract to one or more of the participants in a cost sharing arrangement without obtaining an interest in the covered intangibles may not be included in that arrangement as a participant. The party providing the contract R&D services must, however, receive from the participants an arm's length fee for its services, including a profit opportunity. The fees paid by the participants for contract R&D services, including any profit mark-up, must be included in the pool of R&D costs that are shared under the cost sharing arrangement.

Originally, the 1995 US final cost sharing regulations contained a requirement that a qualifying participant must use or reasonably expect to use covered intangibles in the active conduct of a trade or business. This requirement was replaced with a less stringent condition that a participant must reasonably anticipate that it will benefit from the use of a covered intangible. This wording opens, for example, the possibility that a covered intangible may be developed with the intention of licensing it to a third party. There have been suggestions in the past that this aspect of the cost sharing regulations may be reviewed in response to allegations that removal of the active business requirement has led taxpayers to be over-aggressive in their use of tax havens in cost sharing structures. However, the 2005 US proposed cost sharing regulations do not include any changes to the existing definition of a qualifying participant.

### **917 Cost sharing: the intangible development area and related costs**

The 1995 US final cost sharing regulations provide a flexible definition of intangible development costs that encompasses costs that can be allocated to all of the activities that are related to the development of intangibles that are actually undertaken pursuant to the terms of the cost sharing arrangement. Covered intangibles may include intangibles that were not foreseen at the inception of the cost sharing arrangement.

A participant's costs for R&D include all R&D costs actually incurred by the participant, plus all cost sharing payments it makes to other participants, minus all

cost sharing payments it receives from other participants. Costs include all operating expenses other than depreciation and amortisation (such as advertising, promotion, sales, marketing, warehousing and distribution, and administration expenses) incurred in connection with the intangible development area defined in the cost sharing agreement. Intangible development costs include costs for the use of tangible property (not otherwise included in operating expenses, above) but do not include costs related to the use of tangible property owned by a controlled participant or any intangible property made available to the cost sharing arrangement but do include an arm's length charge for the use of any such property made available to the cost sharing arrangement.

The treatment of compensatory stock options as a cost to be shared has become a controversial issue. The IRS focus on this issue has resulted from the increased use of stock-based compensation by US high-tech companies. In regulations that were finalised in 2003, the IRS provided that the value of compensatory stock options (i.e. the compensation expense portion) is a cost that must be shared among affiliates under a CSA.

The IRS views set forth in the regulations have triggered a wide range of reactions from taxpayers and practitioners. There are concerns that foreign tax authorities may take inconsistent positions, particularly as compensatory stock options are primarily a US phenomenon at this time. The concern as to how the value of stock option compensation is determined, given that there are several different acceptable methods to do so, and the fact that there will likely be a mismatch between the time value of the compensation (and thus the compensation expense deduction) is determined and when the services providers actually performed the services, also has been raised. These concerns no doubt reflect the large amounts at stake: allocation of compensatory stock option costs from the US company to foreign affiliates will increase the amount of the US company's taxable income. The identical issue addressed in the regulations is currently the subject of a number of pending Tax Court cases. In the 2005 US Tax Court case, *Xilinx v. Commissioner*, 125 T.C. 4 (2005), the court held that the company did not have to include stock option compensation in its expense pool under a qualified CSA. However, at the time of this writing, the IRS is appealing the Tax Court's ruling.

### **918 Cost sharing: determination of reasonably anticipated benefits**

If a CSA is in place, the IRS may not make allocations of income or expenses related to the covered intangibles except to the extent that a participant's share of R&D costs as determined under the written cost sharing agreement is not proportionate to its share of reasonably anticipated benefits attributable to the covered intangibles. For this purpose, the benefits attributable to the covered intangibles mean the income generated or the costs saved by the participants' use of the covered intangibles. Moreover, a participant's reasonably anticipated benefits are the aggregate benefits that the participant reasonably anticipates that it will derive over time from the exploitation of the covered intangibles.

A related party participant's proportionate share of R&D costs and its share of anticipated benefits are determined by reference only to the allocable costs and anticipated benefits of other related party participants. Costs allocated to unrelated participants and benefits derived by unrelated participants are not considered.

Reasonably anticipated benefits are determined by using the most reliable estimate of the benefits to be derived from the covered intangibles. Anticipated benefits may be measured directly by reference to the estimated additional income to be generated or the costs to be saved. Alternatively, the anticipated benefits may be estimated indirectly by reference to other factors such as units of production, units sold, sales revenue, operating profits, or any other basis of measurement that has a reasonably identifiable relationship to the additional income expected to be generated or costs expected to be saved by the participants' use of the covered intangibles. The basis for measuring the anticipated benefits must be consistent for all related party participants, and ordinarily must be consistently used over time.

Adjustments may be made, however, to reflect material changes over time in the activities of the participants related to their use of the covered intangibles.

If two or more estimates of the reasonably anticipated benefits are available, in order to determine the most reliable estimate, the completeness and accuracy of the available data and the soundness of the underlying assumptions used in the analysis must be taken into account. If two estimates are equally reliable, either estimate may be used, and no adjustment in the allocation of R&D costs made under the cost sharing agreement should be made by the IRS, based on the difference in the results under the two estimates.

The regulations rely on an application of the Best Method Rule to determine the appropriate method for testing the arm's length character of inter-company transfers of tangible and intangible property. Accordingly, the regulations allow substantial flexibility but are not definitive regarding the allocation of costs under a cost sharing arrangement.

The regulations provide little guidance on the selection of an appropriate indirect basis for measuring anticipated benefits. The principal requirement is that the basis selected be related to the benefits obtained from using the covered intangibles. Thus, units produced or sold may be a reliable measure of anticipated benefits if each related party participant is expected to have a similar per unit increase in net profit or per unit decrease in net loss attributable to use of the covered intangible. This may be the case, for example, where the participants are engaged in the production and sale of substantially uniform products under similar economic conditions. Similarly, sales revenue may be a reliable measure of anticipated benefits where the costs of exploiting the covered intangibles are not substantial, relative to revenues generated, or the principal effect of using the covered intangible is to increase revenue without increasing costs. Sales revenue is unlikely to be a reliable measure of anticipated benefits unless each participant operates at the same level of market. Operating profit is likely to be a reliable measure of anticipated benefits where such profit is largely attributable to the use of the covered intangible or if the share of profits attributable to the use of the covered intangible is expected to be similar for each participant. This is most likely to be the case where the covered intangibles are integral to the business activity of the participant and the marginal effect on profits of using the covered intangibles is substantially the same for each participant.

Determination of the reasonably anticipated benefits from the covered intangibles necessarily depends upon the reliability of projections. The projections should, generally, include a determination of the time period between the inception of the R&D activity and the realisation of the benefits from that activity. In addition, the projections

include a year-by-year estimate of the benefits to be generated by the use of the covered intangibles. If it is anticipated that the benefits of the participants will not significantly change over time, current annual benefits may be used as a reliable measure of future benefits. Where, however, there will be significant variation among the related party participants in the timing of their receipt of benefits, it may be necessary to use discounted present value calculations to reliably determine a participant's proportionate share of benefits.

A significant divergence between projected benefit shares and actual benefit shares among the participants in a cost sharing arrangement may indicate that the projections used were not reliable. Projections of benefit shares will not be considered unreliable, based on a divergence of projected and actual benefit shares, provided the divergence for each related party participant is not more than 20% of a participant's projected benefit share. In addition, projections of benefit shares will not be considered unreliable if the difference between projected and actual benefit shares is due to an extraordinary event beyond the control of the participants.

The 20% rule applies to each participant. Thus, an adjustment of cost-shares may be made by the IRS if any one of the participants fails to meet the 20% test, even though all other participants do meet the exception. Moreover, neither the 20% safe harbour nor the extraordinary event exception will preclude an IRS adjustment if the measure of anticipated benefits was not based on the most reliable measure of anticipated benefits.

For the purpose of determining the divergence between actual and projected benefit shares, all non-US related party participants are aggregated and treated as a single participant. An adjustment by the IRS due to unreliable projections will be made to the cost-shares of foreign participants only if there is a matching adjustment to the cost-shares of US participants, or if the variation between actual and projected benefit shares of the foreign participants has the effect of substantially reducing US income taxes.

The 2005 US proposed cost sharing regulations restate the existing 1995 US final cost sharing regulations with some technical clarifications and changes to conform to the new terminology and framework. The 2005 US proposed cost sharing regulations provide, as is implicit in the existing 1995 US final cost sharing regulations, that for purposes of determining reasonably anticipated benefit shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most current reliable data regarding past and projected future results as is available at such time.

### **919 IRS adjustments to a US participant's cost share**

The IRS may not make transfer pricing allocations with respect to a qualifying cost sharing arrangement except to the extent necessary to make each related party participant's share of intangible development costs equal to its share of reasonably anticipated benefits attributable to the covered intangibles – such adjustments will not ordinarily result in deemed transfers of intangibles. Any such adjustments must be reflected in the year in which the re-allocated costs were incurred. Moreover, when a participant is required to make a cost sharing payment to another participant, the IRS may make appropriate allocations to reflect an arm's length rate of interest for

the time value of money.

If over time the economic substance of an arrangement becomes inconsistent with the terms of a written cost-sharing agreement, the IRS may impute an agreement that is consistent with the actual conduct of the participants. This could happen, for example, if there is a consistent pattern of one related party participant bearing an inappropriately high or low share of the intangible development costs. This could result in a deemed transfer of an interest in the covered intangibles.

Under the 2005 US proposed cost sharing regulations, taxpayers are prohibited from making periodic adjustments under the commensurate with income standard. Instead, the Commissioner is generally authorised to make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with an arm's length result.

As such, the Commissioner may make appropriated adjustments to CSTs to bring intangible development cost shares in line with reasonably anticipated benefit shares. Such adjustments include adding or removing costs from intangible development costs, allocating costs between the intangible development area and other business activities, improving the reliability of the benefits measurement basis used or the projections used to estimate reasonably anticipated benefit shares, and allocating among the controlled participants any unallocated territorial interests in cost-shared intangibles. To the extent the controlled participants consistently and materially fail to bear intangible development costs shares equal to their respective reasonably anticipated benefit shares, the Commissioner is permitted to impute an agreement that is consistent with the controlled participants' course of conduct.

## **920 Cost sharing: buy-in/buy-out payments**

A participant in a cost sharing arrangement acquires an interest in a covered intangible by virtue of having paid for the development of that intangible; no other payment is ordinarily required. A buy-in payment to acquire an interest in an intangible will be required if a pre-existing intangible owned by one participant is made available to the other participants or is otherwise used in the cost sharing arrangement. In that case, each of the other participants must make a buy-in payment to the contributing participant. Similarly, if a new related party participant enters an existing cost sharing arrangement and thereby acquires an interest in covered intangibles, the new participant must make a buy-in payment to each of the related party participants from whom the interest is acquired. Finally, if there is any change in the related party participants' relative interests in covered intangibles, a buy-in payment will be required from all participants obtaining an increased interest in the covered intangibles. A buy-in payment may take the form of a single lump-sum payment, a series of instalment payments, or an ongoing royalty.

A buy-in payment must be equal to the arm's length consideration that would be paid if the transfer of an intangible were to or from an unrelated party. The 1995 US final cost sharing regulations do not provide any safe harbour methods for determining the amount of a buy-in or buy-out payment but rely on the methods set out in the final § 482 regulations dealing with transfers of intangibles. In non-binding rulings involving the valuation of intangibles, the IRS has considered a residual valuation method, which determines intangible asset value by determining the excess of the taxpayer's US stock market capitalisation over the value of the taxpayer's tangible assets,



marketing intangibles, plus other manufacturing intangibles. This method has caused much discussion by taxpayers and practitioners in light of the high US stock market valuations for US internet and other high-tech companies prevalent during the late 1990s. Despite the retreat in the US stock market values for these types of companies, if adopted, this valuation method could result in the significant values for intangible assets, and thus significant buy-in payments.

If a related party participant withdraws from a cost sharing arrangement and by doing so it relinquishes an interest in a covered intangible, a buy-out payment is required only if one or more of the remaining participants obtains an increased interest in the covered intangibles. Thus, the abandonment of specified geographic rights to a covered intangible caused, for example, by the liquidation of a participant previously doing business in that geographic region, may not trigger a buy-out payment unless one of the remaining participants begins doing business in that region.

The 2005 US proposed cost sharing regulations refer to 'buy-in' payments as preliminary or contemporaneous transactions (PCTs) and expand the definition of intangible property subject to a PCT payment to potentially include workforce in place, business opportunity and goodwill. Under this new definition, the contribution of an experienced research team in place would require adequate consideration in the buy-in payment. Furthermore, the 2005 US proposed cost sharing regulations expand the rights required to be transferred in order to eliminate a perceived abuse where the transfer of limited rights could result in lower PCT payments. Therefore, under these proposed regulations, the PCT payment must account for the transfer of exclusive, perpetual and territorial rights to the intangible property. Finally, the 2005 US proposed cost sharing regulations do not allow a reduction in the PCT for the transfer of existing 'make or sell' rights by any participant that has already paid for these rights.

In addition, the 2005 US proposed cost sharing regulations introduce the 'investor model' approach which provides that the amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participants' aggregate net investment in developing cost shared intangibles pursuant to a CSA, attributable to both external contributions and cost contributions, is reasonably anticipated to earn a rate of return equal to the appropriate discount rate.

In determining the valuation of PCT payments, the 2005 US proposed cost sharing regulations make a modification to the existing residual profit split method, and provide three new methods which include the Income Method, Acquisition Price Method, and Market Capitalisation Method. Under the proposed regulations the residual profit split method may not be applied where only one participant makes significant non-routine contributions to the development and exploitation of cost shared intangibles of a CSA.

On 27 September 2007, the IRS reaffirmed its positions in the 2005 US proposed cost sharing regulations with the issuance of the Coordinate Issue Paper (LMSB-04-0907-62) addressing buy-in payments (or PCTs) associated with cost sharing arrangements in all industries. The Paper's purpose is to coordinate, in the field, the examination of all CSAs.

## **921 Cost sharing: administrative requirements**

A related party participant must maintain documentation necessary to establish the total amount of intangible development costs incurred under the cost sharing

arrangement and how each participant's share of those costs was determined. The 2005 US proposed cost sharing regulations require controlled participants to a CSA to timely update and maintain documentation sufficient to meet 10 separate requirements specified in the proposed regulations. This documentation must be provided to the IRS within 30 days of a request. In addition, in order to satisfy the documentation requirements, each controlled participant must file a 'Statement of Controlled Participant to Section 1.482-7 Cost Sharing Arrangement' that complies with the requirements in the 2005 US proposed cost sharing regulations with the IRS Ogden campus within 90 days after the first occurrence of an intangible development cost to which the newly formed CSA applies. Thereafter, for the duration of the CSA, each controlled participant must attach a copy of the original CSA statement along with a schedule of changes to its US income tax return, Schedule M of any Form 5471, any Form 5472 or any Form 8865 filed with respect to that participant.

## **922 Proposed cost sharing regulations in summary**

Sections 915-921 include discussions of the CSA rules under the existing regulations as well as potential significant proposed changes as a result of the 2005 US proposed cost sharing regulations. At the time of writing, it is anticipated that the 2005 US proposed cost sharing regulations will be finalised by the end of 2008. These proposed regulations reflect the concern on the part of the IRS and Treasury that the current regulations allow excessive flexibility in CSAs, and have facilitated what the government considers insufficient buy-in amounts paid to US entities that have contributed pre-existing intangible assets to CSAs.

In summary, the 2005 US proposed cost sharing regulations include three new specified methods of valuation for determining the arm's length buy-in amount and subsequently evaluating it under a new interpretation of the commensurate with income standard, which would permit the IRS but not taxpayers, to adjust buy-in amounts. If adopted in its current form, future CSAs would have to provide in all cases for division of cost-share benefits according to non-overlapping geographic territories. Buy-ins would be measured against an investor model, with emphasis on the realistic alternatives principle available to the parties in the CSA. Buy-in payments would be required to be made for all external contributions to the cost-shared activity. This would include contributions of pre-existing or acquired intangibles, including (controversially) contributions in the form of available workforce in place, anticipated contribution of services and other similar items. The buy-in calculation, however, would not cover the transfer of rights to manufacture or sell current products, which must be valued separately under the existing transfer pricing rules relating to transfers of intangible property.

It is likely that many existing CSAs would need to be amended to conform to the new rules, and buy-in payments made under existing CSAs after the effective date would have to conform to the new 'realistic alternatives' principle.

The implications of the 2005 US proposed cost sharing regulations are still being evaluated but if enacted without amendment to some of their more controversial aspects, the US regime for cost sharing would become far more restrictive.

## **SERVICES REGULATIONS**

### **923 The US services regulations**

The existing US services regulations were issued in 1968, which included the cost safe harbour rule and priced services at cost. On 10 September 2003, the IRS proposed new proposed regulations for the treatment of controlled services transactions, which included a new cost method, the Simplified Cost Based Method (SCBM), introduction of shared services arrangements, and required stock based compensation to be included in the pool of total services costs.

On 4 August 2006, the IRS issued new temporary and proposed services regulations in response to practitioners' feedback from the 2003 proposed regulations. These regulations are effective for taxable years beginning after 31 December 2006. Taxpayers may elect to apply these regulations retroactively to taxable years beginning after 10 September 2003 if all Temporary Regulations are applied to all of the taxpayer's taxable years.

### **924 Services cost method**

The 2006 regulations introduced a new pricing method, the Services Cost Method (SCM) which replaced the previously proposed SCBM. On 16 January 2007, the IRS issued Notice 2007-5, extending the effective date for use of the SCM one year, applying to taxable years beginning 1 January 2008. Taxpayers employing the SCM must state their intention to apply this method to their services in detailed records that are maintained during the entire duration that costs relating to such services are incurred. The records must include all parties involved (i.e. renderer and recipient) and the methods used to allocate costs.

Also, in the 16 January 2007 notice, the IRS issued Rev. Proc 2007-13, which expanded the 'good list' to over 100 low-margin services eligible for the SCM that can be priced at cost, without a mark-up. A service that is not identified on the good list can qualify for the SCM if a benchmarking analysis is performed and the median mark-up on total costs yielded from a set of comparable service providers is less than 7% (low margin services). However, the SCM method is elective, and taxpayers have the option to charge mark-ups for services identified on the good list.

In addition to the good list and the low-margin services, a taxpayer must also comply with the Business Judgment Rule, which is effective for taxable years beginning after 31 December 2006. This rule requires taxpayers to conclude that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or business of the renderer, the recipient, or both. Therefore, during the transition period (1 January 2007 – 31 December 2007) taxpayers may continue to apply the cost safe harbour (i.e. integral vs. non-integral approach) in conjunction with the business judgment rule, but should be including stock-based compensation in total costs.

The regulations also specifically mentions services where the SCM cannot be employed, these services include:

- Manufacturing;
- Production;

- Extraction, exploration or processing of natural resources;
- Construction;
- Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or similar arrangement R&D or experimentation;
- Financial transactions, including guarantees; and
- Insurance or reinsurance.

### **925 Profit split method**

The Profit Split Method (PSM) is modified under the new Temporary Regulations requiring the split of residual profits to be based on 'non-routine contributions' rather than on contributions of intangibles. The IRS defines non-routine contributions as 'one for which the returns cannot be determined by reference to benchmarks.' The new regulations attempt to clarify the application of the PSM for high-value services under Treas. Reg. 1.482-9T(g)(1) which now states that the PSM is 'ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers.' The Temporary Regulations have eliminated references to 'high value' and 'highly integrated transactions,' however, 'routine' transactions are not indicative of transactions with low value. Non-routine contributions include services that cannot be determined by reference to market benchmarks, (e.g. government contracts, reputation, track record of success in a territory of business).

### **926 Contractual arrangements and embedded intangibles**

In analysing transactions involving intangible property, the Temporary Regulations have retained the emphasis on the importance of legal ownership. When intangible property is embedded in controlled services transactions, the economic substance must coincide with the contractual terms. The economic substance must be in accord with the arm's length standard.

### **927 Ownership of intangibles**

The Temporary Regulations have issued new guidance surrounding the ownership of intangibles. For transfer pricing purposes, the owner for legally-protected intangibles is the legal owner. However, in the case of non-legally protected intangibles, the owner is the party with 'practical control' over the intangible. When the legal ownership standard is inconsistent with 'economic substance,' these rules may be dismissed. The Temporary Regulations eliminate the possibility of multiple ownership of a single intangible, as is the case under the 'developer-assister' rule in the existing regulations.

### **928 Benefit test**

The conditions in which an activity is deemed to provide the recipient with a benefit have been revised in the Temporary Regulations. The conditions are:

- (1) If the activity directly results in a reasonably identifiable value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so; or

- (2) If an uncontrolled taxpayer in comparable circumstances would be willing to pay an uncontrolled party for the same or similar activities, or the recipient otherwise would have performed the same or similar activity for itself.

In regards to Passive Association, the Temporary Regulations state that if a benefit results from the controlled taxpayer's status as a member of a controlled group, the recipient is deemed not to obtain a benefit.

Duplicative activities occur 'if an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.' The Temporary Regulations state that duplicative activities result in a benefit if they also reduce the commercial risk associated with the transaction.

### **929 Pass-through costs**

The Temporary Regulations further clarify the rules for 'pass-through' of external costs without a mark-up. This generally applies to situations in which the costs of a controlled service provider include significant charges from uncontrolled parties. Rather than have these costs permitted to 'pass-through' and not be subject to a mark-up under the transfer pricing method used to analyze the controlled services transaction, the Temporary Regulations allows for the evaluation of the third party costs (if material) to be evaluated on a disaggregated basis from the covered service transaction.

### **930 Passive association benefits**

A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

### **931 Stewardship and shareholder activities**

The Temporary Regulations shifts the focus in defining benefit from the service provider to the recipient to be consistent with OECD Guidelines.

Shareholder activities are defined under the Temporary Regulations as an activity in which the 'sole effect,' rather than the 'primary effect' of that activity is either to protect the renderer's capital investment in the recipient or in the other members of the controlled group or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. No charge would be assessed to the group member(s) for these shareholder activities. Examples:

- (1) Preparation and filing of public financial statements; and
- (2) Internal Audit activities.

Stewardship activities are defined as an activity by one member of a group of controlled taxpayers that results in a benefit to a related member. These services would be allocated and charged out to the group members. Examples:

- (1) Expenses relating to a corporate reorganisation (including payments to outside law firms and investment bankers) could require a charge depending on the application of the benefit test;
- (2) Under the Temporary Regulations, the IRS may require US multinationals to charge for many centralised group services provided to foreign affiliates; and
- (3) Activities in the nature of day-to-day management of a controlled group are explicitly excluded from the category of shareholder expenses because the Temporary Regulations do not view such expenses as protecting the renderer's capital investment.

### **932 Stock-based compensation**

The IRS has clarified that stock-based compensation must be included in the total services cost pool. In a comparable analysis, the Temporary Regulations indicate that it is appropriate to adjust the comparables' financial data when there is a 'material difference in accounting for stock-based compensation,' and this difference would affect the arm's length result, adjustments to improve comparability should be made. These adjustments may have an affect on the total services cost of the tested party, the comparables, or both. Examples how total services costs and operating income of the tested party and comparables should be adjusted to account for stock-based compensation are provided in the Temporary Regulations.

The Temporary Regulations do not indicate a best method for calculating stock-based compensation between grant date and spread-at-exercise. However, the examples provided in the Temporary Regulations lean towards a preference for grant date valuation.

### **933 Shared services arrangements**

The Temporary Regulations provide guidance on the Shared Services Arrangements (SSAs), which applies to services that otherwise qualify for the SCM, i.e., are not subject to a mark-up. Costs are allocated based on each participant's share of the reasonably anticipated benefits from the services, with the actual realisation of benefit bearing no influence on the allocation. The taxpayer is required to maintain documentation stating the intent to apply the SCM for services under an SSA.

### **934 Financial guarantees**

Financial guarantees are excluded as eligible services for application of the SCM because the provision of financial guarantees requires compensation at arm's length under the Temporary Regulations. The Temporary Regulations reserve this matter to be addressed in the new 'Global Dealings' regulations, which at the writing of this chapter have yet to be released.

### **935 Contractual relationships**

The Temporary Regulations attempt to clarify when the IRS may impute contractual relationships based on economic substance. Examples in the Temporary Regulations illustrate how economic substance of contractual terms between related parties would be honoured even if the cost plus remuneration percentage was determined by the IRS to fall outside of the arm's length range. However, in the event that the cost plus

determined by the taxpayer is substantially outside the arm's length range, the IRS may impute the contractual relationships. It is unclear what the IRS constitutes as a significant deviation outside the arm's length range.

### **936 Contingent payments**

The Temporary Regulations eliminate having to consider whether an uncontrolled taxpayer would have paid a contingent fee if it engaged in a similar transaction under comparable circumstances. Instead, emphasis is placed on the importance of the economic substance principles under the existing regulations. In other words, whether a particular arrangement entered into by controlled parties has economic substance is not determined by reference to whether it corresponds to arrangements adopted by uncontrolled parties.

### **937 Documentation requirements**

The Temporary Regulations do not require documentation to be in place prior to the taxpayer filing the tax return. However, documentation prepared after the tax return is filed would not provide for penalty protection in the event the IRS disagrees with the application of the method used.

During this transition period, the IRS is providing taxpayers with penalty relief by not penalising taxpayers that undertake reasonable efforts to comply with the new regulations.

## **THE US PENALTY REGIME**

### **938 The final penalty regulations**

The IRS has stated that the objective of the penalty regime is to encourage taxpayers to make reasonable efforts to determine and document the arm's length character of their inter-company transfer prices. The regulations provide guidance on the interpretation of 'reasonable efforts'.

The regulations impose a 20% non-deductible transactional penalty on a tax underpayment attributable to a transfer price claimed on a tax return that is 200% or more, or 50% or less than the arm's length price. The penalty is increased to 40% if the reported transfer price is 400% or more, or 25% or less than the arm's length price. Where these thresholds are met, the transfer pricing penalty will be imposed unless the taxpayer can demonstrate reasonable cause and good faith in the determination of the reported transfer price.

The regulations also impose a 20% net adjustment penalty on a tax underpayment attributable to a net increase in taxable income caused by a net transfer pricing adjustment that exceeds the lesser of USD5 million or 10% of gross receipts. The penalty is increased to 40% if the net transfer pricing adjustment exceeds USD20 million or 20% of gross receipts. Where these thresholds are met, the transfer pricing penalty can be avoided only if a taxpayer can demonstrate that it had a reasonable basis for believing that its transfer pricing would produce arm's length results, and that appropriate documentation of the analysis upon which that belief was based existed at the time the relevant tax return was filed and is turned over to the IRS within 30 days of a request. The principal focus of the transfer pricing regulations is on

these documentation requirements that must be met if a taxpayer is to avoid the assessment of a net adjustment penalty.

For both the transactional penalty and the net adjustment penalty, whether an underpayment of tax is attributable to non-arm's length transfer pricing is determined from the results reported on an income tax return, regardless of whether those reported results differ from the transaction prices initially reflected in a taxpayer's books and records. An amended tax return will be used for this purpose if it is filed before the IRS has contacted the taxpayer regarding an examination of the original return. A US transfer pricing penalty is not a no fault penalty. Even if it is ultimately determined that a taxpayer's transfer prices were not arm's length and the thresholds for either the transactional penalty or net adjustment penalty are met, a penalty will not be imposed if the taxpayer can demonstrate that based upon reasonably available data, it had a reasonable basis for concluding that its analysis of the arm's length character of its transfer pricing was the most reliable, and that it satisfied the documentation requirements set out in the new final regulations.

The US competent authority has stated that transfer pricing penalties will not be subject to negotiation with tax treaty partners in connection with efforts to avoid double taxation.

### **939 The reasonableness test**

A taxpayer's analysis of the arm's length character of its transfer pricing will be considered reasonable if the taxpayer selects and applies in a reasonable manner a transfer pricing method specified in the transfer pricing regulations. To demonstrate that the selection and application of a method was reasonable, a taxpayer must apply the Best Method Rule and make a reasonable effort to evaluate the potential application of other specified pricing methods. If a taxpayer selects a transfer pricing method that is not specified in the regulations, the taxpayer must demonstrate a reasonable belief that none of the specified methods was likely to provide a reliable measure of an arm's length result, and that the selection and application of the unspecified method would provide a reliable measure of an arm's length result.

In applying the best method rule, the final regulations make it clear that ordinarily it will not be necessary to undertake a thorough analysis under every potentially applicable method. The final regulations contemplate that in many cases the nature of the available data will readily indicate that a particular method will or will not likely provide a reliable measure of an arm's length result. Thus, a detailed analysis of multiple transfer pricing methods should not be necessary except in unusual and complex cases.

The regulations specify that the following seven factors should be considered in determining whether a taxpayer's selection and application of a transfer pricing method has been reasonable:

- (1) the experience and knowledge of the taxpayer and its affiliates;
- (2) the availability of accurate data and the thoroughness of the taxpayer's search for data;
- (3) the extent to which the taxpayer followed the requirements of the transfer pricing regulations;



- (4) the extent to which the taxpayer relied upon an analysis or study prepared by a qualified professional;
- (5) whether the taxpayer arbitrarily sought to produce transfer pricing results at the extreme point of the arm's length range;
- (6) the extent to which the taxpayer relied on an advance pricing agreement applicable to a prior tax year, or a pricing methodology specifically approved by the IRS during an examination of the same transactions in a prior year; and
- (7) the size of a transfer pricing adjustment in relation to the magnitude of the inter-company transactions out of which the adjustment arose.

In determining what level of effort should be put into obtaining data on which to base a transfer pricing analysis, a taxpayer may weigh the expense of additional research against the likelihood of finding new data that would improve the reliability of the analysis. Taxpayers are not required to search for relevant data after the end of the tax year but are required to retain any relevant data that is in fact acquired after the year-end but before the tax return is filed.

#### **940 The contemporaneous documentation requirement**

To avoid a transfer pricing penalty, a taxpayer must maintain sufficient documentation to establish that it reasonably concluded that, given the available data, its selection and application of a pricing method provided the most reliable measure of an arm's length result and must provide that documentation to the IRS within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates.

The announcement by the Commissioner of the IRS Large and Midsize Business Division (on 23 January 2003) indicates that the IRS is stepping up enforcement of the 30-day rule and adopting a standard practice of requiring field examiners to request a taxpayer's contemporaneous documentation within 30 days at the commencement of every examination of a taxpayer with significant inter-company transactions.

There is no requirement to provide any documentation to the IRS in advance of such a request, and the tax return disclosure requirements relating to the use of unspecified methods, the profit split method and lump-sum payments for intangibles originally included in the 1993 Temporary Regulations were not retained in the final regulations. In this respect, the US regime is less onerous than some other jurisdictions (e.g. Canada Australia, and India). However, in contrast, it should be noted that the IRS apparently is enforcing tax return disclosure requirements relating to the existence of cost sharing arrangements (see above).

#### **941 Principal documents**

To meet this documentation requirement the following principal documents, which must exist when the relevant tax return is filed, should accurately and completely describe the basic transfer pricing analysis conducted by a taxpayer:

- (1) an overview of the taxpayer's business, including an analysis of economic and legal factors that affect transfer pricing;

- (2) a description of the taxpayer's organisational structure, including an organisational chart, covering all related parties engaged in potentially relevant transactions;
- (3) any documentation specifically required by the transfer pricing regulations;
- (4) a description of the selected pricing method and an explanation of why that method was selected;
- (5) a description of alternative methods that were considered and an explanation of why they were not selected;
- (6) a description of the controlled transactions, including the terms of sale, and any internal data used to analyse those transactions;
- (7) a description of the comparable uncontrolled transactions or parties that were used with the transfer pricing method, how comparability was evaluated, and what comparability adjustments were made, if any; and
- (8) an explanation of the economic analysis and projections relied upon in applying the selected transfer pricing method.

The following additional principal documents must also be maintained by a taxpayer and must be turned over to the IRS within the 30-day period but do not have to exist at the time the relevant tax return is filed:

- (1) a description of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return that would be useful in determining whether the taxpayer's selection and application of its transfer pricing method was reasonable; and
- (2) a general index of the principal and background documents related to its transfer pricing analysis and a description of the record keeping system used for cataloguing and accessing these documents.

## 942 Background documents

Background documents include anything necessary to support the principal documents, including documents listed in the § 6038A regulations, which cover information that must be maintained by foreign-owned corporations. Background documents do not need to be provided to the IRS in connection with a request for principal documents but if the IRS makes a separate request for background documents, they must be provided within 30 days.

The regulations provide that the 30-day requirement for providing documentation to the IRS applies only to a request issued in connection with an examination of the tax year to which the documentation relates. The IRS has stated that it may also seek to obtain transfer pricing documentation related to subsequent tax years as well. A taxpayer is not required to comply with that request within 30 days in order to avoid potential transfer pricing penalties.

## 943 FIN 48

Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), specifies a comprehensive model for how companies should determine and disclose in their financial statements uncertain tax

positions that they have taken or expect to take on their tax returns. Existing guidance on the application of income tax law is complicated and at times ambiguous; thus it is often unclear whether a particular position adopted on a tax return will ultimately be sustained or whether additional future payments will be required. As a result of limited specific authoritative literature on accounting for uncertain tax positions, significant diversity in practice has developed. This diversity in accounting raised concerns that tax contingency reserves had become susceptible to earnings manipulations, and that companies' reserves could not reasonably be compared until standards for recording tax benefits were strengthened and standardised.

Under FIN 48, a company's financial statements will reflect expected future tax consequences of all uncertain tax positions. FIN 48 is effective as of the beginning of fiscal years that start after 15 December 2006. The estimation of tax exposure is to be retrospective as well as prospective. Tax reserves should be assessed under the assumption that taxing authorities have full knowledge of the position and all relevant facts. Each tax position must be evaluated on its own merits, without consideration of offsets or aggregations, and in light of multiple authoritative sources including legislation and intent, regulations, rulings, and case law, as well as past administrative practices and precedents.

Two principles central to FIN 48 are recognition and measurement. The principle of 'recognition' means that a tax benefit from an uncertain position may be recognised only if it is 'more likely than not' that the position is sustainable under challenge from a taxing authority based on its technical merits, and without consideration of the likelihood of detection. With regard to 'measurement,' FIN 48 instructs that the tax benefit of an uncertain tax position be quantified using a methodology based on 'cumulative probability.' That is, a company is to book the largest amount of tax benefit which has a greater than 50% likelihood of being realised upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

Because transfer pricing is a significant source of tax uncertainty, it must be considered in developing a tax provision. The existence of contemporaneous documentation covering a company's inter-company transactions is not sufficient to eliminate tax exposure uncertainty associated with those transactions. Often, the uncertainty associated with transfer pricing relates not to whether a taxpayer is entitled to a position but, rather, the amount of benefit the taxpayer can claim. The form and detail of documentation required to support a company's determination of its uncertain tax positions associated with transfer pricing will depend on many factors including the nature of the uncertain tax positions, the complexity of the issues under consideration and the materiality of the dollar amounts involved.

#### **944 SEC Roadmap: Conversion of US GAAP to IFRS**

In November 2008, the US Securities and Exchange Commission (SEC) released its proposed roadmap for the mandatory adoption of International Financial Reporting Standard (IFRS) in the US. The proposed roadmap currently provides that US issuers adopt IFRS for financial reporting purposes as early as 2014, with the potential for voluntary adoption as early as 2009. Although the mandatory conversion date is 1 January 2014, US issuers will be required to issue their financial reports with three-year comparative financials, which means that these companies' financials for the 2012 and 2013 must also be reported under IFRS.

For many US MNCs, the conversion to IFRS presents opportunities for these companies to harmonise their internal transfer pricing policies, typically based on US Generally Accepted Accounting Principles (US GAAP), to IFRS, the new accounting standard of choice for many of the jurisdictions in which their affiliates operate. However, considering the significant differences in the accounting for revenue and expense items between US GAAP and IFRS (e.g., as many as four hundred potential differences impacting the pre-tax income), the adoption of IFRS also presents many implementation and risk management challenges that need to be considered well in advance of the conversion date.

The accounting policies adopted by the MNCs accounting/finance departments will have profound impacts on the MNCs transfer pricing footprint, including the planning and setting of prices, documentation, defence of the group's inter-company policies in the event of an examination by a taxing authority, and in negotiating tax rulings advance pricing agreements, and the like. Considering the significant impacts IFRS conversion will have on the MNCs transfer pricing landscape, it is vital that the tax department be involved, and if not, at the very least, be aware of the implications each of these policies will have on the transfer pricing aspect of the group's tax profile.

## **COMPETENT AUTHORITY**

### **945 The 2006 revenue procedure**

The competent authority process may be invoked by taxpayers when they consider that the actions of the US or another country with which the US has concluded a tax treaty, or both parties, result or will result in taxation that is contrary to the provisions of a treaty.

Taxpayers have the option of requesting competent authority assistance without first seeking a review of issues not agreed in the US by the IRS Appeals Division. Issues may also be simultaneously considered by the US competent authority and the IRS Appeals Division. Competent authority agreements may be extended to resolve similar issues in subsequent tax years.

Under section 12 of the Revenue Procedure, the limited circumstances in which the US competent authority may decline to take up the taxpayer's case with a treaty partner are enumerated. One such circumstance is if the taxpayer does not agree that competent authority negotiations are a government to government activity and they do not include the taxpayer's participation in the negotiation proceedings. Another is if the transaction giving rise to the request for competent authority assistance is a listed transaction under the US Regulations as a tax avoidance transaction.

### **946 The scope of competent authority assistance**

With one exception, the treaty with Bermuda, all US income tax treaties contain a Mutual Agreement Article that requires the competent authorities of the two treaty countries to consult with one another in an attempt to reduce or eliminate double taxation that would otherwise occur when the two countries claim simultaneous jurisdiction to tax the same income of a multinational enterprises or an affiliated group.

The Mutual Agreement Article contained in US tax treaties does not require the competent authorities to reach an agreement eliminating double taxation in a particular case. Rather, the treaties require only that the competent authorities make a good faith effort to reach such an agreement. Thus, there is no guarantee that competent authority assistance will result in the elimination of double taxation in every case; in practice, however, the vast majority of cases are concluded with an agreement that avoids double taxation. Latest statistics from the US CA (for the IRS's fiscal 2007) office indicates that it was able to obtain relief (full or partial) approximately 96% of the cases reviewed.

Competent authority negotiations are a government-to-government process. Direct taxpayer participation in the negotiations is not permitted. However, a taxpayer may take a very proactive approach to competent authority proceedings, presenting directly to each government its view of the facts, arguments and supporting evidence in a particular case. The taxpayer can facilitate the negotiation process between the two governments by developing alternatives and responses to their problems and concerns.

Competent authority relief is most commonly sought in the context of transfer pricing cases, where one country reallocates income among related entities in a manner inconsistent with the treatment of the same transactions in the other country. In such cases, competent authority relief is intended to avoid double taxation by either eliminating or reducing the adjustment or by making a correlative reduction of taxable income in the country from which income has been allocated. In transfer pricing cases, the US competent authority is guided by the § 482 regulations but is not strictly bound by the regulations and may take into account all the facts and circumstances, including the purpose of the treaty to avoid double taxation.

Other types of issues for which competent authority assistance may be sought include, inter alia, withholding tax issues, qualifications for treaty benefits and zero rate withholding for dividends and certain treaty interpretative issues.

### **947 When to request competent authority assistance**

In the case of a US-initiated adjustment, a written request for competent authority relief may be submitted as soon as practical after the amount of the proposed IRS adjustment is communicated in writing to the taxpayer. For a foreign-initiated adjustment, competent authority assistance may be requested as soon as the possibility of double taxation arises. Once competent authority has been requested, the applicable treaty may provide general guidance with respect to the types of issues the competent authorities may address. These issues could be allocation of income, deductions, credits, or allowances between related persons, determination of the source and characterisation of particular items of income, and the common meaning or interpretation of terms used in the treaty.

### **948 Competent authority: pre-filing and post-agreement conferences**

The Revenue Procedure provides for a pre-filing conference at which the taxpayer may discuss the practical aspects of obtaining the assistance of the US competent authority and the actions necessary to facilitate the negotiations with the foreign treaty partner. The Revenue Procedure also provides for a post-agreement conference after an agreement has been reached by the competent authorities to discuss the

resolution of the issues considered. There is no explicit provision for conferences while the issues are being considered by the competent authorities of both countries but the US competent authority has a practice of meeting and/or otherwise communicating with the taxpayer throughout the period of negotiations with the foreign treaty partner.

#### **949 Competent authority: small case procedures**

To be eligible for the small case procedure, the total proposed adjustments assessments must fall below certain specified amounts. Corporations would qualify for this small case procedure if the proposed adjustments were not more than USD1 million.

#### **950 Competent authority: statute of limitation protective measures**

The statute of limitations or other procedural barriers under US or non-US law may preclude or limit the extent of the assistance available from the competent authorities. The US competent authority has generally sought to read into treaties a waiver of procedural barriers that may exist under US domestic law, even in the absence of specific language to that effect in the treaty. The same policy is not always followed by the US's treaty partners. Therefore, a taxpayer seeking the assistance of the US competent authority must take whatever protective measures are necessary to ensure that implementation of a competent authority agreement will not be barred by administrative, legal, or procedural barriers that exist under domestic law in either country.

In particular, the taxpayer must take steps to prevent the applicable statute of limitations from expiring in the other country. If a treaty partner declines to enter into competent authority negotiations, or if a competent authority agreement cannot be implemented because the non-US statute of limitations has expired, a taxpayer's failure to take protective measures in a timely fashion may cause the US competent authority to conclude that the taxpayer failed to exhaust its competent authority remedies for foreign tax credit purposes.

Some US treaties contain provisions that are intended to waive or otherwise remove procedural barriers to the credit or refund of tax pursuant to a competent authority agreement, even though the otherwise applicable statute of limitations has expired. The 2006 Revenue Procedure warns taxpayers not to rely on these provisions because of differences among treaty partners in interpreting these waiver provisions. The limits a treaty may impose on the issues the competent authority may address are also another reason for a taxpayer to take protective measures to ensure that implementation of a competent authority agreement will not be barred.

Most US treaties also contain specific time limitations in which a case may be brought before the applicable competent authorities. These time limitations are separate from the domestic statute limitations. For example, the treaty with Canada requires that the other country be notified of a proposed adjustment within six years from the end of the taxable year to which the case relates. This notification under the treaty can be accomplished, from a US perspective, by filing either a competent authority request pertaining to the proposed adjustments or a letter requesting the preservation of the taxpayer's right to seek competent authority assistance at a later date, after administrative remedies in the other country have been pursued. If the

latter course is followed, this letter must be updated annually until such time as the actual competent authority submission is filed or the taxpayer determines it no longer needs to protect its rights to go to competent authority.

### **951 Competent authority: unilateral withdrawal or reduction of US-initiated adjustments**

Where the IRS has made a transfer pricing allocation, the primary goal of the US competent authority is to obtain a correlative adjustment from the foreign treaty country. Unilateral withdrawal or reduction of US-initiated adjustments, therefore, generally will not be considered. Only in extraordinary circumstances will the US competent authority consider unilateral relief to avoid double taxation.

### **952 Competent authority: repatriation of funds following a transfer pricing adjustment**

In 1999, the US issued Revenue Procedure 99-32 that provided for the tax-free repatriation of certain amounts following a transfer pricing allocation to a US taxpayer, broadly with the intention of allowing the taxpayer to move funds to reflect the agreed allocation of income following the transfer pricing adjustment. In cases involving a treaty country, co-ordination with the US competent authority is required before concluding a closing agreement with the taxpayer.

The Revenue Procedure requires the taxpayer to establish an account receivable, which may be paid without any tax consequence, provided it is paid within 90 days of the closing agreement or tax return filing for the year in which the adjustment was reported. The following should be taken into account when establishing an account receivable:

- (1) Absent payment of the account receivable within 90 days, the amount is treated as a dividend or capital contribution.
- (2) The account receivable bears interest at an arm's length rate.
- (3) The receivable is deemed to have been created on the last day of the year subject to the transfer pricing allocation, with the interest accrued being included in the income of the appropriate corporation each year the account receivable is deemed outstanding.

The Revenue Procedure the IRS previously issued in this area provided that previously paid dividends could be offset by the cash payment made in response to the primary transfer pricing adjustment. Under the 1999 Revenue Procedure, a taxpayer may only offset (i) dividends paid in a year in which a taxpayer-initiated adjustment relates if offset treatment is claimed on a timely income tax return (or an amended tax return) or (ii) in the same year that a closing agreement is entered into in connection with an IRS-initiated adjustment. In the former case, the dividend is treated as a prepayment of interest and principle on the deemed account receivable.

Under the 1999 Revenue Procedure, relief is not available, however, with respect to transactions where a transfer pricing penalty is sustained. Effectively, this requirement imposes an additional tax for failure to maintain contemporaneous documentation to substantiate arm's length transfer pricing.

### 953 Interest and penalties

The US competent authority generally has no authority to negotiate or provide relief in respect of interest and penalties.

## ADVANCE PRICING AGREEMENTS (APAS)

### 954 APAs: US procedures

The US was the first country to issue a formal, comprehensive set of procedures relating to the issue of binding advance agreements dealing with the application of the arm's length standard to inter-company transfer prices. Under the procedure, the taxpayer proposes a transfer pricing method (TPM) and provides data intended to show that the TPM is the appropriate application of the best method within the meaning of the regulations for determining arm's length results between the taxpayer and specified affiliates with respect to specified inter-company transactions. The IRS evaluates the APA request by analyzing the data submitted and any other relevant information. After discussion, if the taxpayer's proposal is acceptable, a written agreement is signed by the taxpayer and the IRS.

The procedures specify a detailed list of data that must be provided to the IRS with the application. There is also a user fee for participation in the program, which currently ranges between USD10,000 and USD50,000, based on the size of the taxpayer and the nature of the request.

In the application, the taxpayer must propose and describe a set of critical assumptions. A critical assumption is described as any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business or economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume.

The taxpayer must file an annual report for the duration of the agreement, which will normally include:

- (1) the application of the TPM to the actual operations for the year;
- (2) a description of any material lack of conformity with the critical assumptions;  
and
- (3) an analysis of any compensating adjustments to be paid by one entity to another, and the manner in which the payments are to be made.

The taxpayer must propose an initial term for the APA appropriate to the industry, product or transaction involved, and must specify for which taxable year the agreement will be effective. The APA request must be filed no later than the extended filing date for the Federal income tax return for the first taxable year to be covered by the APA.

The effect of an APA is to guarantee that the IRS will regard the results of the TPM as satisfying the arm's length standard if the taxpayer complies with the terms and conditions of the APA. The APA may be retroactively revoked in the case of fraud or malfeasance, cancelled in the event of misrepresentation, mistake/omission of fact, or lack of good faith compliance, or revised if the critical assumptions change. Adherence to the terms and conditions may be subject to audit – this will not include



re-evaluation of the TPM.

Traditionally, the IRS APA procedures were limited to issues concerning transfer pricing matters in the context of section 482 of the Internal Revenue Code. However, effective 9 June 2008 the APA procedures (through Rev. Proc. 2008-31) were modified to expand the scope of the APA Program's purview to include other issues for which transfer pricing principles may be relevant, including: 'attribution of profits to permanent establishment under an income tax treaty, determining the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the United States, and determining the amounts of income derived from sources partly within and partly without the United States, as well as related subsidiary issues.' The expansion of the program's scope may not necessarily translate into an immediate increase in the number of non-section 482 cases within the program as the IRS has publicly indicated that it will be selective in the cases admitted into the program. Nevertheless, the expansion of the program's scope of review, providing for other non-section 482 issues that may be resolved through the APA process, is a welcomed development.

### **955 Rollbacks**

APAs may, at the taxpayer's request at any point prior to the conclusion of an agreement, and with agreement of the responsible IRS District, be rolled back to cover earlier taxable years. This may be an effective mechanism for taxpayers to resolve existing audit issues.

### **956 Bilateral and unilateral APAs – impact on competent authority**

When a taxpayer and the IRS enter into an APA, the US competent authority will, upon a request by the taxpayer, attempt to negotiate a bilateral APA with the competent authority of the treaty country that would be affected by the transfer pricing methodology. The IRS has encouraged taxpayers to seek such bilateral APAs through the US competent authority.

If a taxpayer and the IRS enter into a unilateral APA, treaty partners may be notified of the taxpayer's request for the unilateral APA involving transactions with that country. Additionally, the regular competent authority procedures will apply if double taxation subsequently develops as a result of the taxpayer's compliance with the unilateral APA. Importantly, the US competent authority may deviate from the terms and conditions of the APA in an attempt to negotiate a settlement with the foreign competent authority. However, the 2006 Revenue procedure includes a strongly worded warning that a unilateral APA may hinder the ability of the US competent authority to reach a mutual agreement, which will provide relief from double taxation, particularly when a contemporaneous bilateral or multilateral APA request would have been both effective and practical to obtain consistent treatment of the APA matters in a treaty country.

### **957 APAs for small business taxpayers and IRS-initiated APAs**

In an effort to make the APA program more accessible to all taxpayers, the IRS released a notice in early 1998 proposing special, simplified APA procedures for small business taxpayers (SBT). The notice provides that a SBT is any US taxpayer with total gross income less than USD200 million. Under the simplified APA procedures, the entire APA process is accelerated and streamlined, and the IRS will

provide the SBT with more assistance than it does in a standard APA.

In an effort to streamline the APA process, the IRS may agree to apply streamlined procedures to a particular APA request, even if it does not conform fully to the requirements for 'small business' treatment.

The IRS has announced a program under which district examiners are encouraged to suggest to taxpayers that they seek APAs, if the examiners believe that APAs might speed issue resolution.

### **958 Developments in the APA program**

There is increased specialisation and coordination in the APA office, with teams designated to specific industries/issues, such as automotive, pharmaceutical and medical devices, cost sharing, financial products and semiconductors.

The APA program is also getting stricter with its deadlines. From now on, if the date on which the IRS and the taxpayer have agreed to complete an APA passes and the case goes unresolved, both parties will have to submit a joint status report explaining the reason for the delay and mapping out a new plan to close the case within three to six months. If the IRS and the taxpayer fail to meet the second target date, the new procedures call for an automatic all hands meeting of key officials from both sides. For an APA that has been executed, the taxpayer is required to submit an annual report showing its compliance with the terms of the agreement. Taxpayers now must also submit an APA Annual Report Summary, which is a standardised form reflecting key data, as part of the APA annual report.

## **COMPARISON WITH THE OECD TRANSFER PRICING GUIDELINES**

### **959 The best method rule**

As noted in 906, the US Regulations require application of the Best Method Rule in the selection of a pricing method. The OECD Guidelines do not explicitly refer to the Best Method Rule by name but do adopt the same principle. Under the OECD Guidelines, a taxpayer must select the method that provides the best estimate of an arm's length price, taking into account:

- (1) the facts and circumstances of the case;
- (2) the mix of evidence available; and
- (3) the relative reliability of the various methods under consideration.

### **960 Comparability analysis**

Both the US Regulations and the OECD Guidelines provide that the arm's length character of an inter-company transaction is ordinarily determined by comparing the results under the regulations or the conditions under the Guidelines (i.e. in both cases meaning either prices or profits) of that controlled transaction to the results realised or conditions present in comparable uncontrolled transactions. Comparability factors that must be taken into account include functions performed, risks assumed, contractual terms and economic conditions present, and the characteristics of the property transferred or the services provided. Determination of the degree of

comparability must be based on a functional analysis made to identify the economically significant functions performed, assets used, and risks assumed by the controlled and uncontrolled parties involved in the transactions under review.

Both the US Regulations and the OECD Guidelines permit the use of inexact comparables that are similar to the controlled transaction under review. Reasonably accurate adjustments must be made to the uncontrolled comparables, however, to take into account material differences between the controlled and uncontrolled transactions if such adjustments will improve the reliability of the results obtained under the selected pricing method. Both the US Regulations and the OECD Guidelines expressly prohibit the use of unadjusted industry average returns to establish an arm's length result.

An important comparability factor under both the US Regulations and the OECD Guidelines is the allocation of risk within the controlled group. The types of risks that must be taken into account under both sets of rules include: market risks; risk of loss associated with the investment in and use of property, plant, and equipment; risks associated with the success or failure of R&D activities; and financial risks such as those caused by currency exchange rate and interest rate variability. In addition, under both sets of rules the determination of which party actually bears a risk depends, in part, on the actual conduct of the parties and the degree to which a party exercises control over the business activities associated with the risk.

### **961 Market penetration strategies**

Consistent with the US Regulations, the OECD Guidelines recognise that market penetration strategies may affect transfer prices. Both the Regulations and the Guidelines require that where a taxpayer has undertaken such business strategies, it must be shown that:

- (1) there is a reasonable expectation that future profits will provide a reasonable return in relation to the costs incurred to implement the strategy; and
- (2) the strategy is pursued for a reasonable period of time given the industry and product in question.

The OECD Guidelines are generally less restrictive concerning market penetration strategies than the US Regulations, which require a very extensive factual showing and documentation.

### **962 Arm's length range**

Like the US Regulations, the OECD Guidelines provide that no adjustment should be made to a taxpayer's transfer pricing results if those results are within an arm's length range. The Guidelines do not include specific rules for establishing the arm's length range but do recognise that the existence of substantial deviation among the results of the comparables suggests that some of the comparables may not be as reliable as others, or that significant adjustments to the results of the comparables may be necessary.

### **963 What has to be at arm's length? Setting prices versus evaluating the result**

The primary focus of the US Regulations is on whether a taxpayer has reflected arm's

length results on its US income tax return; the actual methods and procedures used by taxpayers to set transfer prices are not relevant. The OECD Guidelines, however, tend to focus less on the results of transfer pricing and more on whether the transfer prices were established in an arm's length manner substantially similar to the manner in which uncontrolled parties would negotiate prices. Thus, the Guidelines put significant emphasis on factors known by the taxpayer at the time transfer prices were established.

#### **964 Traditional transactional methods**

The OECD Guidelines express a strong preference for the use of traditional transaction methods for testing the arm's length character of transfer prices for transfers of tangible property. These methods include the CUP method, the resale price method, and the cost plus method. These same methods are 'specified methods' under the US Regulations.

Under both the US Regulations and the OECD Guidelines, the focus is on the comparability of products under the CUP method, and the comparability of functions under the resale price and cost plus methods. Under all three methods and under both sets of rules, comparability adjustments must take into account material differences in operating expenses, accounting conventions, geographic markets, and business experience and management efficiency.

There are no material substantive differences between the US Regulations and the OECD Guidelines in the theoretical concepts underlying these methods, the manner in which these methods are to be applied, or the conditions under which these methods would likely be the best method. The US Regulations and the Guidelines differ only in their evaluation of the probability that comparable uncontrolled transactions can be identified, and that adequate and reliable data about the comparables can reasonably be obtained. While the Guidelines recognise that there may be practical problems in the application of these methods in some cases, the Guidelines assume that such cases will be the exception.

The OECD Guidelines provide as follows:

*Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, traditional transaction methods are preferable to other methods. However the complexities of real life business situations may put practical difficulties in the way of the application of the traditional transaction methods. In those exceptional situations, where there are no data available or the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods, it may become necessary to address whether and under what conditions other methods may be used.*

The experience in the US has been that it often is not possible to identify uncontrolled transactions that meet the comparability standards for the traditional transaction methods, which are substantially the same under both the US Regulations and the OECD Guidelines. Thus, the inability to apply these methods in practice is likely to be a common case, and not the exceptional case as is assumed by the Guidelines.

**965 Other methods**

Both the US Regulations and the OECD Guidelines provide for the use of other methods when the traditional transaction methods cannot be used. Under the US Regulations, a taxpayer may use the CPM or the profit split method. Under the Guidelines, a taxpayer may use the profit split method or the transactional net margin method (TNMM). In most cases, as explained below, the CPM and the TNMM are virtually indistinguishable. The emphasis on comparability throughout the US Regulations, however, is intended to limit the use of profit split methods to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable comparables under some other method. The Guidelines, on the other hand, express a strong preference for the use of the profit split over the TNMM.

**966 Transactional net margin method (TNMM)**

TNMM compares the operating profit relative to an appropriate base (i.e. a profit level indicator) of the controlled enterprise that is the least complex and owns no valuable intangibles (i.e. the tested party) to a similar measure of operating profit realised by comparable uncontrolled parties in a manner consistent with the manner in which the resale price or cost plus methods are applied. The operating rules for TNMM are thus substantially the same as those for CPM. Both methods require that the analysis be applied to an appropriate business segment and use consistent measures of profitability and consistent accounting conventions.

The OECD Guidelines do require that TNMM be applied on a transactional basis. The precise meaning of this requirement is not clear. It will ordinarily not be possible to identify net profit margins of comparables on a truly transactional basis, and in many cases, taxpayers will have difficulty identifying their own net profits on a transactional basis. In any event, it appears that TNMM is intended to be applied in the same manner as the resale price and cost plus methods, which ordinarily look to overall gross margins for an entire business segment for the full taxable year. Presumably, TNMM should be applied in the same manner.

The OECD Guidelines thus do not prohibit the use of CPM. They do provide, however, that the only profit-based methods such as CPM and so-called modified resale price/cost plus methods that satisfy the arm's length standard are those that are consistent with TNMM.

**967 Intangible property**

In respect to the treatment of intangible property, the OECD has recently issued a chapter discussing the special considerations arising under the arm's length principle for establishing transfer pricing for transactions involving intangible property. The OECD places emphasis on the actions that would have been taken by unrelated third parties at the time the transaction occurred. The Guidelines focus on the relative economic contribution made by various group members towards the development of the value of the intangible and on the exploitation rights that have been transferred in an inter-company transaction. This is particularly true in the case of the pricing of marketing intangibles. The Guidelines thus focus on economic ownership of the intangible as opposed to legal ownership.

The OECD Guidelines do not provide significant new guidance for the pricing of intangibles by providing specific standards of comparability. The Guidelines, similar to the US Regulations provide that prices for intangibles should be based on:

- (1) the anticipated benefits to each party;
- (2) prior agreement on price adjustments, or short term contracts; or
- (3) the allocation of the cost or benefit of uncertainty to one party in the transaction, with the possibility of renegotiation in the event of extreme or unforeseen circumstances.

The only pricing method that is specifically approved is the CUP method, which is equivalent to the comparable uncontrolled transaction (CUT) method in the US Regulations. The Guidelines give a cautious endorsement to the use of profit split methods or the TNMM when it is difficult to apply a transactional method. This is not inconsistent with the outcome that would be expected if the US Best Method Rule were applied in the same circumstances except for the preference of profit split over the TNMM.

The redefining of the IP ownership rules for non-legally protected intangibles under the proposed regulations will likely attract much debate between the US and its treaty partners who have adopted the OECD Guidelines on this matter. Uncertainties in the definition of 'practical control' and 'economic substance' will be the main drivers of such potential disputes.

### **968 Periodic adjustments under the OECD Guidelines**

The main area of potential difficulty arises from the focus in the US Regulations on achieving an arm's length result. There is a very evident potential for dispute as to whether the concept of periodic adjustments under the US Regulations (described above) is at odds with the statements in the Guidelines concerning the use of hindsight. However, the OECD clearly affirms the right of tax authorities to audit the accuracy of the forecasts that were used to establish transfer pricing arrangements, and to make adjustments if the projections on which the pricing was based prove to be inadequate or unreasonable.

### **969 Services**

Both the US Regulations and the OECD Guidelines focus on satisfying the arm's length standard by the recharge of costs specifically incurred by one group member to provide a service to another group member. Under both the US Regulations and the Guidelines, costs incurred include a reasonable allocation of indirect costs.

As to whether the arm's length charge for services also includes a profit to the service provider, the Guidelines state that the inclusion of a profit margin is normally part of the cost of the services. In an arm's length transaction, an independent enterprise would normally seek to charge for services in such a way as to generate a profit. There might be circumstances, however, in which an independent enterprise may not realise a profit from the performance of service activities alone. For example, the services provider might offer its services to increase profitability by complementing its range of activities.

The proposed regulations (on Services) are intended to conform the US Regulations

to the OECD Guidelines by eliminating the cost safe harbour method for non-integral activities. However, this intention is partially negated with proposal of the elective Services Cost Method for certain types of activities deemed 'low margin' services (See 923 to 937).

### **970 Documentation and penalties**

The OECD Guidelines recommend that taxpayers make reasonable efforts at the time transfer pricing is established to determine whether their transfer pricing results meet the arm's length standard, and they advise taxpayers that it would be prudent to document those efforts on a contemporaneous basis. The Guidelines also admonish tax authorities to balance their needs for taxpayer documentation with the cost and administrative burden imposed on taxpayers in the preparation of that documentation. The Guidelines also note that adequate record keeping and voluntary production of documents facilitates examinations and the resolution of transfer pricing issues that arise.

The OECD Guidelines include a cautious acknowledgement that penalties may play a legitimate role in improving tax compliance in the transfer pricing area. The Guidelines encourage member countries to administer any such penalty system in a manner that is fair and not unduly onerous for taxpayers.

# 10 Transfer pricing and indirect taxes

## 1001 Customs duty implications

Goods moved across international borders and imported from one customs jurisdiction into another are potentially subject to customs duties and, in some cases, to other duties and taxes such as value added tax (VAT) (which are beyond the scope of this book). In determining the transfer price for such goods, consideration must be given not only to the corporate income tax repercussions but also to the customs duty implications and, in certain circumstances, there may be an apparent conflict between the treatment of a transaction for the purposes of the two regimes. Careful planning is then necessary to achieve a price that satisfies the requirements of both the tax and customs authorities without incurring excessive liabilities.

## 1002 WTO Valuation Agreement

Most countries levy *ad valorem* duties and have complex regulations governing the determination of the value of imported goods for customs purposes. All references in this book to customs valuation (unless otherwise stated) are to the World Trade Organisation (WTO) Agreement on implementation of Article VII of the General Agreement on Tariffs and Trade 1994 ('the WTO Valuation Agreement'), formerly known as the GATT Customs Valuation Code. Under the Uruguay Round Agreement, all members of the WTO were required to adopt the WTO Valuation Agreement within a specified period; however, some developing countries have not done so. Nevertheless, the laws of most trading countries are now based on the WTO Valuation Agreement.

The basic principle of the WTO Valuation Agreement is that, wherever possible, valuation should be based on the 'transaction value' – the price paid or payable for the goods when sold for export to the country of importation, subject to certain prescribed conditions and adjustments. The most significant condition for acceptance of the transaction value by the customs authorities is that the price has not been influenced by any relationship between the parties. While different countries have widely varying standards to determine whether or not companies are 'related' for direct tax purposes, the WTO Valuation Agreement 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 WTO Valuation Agreement if:

- (1) they are officers or directors of one another's businesses;
- (2) they are legally recognised partners in business;
- (3) they are employer and employee;
- (4) there is any person who directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them;
- (5) one of them directly or indirectly controls the other \*;
- (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.

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

### **1003 Relationship between customs and tax rules**

Although the customs valuation rules are broadly similar to the OECD transfer pricing rules discussed elsewhere in this book, there are some significant differences and it cannot be assumed that a price that is acceptable to the Revenue authorities will necessarily also conform to the customs value rules.

At a basic level, a tax authority focuses on the accuracy of a transfer price as reflected on a tax return (annual basis aggregated across the entire business). Conversely, a customs authority applies duties against the value of the merchandise at the time of entry into a customs territory (at a transactional level product type by product type). Thus, an immediate potential conflict arises.

In addition to this inherent difference, the two governmental authorities (tax and customs) are working at cross purposes. On the one hand, a low value for customs purposes will result in lower duties while on the other hand this same low value will result in a higher income/profit in the country of importation and result in higher taxes.

Although variations on the same theme, value for transfer pricing and for customs purposes share a common founding principle: the price established for goods traded between related parties must be consistent with the price that would have been realised if the parties were unrelated and the transaction occurred under the same circumstances. This principle is colloquially known as the 'arm's length principle.'

### **1004 Intangibles**

Import duty is not normally applied to the cross-border movement of intangible property. However, the value of intangibles may form part of the customs value of imported goods if they both relate to, and are supplied as, a condition of the sale of those goods. Thus, some commissions, certain royalties and licence fees, contributions to research and development (R&D), design, engineering and tooling costs and other payments made by the buyer of the imported goods to the seller may be subject to duty if certain conditions are fulfilled. Conversely, certain costs and payments that may be included in the price of imported goods are deductible in arriving at the customs value or can be excluded if they are invoiced and/or declared separately from the goods themselves.

### **1005 The Brussels definition of value**

Those few countries that do not subscribe to the WTO Valuation Agreement (typically developing countries such as Côte d'Ivoire and Montserrat) continue to rely upon an older international code, the Brussels definition of value (BDV), which is based on the principle of an entirely notional 'normal' value. Under the BDV, there need be no connection whatsoever between the customs value and the price paid for the goods, so that the customs implications of importing goods into these countries have little or no significance for transfer pricing.

### **1006 Specific duties and fixed values**

Not all products are assessed a duty based on their value. Some products are assessed specific duties (e.g. a fixed amount per gallon/liter). In addition, some countries, for example, Lebanon and Sri Lanka, levy specific duties on certain categories of imported goods so that the actual price paid for them does not impact the duty owed. It is important to note, however, that many countries require the value declared to be 'correct' regardless of whether it impacts the amounts of duty paid, and have penalty provisions for 'non-revenue loss' violations. Similarly, some countries apply fixed or official minimum values for certain goods and this also makes the transfer price irrelevant as a method of determining the value of imported goods for customs purposes. However, these latter practices are gradually disappearing as the countries concerned adopt the WTO Valuation Agreement.

### **1007 Sales taxes, value added taxes and excise duties**

Generally, the value of imported goods for the purposes of other *ad valorem* duties and taxes tends to follow the value for customs purposes. There are, however, special rules in many countries and, while a detailed discussion of these is outside the scope of this book, they must be taken into account when planning a transfer pricing and business policy.

### **1008 Antidumping duties / Countervailing duties**

Anti-dumping duties are levied when, as the result of a formal investigation, it is determined that domestic producers have been or may be damaged because imported goods are sold in the country in question at less than a fair value, having regard to the price at which the same goods are sold in the country of export or, in certain cases, in a third country. In theory, it may appear that, if goods are sold at a dumped price, that price will not be acceptable to the revenue authority in the country of export although the revenue authority in the country of import would presumably have no problem with it. In practice, however, because dumping is a product of differentials between prices in two markets, it is perfectly possible for a transfer price to offend the anti-dumping regulations while being acceptable to the revenue authorities or vice versa. Although, the need for the aggrieved industry to make its case and the administration to be satisfied that the dumping is causing injury mean that dumped prices do not necessarily result in the imposition of anti-dumping duties.

Whereas anti-dumping duties are assessed against companies for their business practices, countervailing duties are assessed based on government 'subsidies' or assistance. These cases target the actions of all trading entities in a particular industry who are receiving some kind of export-generating assistance from the government of the exporting country. As with anti-dumping duties, the government subsidies can impact the transfer price of goods by removing some of the costs from the price of the exported goods. Accordingly, the transfer price would then be artificially low. However, and as is the case with anti-dumping duties, the aggrieved industry must bring forth the case to the importing country's government. The complainants must show that they either have been harmed, or will be harmed, by the abnormally strong trading position of the entities that received the government subsidies.

**1009 Establishing a transfer pricing policy – technical considerations**

Where the proposed transfer pricing policy relates to international movements of goods that attract customs duties or other taxes on imports, it is necessary to determine whether the policy will:

- (1) meet the requirements of the customs authority in the country of importation;
- (2) create opportunities for tax and customs planning to reduce the values for customs purposes without prejudice to the transfer pricing policy.

When traders use the transfer price as the value for customs purposes, they exercise an option which is both convenient and rife with pitfalls. The parties to the transaction must be able to demonstrate that, at the time the customs value was reported, supporting documentation was available to demonstrate that the transfer price was determined using acceptable valuation methods and applicable data. In essence, the customs value reported by related entities must mimic that which would have been established in an 'arm's length transaction' according to customs rules. It is interesting to note that several customs authorities have issued written guidance specifically stating that a transfer pricing study, in and of itself is not sufficient to support customs value requirements.

**1010 Adjustments**

Before attempting to validate the transfer price for customs purposes, it may be necessary to make certain adjustments to deduct those items that can be excluded from the customs value of the goods, even though they are included in the price, and to add those items that must be included in the customs value, even though they are excluded from the price.

Costs and payments that may be excluded from the transfer price of goods when included in such price include the following:

- (1) costs of freight, insurance and handling that are excluded by the regulations of the country of importation (these costs are not always excludable);
- (2) costs that relate to such activities undertaken after the goods have left the country of export;
- (3) import duties and other taxes (including sales and value added taxes and excise duties) that are levied on importation of the goods into the country of import;
- (4) charges for construction, erection, assembly, maintenance or technical assistance, undertaken after importation on goods such as industrial plant, machinery or equipment if separately itemised;
- (5) charges for the right to reproduce the imported goods in the country of importation; and
- (6) buying commissions.

There are certain costs that may be excluded from the customs value if they are separated from the price of the goods. The method of excluding these costs and payments – known as price unbundling – is explained later.

It is important to note that there may also be other costs and payments that must be included in the customs value (added to the price) of the goods when not included

in the transfer price. The costs and payments that must be added to the transfer price for customs purposes (if they are not already included) are as follows:

- (1) commissions (other than buying commissions);
- (2) freight, insurance and handling charges up to the point designated in the rules of the country of import (this can vary by country);
- (3) royalties, if they both relate to the imported goods and the underlying rights were sold as a condition of the sale of the goods by the supplier (this also can vary by country);
- (4) 'assists', i.e. the value of goods and services provided free of charge or at a reduced cost by the buyer to the seller for use in connection with the production or sale of the goods;
- (5) any quantifiable part of the proceeds of resale of the goods by the buyer that accrue to the seller (other than dividends paid out of the net profits of the buyer's overall business);
- (6) the value, if quantifiable, of any condition or consideration to which the transfer price is subject as per the rules of the country of import;
- (7) any additional payments for the goods, which are made directly or indirectly by the buyer to the seller, including any such payments that are made to a third party to satisfy an obligation of the seller;
- (8) the cost of containers treated as one with the imported goods; and
- (9) the cost of labour and materials in packing the goods.

### **1011 Validation of the transfer price for customs purposes**

The WTO Valuation Agreement provides both quantitative and qualitative criteria for validating a price of goods. The quantitative criteria defined below are, however, dependent upon the existence of values for identical or similar goods that have already been accepted by the customs authority in question (or, in the case of the EU, by a customs authority in another member state). In practice, therefore, unless there are parallel imports into the same customs territory by buyers not related to the seller, these criteria will not be applicable. The quantitative criteria are:

- (1) the price paid approximates closely to a transaction value in a sale between a seller and unrelated buyer at or about the same time; or
- (2) the price paid approximates closely to the customs value of identical or similar goods imported into the same customs territory at or about the same time.

The qualitative criteria are not specifically defined, although the explanatory notes to the WTO Valuation Agreement do provide some examples. Essentially, the customs authority must be satisfied that the overseas supplier and the importer trade with each other as if the two parties were not related. Any reasonable evidence to this effect should be sufficient but the following circumstances, in particular, should lead the customs authority to conclude that the price has not been influenced by the relationship:

- (1) the price is calculated on a basis consistent with industry pricing practices;

- (2) the price is the same as would be charged to an unrelated customer;
- (3) the price is sufficient for the seller to recover all costs and make a reasonable profit; or
- (4) the use of an alternative method of valuation, (e.g. deductive or resale-minus method), produces the same customs value.

If the application of any of the above criteria confirms that the proposed transfer pricing policy will yield transaction values that are acceptable values for customs purposes, no further action is necessary other than to determine whether any adjustments need to be made to the price and whether prior application should be made to customs for a ruling.

Since the objective of both the tax and customs rules is to arrive at a price that is not influenced by the relationship between the parties, there should be no substantial difference between a transfer price that meets the requirements of both tax authorities and one that constitutes an acceptable transaction value for customs purposes. However, given the degree of flexibility inherent in both sets of rules, some variation is inevitable and, in certain cases where this flexibility has been exploited for commercial or income tax purposes, the difference may be sufficient to result in a transfer price that either is unacceptable to the customs authority or will result in an excessive liability to customs duty.

### **1012 Transfer prices below the acceptable customs value**

If none of the methods described above enables the transfer prices to be validated for customs valuation purposes, because they are lower than the acceptable value, the taxpayer has the following options:

- (1) to modify the transfer pricing policy; or
- (2) to submit valuation for customs purposes on the basis of an alternative method of determining value.

The choice between these two options will depend upon the circumstances in each case but the following factors need to be considered:

- (1) The interest of the customs authority in the country of import is, in principle, the same as that of the revenue authority in the country of export: both are concerned that the transfer price may be too low. A transfer pricing policy that produces prices unacceptable for customs purposes, may, therefore, not be acceptable to the exporting country's revenue authority.
- (2) The methods of validating a transfer price are based, for the most part, on the application of the alternative methods of valuation to determine whether their use will yield a customs value that is significantly different to the actual transfer price. The results of the validation exercise will therefore indicate the customs values likely to be acceptable to the customs authority under each method. The alternative methods must be applied in strict hierarchical order, except that the importer has the option of choosing either the computed (i.e. cost plus) or deductive (i.e. resale-minus) method of valuation and is free to choose the method that yields the lower customs value.

**1013 Transfer price exceeds acceptable customs value**

If the application of the validation methods demonstrates that the transfer price is higher than the value that could be justified for customs purposes, the taxpayer has the following options:

- (1) to consider the scope for unbundling the transfer prices;
- (2) to modify the transfer pricing policy; or
- (3) to submit valuation on the basis of an alternative method.

The transfer price may exceed the acceptable customs value of the imported goods because it includes elements of cost and payments that need not be included in the customs value. An exercise to 'unbundle' the transfer price and to separate those elements may result in a customs value that is significantly less than the transfer price. In most jurisdictions, there is no legislative requirement to reconcile the value of imported goods for customs purposes with the inventory value of those goods for corporate income tax purposes. Where such a requirement does exist, however – notably in the US – due account can be taken of those elements that form part of the inventory value but are not required to be included in the value for customs purposes. If the unbundled transfer price still exceeds the acceptable customs value, the taxpayer should consider whether the transfer price does, in fact, meet the requirements of the revenue authority in the country of importation.

Corporate income tax is levied only on the profits of a transaction, whereas customs duties are paid on its full value, irrespective of whether a profit or loss is made. In certain circumstances, notably where there are losses, a high transfer price – even if it is acceptable to the revenue authorities – may result in a net increase, rather than a reduction, in the overall tax burden when the increased duty liability is taken into account.

Customs will not normally entertain the argument that a transaction value is unacceptable solely because it has been inflated as a result of the relationship between the buyer and seller of the goods. It may be, however, that the circumstances surrounding the transactions between the buyer and seller are such as to preclude valuation on the basis of the transfer price, namely:

- (1) the price is subject to some condition or consideration that cannot be quantified (e.g. the goods are supplied on consignment and the transfer price will be dependent upon when, to whom and in what quantity, the goods are resold);
- (2) an unquantified part of the proceeds of the resale of the goods by the buyer accrues to the seller (other than in the form of dividends paid out of the net profits of the buyer's total business);
- (3) the seller has imposed upon the buyer a restriction that affects the value of the goods in question (e.g. they can only be resold to a certain class of purchaser);  
or
- (4) the goods are supplied on hire or lease or on some other terms which do not constitute a sale of the goods (e.g. on a contingency basis).

**1014 Alternative methods of valuation**

Once it is established that the imported goods cannot be valued for customs purposes

on the basis of the transaction value, the link between the transfer price for commercial and income tax purposes and the value of the goods for customs purposes is broken. The taxpayer will then be free to determine a transfer price without regard to the customs implications, irrespective of whether the price so determined is higher or lower than the value of the goods for customs purposes, except for countries like the US where the inventory value for tax purposes cannot exceed the customs value. Several different Transfer Pricing Methods (TPMs) are available, many of which are sufficiently flexible to apply to a variety of transaction types. Traditional TPMs are the Comparable Uncontrolled Price (CUP) method, the Cost Plus method, and the Resale Price method. Other methods are the Profit Split and the Transactional Net Margin methods.

The alternative methods of customs valuation are similar to some of the methods used to validate transfer prices for income tax purposes but the WTO Valuation Agreement requires that they be applied, with one exception, in strict hierarchical order as set out below:

- (1) **Value of identical goods.** The transaction value of identical merchandise sold for export to the same country of importation and exported at or about the same time as the goods being valued. The value of the identical merchandise must be a previously accepted customs value and the transaction must include identical goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued.
- (2) **Value of similar goods.** As in (1) except that the goods need not be identical to those being valued, although they must be commercially interchangeable.
- (3) **Deductive value.** A notional import value deduced from the price at which the goods are first resold after importation to an unrelated buyer. In arriving at the deductive value, the importer may deduct specific costs such as duty and freight in the country of importation and either his/her commission or the profit and general expenses normally earned by importers in the country in question of goods of the same class or kind.
- (4) **Computed value.** A notional import value computed by adding to the total cost of producing the imported goods the profit and general expenses usually added by manufacturers in the same country of goods of the same class or kind. Note that, as an exception to the hierarchical rule and at the option of the importer, the computed valuation method can be used in preference to the deductive valuation method.

The valuation of identical or similar merchandise is similar to the CUP method. The CUP method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted. While simple on its face, the method is difficult to apply. The fact that any minor change in the circumstances of trade (e.g. billing period, amount of goods traded, marking/branding, etc.), may have a significant effect on the price makes it exceedingly difficult to find a transaction(s) that is sufficiently comparable.

The deductive value method is similar to the resale price (RP) method. The RP method determines price by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross mark-up from the sale price to an unrelated third party, with the appropriate

gross margin being determined by examining the conditions under which the goods/services are sold, and comparing said transaction to other third party transactions. Thus, depending on the data available, either the CP or the RP method will be most the appropriate method to apply.

The computed value method is similar to the cost plus (CP) method. The CP method is determined by adding an appropriate mark-up to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with the appropriate mark-up being based on the profits of other companies comparable to the parties to the transaction. Amounts may be added for the cost of materials, labour, manufacturing, transportation, etc. Given the variables required for the proper application of this method, it is most appropriately used for the valuation of finished goods. As a matter of practice, some customs administrations will not accept the use of this method by importers given that the accounting for costs occurs in the country of export, which makes verification by local authorities difficult.

If it proves impossible to find a value under any of the above methods, a value must be found using any reasonable method that is compatible with the WTO Valuation Agreement and is not specifically proscribed. In practice, customs authorities often adopt a flexible application of either the transaction value rules or one of the alternative methods in order to arrive at an acceptable value.

### **1015 Implementation of the customs pricing policy**

The procedures for declaring the value of imported goods to customs authorities vary from country to country. In most cases, however, some form of declaration as to the value of the goods will be required at importation and the importer may be required to state whether the seller of the goods is a related party and, if so, whether the relationship has influenced the price.

In some cases – such as where identical goods are sold to an independent buyer in the same country of importation at the same price – the importer will be able to declare the transfer price with any necessary adjustments as the value for customs purposes. In most cases, however, the position will be less clear and, where the local rules permit, the importer would be strongly advised to seek a definitive ruling in advance from the customs authority or, at least, to obtain the authority's opinion as to the validity of the values that it intends to declare.

Strictly speaking, the WTO Valuation Agreement places the onus on the customs authority to prove that a price has been influenced by a relationship between the parties. In practice, however, the importer would be well-advised – even if it is not intended to seek an advance ruling or opinion – to undertake an exercise to validate transfer prices for customs purposes and to maintain the necessary records, calculations and documentation for use in the event of a customs audit or enquiry.

### **1016 Transfers of intangibles**

Intangibles, *per se*, are not subject to import duty but, when supplied as part of a package of goods and services, the value of intangibles may constitute part of the customs value of the imports. When a package of goods and services is supplied for a single, bundled price, customs duty will be paid on that price in full, unless, it contains any elements of cost that can be separately quantified and is permitted to be deducted from the price. As explained previously, it is up to the importer and the



foreign supplier to unbundle the price so as to separately quantify and invoice the value of those costs that do not have to be added to the customs value of imported goods if they are not already included. However, the following categories of intangibles are, subject to certain conditions, required to be included in the customs value of imported goods:

- (1) payments by the importer, in the form of royalties or licence fees, for the use of trademarks, designs, patents, technology and similar rights, provided that the rights in question relate to the imported goods and that the payment therefore is a condition of the sale of the goods by the seller to the buyer;
- (2) intangible 'assists', except where the work is undertaken in the country of importation;
- (3) payments for computer software (subject to the options described in the GATT decision of 24 September 1984);
- (4) payments for the right to resell or distribute imported goods (but excluding a voluntary payment by the buyer to acquire an exclusive right to resell or distribute the imported goods in a particular territory); and
- (5) design, development, engineering and similar costs, which represent part of the cost of manufacturing or producing the imported goods.

### **1017 Royalties and licence fees**

This is the most complex area of customs valuation and each case has to be examined carefully to determine whether a liability to import duty arises. The following guidelines will be helpful:

- (1) The key consideration in determining whether a royalty or licence fee is dutiable is the nature of the rights for which the payment is made. The basis on which the payment is calculated is usually not relevant.
- (2) Generally, if the imported goods are resold in the same state in which they are imported, any royalties or licence fees payable as a condition of the importation of those goods are likely to be dutiable. For example, if imported goods are resold under the manufacturer's trademark – whether it is affixed to the goods before or after importation – the corresponding royalty payment will be dutiable, even if the payment is based on income from sale of the goods in the country of importation.
- (3) However, where goods are subjected, after importation, to substantial processing or are incorporated into other goods, such that the resulting product does not have the characteristics of the imported goods, it is likely that the royalty or licence fee will not be considered to relate to the imported goods, provided that the rights in question relate to the finished product. An example of this would be where the rights conferred on the buyer enable him to manufacture a product using the seller's technology, patents or know-how or to sell that product under the seller's trademark. In such circumstances, it is unlikely that the royalty payments would be regarded as part of the customs value of raw – materials or components imported by the buyer from the seller for incorporation in the finished product. It may be necessary, however, to include at least part of the royalty in

the customs value of the imported components if those components contain the essential characteristics of the finished product (see point (4) below).

- (4) Difficulties frequently arise where the imported materials or components are considered by the customs authority to contain the essential characteristics of the finished product. For example, the buyer may be paying a royalty for technology that supposedly relates to the manufacture of the finished product in the country of importation. However, if the process of manufacture is, in reality, no more than a simple assembly operation, customs may take the view that the technology is incorporated in the imported components rather than the manufacturing operation and deem the royalty to be dutiable. Another example is where the seller's particular expertise or 'specialty' is clearly incorporated in one key component, which is imported. Thus, royalties paid for a company's unique technology, which is incorporated in a single imported semiconductor device could be deemed dutiable even if the whole of the rest of the system is manufactured in the country of importation from locally sourced parts.
- (5) In circumstances where an importer is manufacturing some products locally using the affiliate's designs, know-how and materials or components, while importing others as finished items from the same or another affiliate, care must be taken to distinguish the rights and royalties applicable to each. In such cases, it would normally be expected that the seller would recover all its research, development and design costs in the price of the products that it manufactures and exports to the buyer; it is inappropriate therefore to charge royalties for those products.
- (6) It is to be noted that the dutiability of royalty and licence fees may be subject to varying interpretations in different countries. Some countries, for example, may consider periodic lump-sum licensing fees to be non-dutiable charges, provided that payments are not directly related to specific importations.
- (7) Cost sharing agreements (i.e. for R&D) can prove problematic if adequate documentation is not maintained establishing what portion, if any, of development costs relates to the import of products. In such instances, the local import authorities may take the position that all such costs in a general pooling of costs are considered dutiable.

In the case of the products manufactured in the country of importation, however, a royalty or licence fee is the only way in which the owner of the intangible can recover its costs. However, if a royalty refers to 'the right to manufacture and distribute the company's products in the territory', it will be deemed to relate to the imported products as well as those manufactured in the country of export. Alternative wording – 'the right to manufacture the company's products in country A and to sell such products as it manufactures in the territory' – may avoid unnecessary liability to duty. Payments for the right to reproduce imported goods in the country of importation are specifically excluded from the customs value of imported goods.

### **1018 Intangible assists**

Intangible assists consist of designs, specifications and engineering information that are supplied by the buyer of the imported goods to the seller either free of charge

or at reduced cost. If the work is undertaken within the country of importation, such assists are not dutiable but, if the work is undertaken in the country in which the goods are manufactured, or in any other country, the assists are deemed to be part of the customs value of the imported goods.

There are different interpretations of what is meant by the word 'undertaken'. Some customs authorities will accept, for example, that work undertaken by the buyer's designers who are based in the country of importation but who actually designed the product in the country of manufacture, would not result in a dutiable assist; others, however, would take the opposite view. However, even if work is performed in the country of importation but paid for by the foreign seller and recharged to the importer, it may constitute a dutiable cost as representing part of the price paid or payable for the imported product. The value of an assist is the cost to the buyer of either producing it or acquiring it and it is not necessary to add a mark-up or handling fee.

### **1019 Interest**

Interest incurred by the manufacturer of imported goods is deemed to be part of the cost of producing the goods and should therefore be included in the price. However, where the importer pays interest – either to the seller or a third party – under a financing agreement related to the purchase of the imported goods, that interest need not be included in or added to the customs value of imported goods provided that:

- (1) the financing agreement is in writing (although this need only be a clause in the agreement for the sale of the goods);
- (2) the rate of interest is consistent with contemporary commercial rates of interest for such transactions in the country in which the agreement is made;
- (3) the buyer has a genuine option to pay for the goods promptly and thereby avoid incurring the interest charge;
- (4) the interest is separately invoiced or shown as a separate amount on the invoice for the goods; and
- (5) in some countries, such as the US, the interest must be treated as an interest expense on the books and records of the importer.

### **1020 Computer software**

Contracting parties to the WTO Valuation Agreement may value software for use with data processing equipment on one of two alternative bases, namely:

- (1) the full value of the software including both the carrier medium (disk, tape, etc) and the program data or instructions recorded thereon; or
- (2) the value of the carrier medium only.

The second option applies only to software in the form of magnetic tapes, disks and similar media. Software on the hard disk within a computer or embedded in semiconductor devices ('firmware') is dutiable on the full value. Similarly, this option does not extend to software that includes audio or visual material. Although this exclusion was originally intended to cover 'leisure' products such as computer games, movies, music, etc., more and more 'serious' software now incorporates audio and visual material and, in some jurisdictions, may be subject to duty on the full value.

The terms of the present valuation options on software date from 1985, and have been overtaken by advances in both technology and commercial practice in the data processing industry. Furthermore, it should be noted that the Information Technology Agreement (ITA) has resulted in most movements of computer software becoming subject to a zero rate of duty. It is inevitable therefore that importers will face anomalies and uncertainties in the valuation of software unless or until the WTO Valuation Agreement is updated to reflect these developments. However, it is worth noting that software and other 'goods' transmitted electronically do not attract customs duty even if, in their physical manifestation, they would be dutiable (e.g. music CDs, videos, etc.).

### **1021 Design, development, engineering and similar charges**

The costs of these activities are normally expected to be included in the price paid for the imported goods. However, there are circumstances in which companies may wish to recover these costs from their affiliates by way of a separate charge. Furthermore, the affiliate may be supplied not with finished products but only with components on which it is not normal to seek to recover such costs.

Generally speaking, any payment for design and similar expenses that relates to imported goods will be regarded as part of the customs value of those goods and an appropriate apportionment will have to be made and added to the price of the goods. Costs for research, if properly documented as such, will not be subject to duty.

Where components are supplied to the buyer and a separate charge is made relating to the design of the finished product that is manufactured in the country of importation, some difficulty may arise. If the components are purchased by the seller from third party suppliers, the costs of design are likely to be included in the supplier's price and no further action is necessary. However, where some or all of the components are produced by the seller and design costs have not been included in the price, it will be necessary to attempt to allocate an appropriate proportion of the total charge for design to the components in question.

### **1022 The impact of transfer pricing policy changes**

Where the basis of customs valuation is the transaction value – the price actually paid or to be paid for the imported goods – any change in the method of determining the transfer price may affect the validity of that price for customs purposes. It may also trigger a requirement to notify the customs authority if the buyer holds a ruling that is subject to cancellation or review in the event of a change in commercial circumstances.

If the proposed change in pricing arrangements is significant, it will be necessary to repeat the validation exercise described previously to determine whether or not the new policy will produce an acceptable value for duty purposes. Examples of significant changes are:

- (1) a shift in the allocation of profit from one entity to another;
- (2) a shift of responsibility for certain functions from one entity to another;
- (3) a change in the transaction structure, such as the interposition or removal of an export company, a foreign sales corporation or a re-invoicing centre; or
- (4) any changes in pricing levels that exceed normal commercial margins of fluctuation.

Provided that the changes represent realistic responses to changes in commercial circumstances, there should be no difficulty in validating the new prices for customs valuation purposes. However, where no such justification for the changes exists – and particularly where the price change is substantial – it may be difficult to explain satisfactorily why the prices now being proposed have not previously been charged since the commercial circumstances are substantially unchanged.

If the proposal is to increase prices, the customs authority may take the view that the values previously declared, based on the current transfer pricing policy, were too low and, depending upon local regulations, they may be able to recover substantial arrears of duty and to impose penalties. Conversely, even if the customs authority accepts that the current transfer prices are higher than commercial circumstances justify, there will probably be no basis for claiming repayment of duties overpaid even if the seller credits the buyer with the difference between the existing and proposed prices on a historical basis.

### **1023 The impact of retrospective transfer price adjustments**

The WTO Valuation Agreement contains no specific provisions for dealing with adjustments to transaction values and, therefore, the rules and practice in each country will determine how customs authorities will respond if a price already paid is subject to subsequent adjustment for commercial or corporation tax purposes.

The transaction value principle states that the price for the goods ‘when sold for export to the country of importation’ should represent the customs value of those goods. Provided, therefore, that the price paid or agreed to be paid at that time was not in any way provisional or subject to review or adjustment in the light of future events, specified or otherwise, that price must be the customs value of the goods. If, subsequently, that price is adjusted as a result of circumstances that were not foreseen at the time of the sale for export – or that, if they had been foreseen, were not expected or intended to lead to a price adjustment – there appears to be no provision under the WTO Valuation Agreement that would either:

- (1) in the event of a downward adjustment, allow the importer to recover duty overpaid; or
- (2) in the event of an upward adjustment, allow the customs authority to recover duty underpaid.

However, it is likely that, so far as customs authorities are concerned, the above is true only of occasional and non-recurring adjustments. If, for example, a company were to make a practice of reviewing its results at the end of each fiscal year and decided to reallocate profit between itself and its affiliates, it is probable that customs would take the view that such adjustments were effectively part of the company’s transfer pricing policy, even if no reference to it appeared in any written description of that policy. In those circumstances, subject to any statute of limitations, they would be likely to seek arrears of duty and possibly also penalties for all previous years in which upward adjustments had been made. While some customs jurisdictions may give credit for any downward adjustments in assessing the amount of duty due, it is unlikely that they would accept a claim for repayment where a net over-declaration of value could be substantial.

Where a company’s transfer pricing policy specifically provides for periodic review and retrospective price adjustment – for example, to meet the requirements of the IRS

and other revenue authorities – customs will certainly regard any adjustments as directly applicable to the values declared at the time of importation. Any upward adjustments will therefore have to be declared and the additional duty paid. Downward adjustment, in some countries, may be considered post-importation rebates and thus claims for overpaid duties will not be accepted. However, in the US, importers may take advantage of Custom's Reconciliation Program, which provides the opportunity to routinely adjust the value of imported goods and either collect or pay duties, as the case may be.

In addition, in the US, a specific IRS provision exists (1059A), which requires that the inventory basis for tax purposes does not exceed the customs value (plus certain allowable adjustments). Therefore, the possibility exists that the IRS authorities could disallow any upward price adjustment in the event it causes the inventory taxable basis to exceed the customs value. In order to avoid penalties for failing to declare the full value of imported goods, and to ensure that duty can be recovered in the event of price reductions, it is recommended that any transfer pricing policy that involves retrospective price adjustments should be notified to customs in advance. Some authorities are amenable to arrangements whereby provisional values are declared at the time of importation and subsequent adjustments are reported on a periodic basis, provided they are accompanied by the appropriate additional duties or claims for repayment.

As an alternative to the above, it may in some cases be in the importer's interests to take the position that, at the time of importation, there is no transaction value because the eventual price for the goods cannot then be determined. In that event, the importer could seek valuation under one of the alternative methods described above.

#### **1024 The impact of international structure**

The structure of a transaction chain that involves at least one cross-border movement between different customs jurisdictions can have a significant impact on duty liabilities. Transaction values exist only where there is a price for imported goods between two separate legal entities in a sale whereby ownership of the goods and the attendant risks pass from the seller to the buyer. In the absence of such a sales price between the exporter and importer therefore, the customs value must be based on either another sales transaction, if there is one, or on one of the alternative methods of valuation described above. The following examples illustrate the impact of various structures on the value of imported goods for duty purposes:

- (1) Where an exporter uses a subsidiary company in the country of importation as its distributor, and the latter buys imported goods as a principal and resells them to end customers, the price between the two companies is, in principle, acceptable for customs purposes. However, this is not the case where the distributor is merely a branch of the exporter and part of the same legal entity. In that event, unless there is another transaction value, duty will be payable on the selling price to the end customer, including the gross margin of the branch.
- (2) Similarly, there will be no transaction value if the subsidiary merely acts as a selling agent or commissionaire for the exporter and does not own the imported goods. Again, duty will be payable on the selling price to the end customer including, in this case, the subsidiary's commission.

- (3) Transactions involving re-invoicing operations that merely issue a new invoice in a different currency and do not take title or risk in respect of the imported goods are ignored for customs purposes, as are those involving foreign sales corporations (FSCs), which are remunerated by way of commission. However, transactions involving FSCs that act as principals may provide a basis of valuation.

The customs laws of the EU and the US (but not, at present, any other jurisdiction) recognise a transaction value, based on a sale for export to the country of import even when there are subsequent sales in the supply chain (successive or first sale concept). This means, for example, that if a manufacturer in the US sells goods for USD80 to a US exporter who, in turn, sells them to an importer in the EU for USD100, the latter will be able to declare a value of USD80 for duty purposes, even although USD100 was paid for the goods. Acceptance of the price in the earlier sale is conditional upon:

- (1) the goods being clearly intended for export to the country of importation at the time of the earlier sale;
- (2) the price being the total consideration for the goods in the earlier sale and not being influenced by any relationship between the buyer and seller; and
- (3) the goods being in the same physical condition both at the time of the earlier sale and at importation.

Apart from allowing duty legitimately to be paid on what is, in most cases, a lower value, the 'successive sales' concept in the EU and 'first sale' approach in the US also have the benefit of decoupling the value of imported goods for duty purposes from the values of those goods for the purposes of determining the taxable profits of the importer and exporter. Japan also provides for duty reduction based on a principle very similar to that which underlies the US' and EU's 'first sale' program, albeit in a more complex manner.

### **1025 Dealing with an audit of pricing by an indirect tax authority**

For similar reasons to those advanced by the tax authorities, customs authorities are taking an increasing interest in the validity of values declared by importers on the basis of transfer prices between related parties. The principal areas on which they focus their inquiries are:

- (1) whether the transfer price allows full recovery of all relevant costs, including general and administrative overheads and relevant R&D;
- (2) whether the addition for profit occurs on an arm's length basis; or
- (3) whether all appropriate additions have been made for royalties, R&D payments and assists.

Traditionally, customs authorities have tended to operate in a vacuum with no consideration for either the commercial or tax environments within which transfer pricing policies are developed and implemented. This has led to considerable frustration as companies have tried to defend to customs officers prices that are not only commercially justifiable but have already been accepted by the revenue authorities. However, this situation is changing in some jurisdictions where customs authorities are making efforts to understand the OECD Guidelines and are increasingly interfacing

and cooperating with their direct-tax revenue colleagues. It is unlikely that greater knowledge and understanding will lead to fewer customs valuation audits – indeed, the opposite is more likely to be the case – but it should mean that they are less troublesome for importers.

As for tax purposes, the availability of documentation that describes the company's overall transfer pricing policy and demonstrates how individual transaction values have been calculated is essential. In addition, a similar approach to customs value documentation should also be undertaken. This can start with the transfer pricing documentation and include the appropriate additional analysis required by customs. In addition, where the position is complex and there is likely to be any contention as to the correct values, it is strongly recommended that the facts and legal arguments be presented to the customs authority before the relevant imports commence and, as advisable, a formal ruling or opinion obtained. Although these will not preclude subsequent audit, the latter should then be confined to verification of the relevant facts rather than involve arguments about issues of principle.

### **1026 Strategy based on balance and leverage**

A prudent company will take the same care and documentation approach for customs as it does for transfer pricing. Considering the above, it generally can be argued that an importer's sole reliance on a transfer pricing analysis would likely not be sufficient to support the proper appraisal of merchandise for customs valuation purposes. To believe and act otherwise runs the risk of being subjected to fines, penalties and/or a mandated application of an alternative customs valuation method that may be difficult and costly to implement and sustain. Indeed, the 'belief' that if a taxpayer has done a transfer pricing study then its customs value must be correct has been proven wrong time and time again.

Still, a transfer pricing analysis and related documentation can be leveraged to provide a basis from which a customs value may be derived and supported. This assumes, of course, that all required statutory adjustments are applied and other relevant considerations are factored in. The potential benefits to global traders from finding an appropriate balance in the transfer pricing and customs valuation nexus are many and include, among others, the following:

- A foundation for establishing inter-company pricing policies for customs purposes that help to decrease accounting issues that are created by gaps, lack of coverage, or contradictions among inter-company pricing initiatives;
- The ability to significantly reduce the potential of a customs audit as well as the financial exposure related to penalties associated with non-compliance of customs regulations;
- A global (or at least multijurisdictional), long-term coordinated inter-company customs valuation documentation compliance solution that considers products/product line, market conditions, and other key economic factors;
- A basis for proactively managing value adjustments to achieve 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 result;



- The ability to identify planning opportunities related to the valuation of merchandise and intangibles (e.g. royalties, licence fees, research and development, warranties, marketing and advertising, cost sharing arrangement, etc.) via alternative methods of appraisalment;
- The development of limits to customs authorities' ability to interpret Art. 1.2(a) and (b) of the WTO Customs Valuation Agreement relating to the acceptability of using the transfer price as an initial basis for the customs value of imported merchandise; and
- Enhanced financial reporting compliance related to inter-company cross-border transactions to satisfy obligations under Sarbanes-Oxley reporting requirements.

# 11 Procedures for achieving an offsetting adjustment

## 1101 Introduction

Early consideration should be given to the procedures that might be followed to obtain compensating adjustments in other jurisdictions should a transfer pricing audit lead to additional tax liabilities in a particular jurisdiction. The attitudes of revenue authorities vary and will depend upon the overall circumstances (such as whether they consider that the taxpayer has deliberately sought to reduce their taxes by what they perceive to be 'abusive' transfer pricing).

Generally there will be no scope to make adjustments in the absence of a double tax treaty or multi-country convention. However, it might be possible to render further invoices in later years reflecting pricing adjustments, although these types of adjustments are frowned upon and will attract scrutiny from the tax authority of the receiving jurisdiction. Very careful attention needs to be paid to the legal position of the company accepting retroactive charges and to other possible consequences, particularly to indirect taxes. Nevertheless, in a few cases this may afford relief.

The ability to seek relief under the Mutual Agreement Procedure process and, more particularly, under the European Union Convention, which is discussed in this chapter, is sometimes cited by taxpayers as if it is an easy solution to transfer pricing problems. This is not the case and should certainly not be viewed as allowing taxpayers to avoid paying careful attention to the implementation of a coherent transfer pricing policy and to its defence on audit.

## 1102 Competent authority

Competent authority procedures for the relief of double taxation are typically established in bilateral tax treaties and must always be considered when a tax authority proposes an adjustment to prices. For instance, where a US subsidiary accepts that the price of each widget sold to it by its UK parent should be reduced by, say, £10, to satisfy the US Internal Revenue Service, will the UK Inland Revenue accept a corresponding reduction in UK taxable income? This type of question will necessarily involve consultation with the competent authorities. Virtually all double tax treaties contain provisions similar to those set out in Article 25 of the OECD Model. These provide that a taxpayer may petition the competent authority of the state in which he/she is resident where the actions of one or both of the treaty partners '... result or will result for him/her in taxation not in accordance with the provisions of [the double tax treaty]'

In the course of an audit, a taxpayer will need to consider whether reference should be made to the competent authority procedures and at what stage. It is necessary to pay attention to the required procedures and, more particularly, to the statute of limitations under each treaty. Adjustments may well not be possible after a tax liability has become final and only if the other revenue authority is prepared to give relief will double taxation then be avoided. While in general, revenue authorities consider that

their enquiry should have been concluded before they begin discussions with the other revenue authority they may be prepared to delay the finalisation of any assessment and, in particularly complex cases, may be willing to operate the procedure in parallel with the conduct of their audit. However lengthy or uncertain they are, the competent authority procedures remain the main process through which a taxpayer can hope to avoid double taxation after paying tax in respect of a transfer pricing adjustment.

It is significant to note that the Mutual Agreement Procedure under a double tax treaty ordinarily provides an alternative process of dispute resolution and is an option available to the taxpayer in addition to and concurrently with the prevailing appellate procedures under domestic law. The reference to the competent authority is to be made by the aggrieved party impacted by taxation not in accordance with the treaty. Consequently, the reference would be made by the taxpayer, which has or may suffer double taxation arising from the adjustment to the transfer price of an associated enterprise, rather than the enterprise itself.

Further, it is important to recognise that the charter of the Mutual Agreement Procedure process is to mitigate taxation not in accordance with the treaty and not a means of eliminating the tax impact of a proposed transfer pricing adjustment. The Mutual Agreement Procedure is a negotiation process between the competent authorities and ordinarily involves a compromise on both sides, by way of reaching a consensus on the acceptable transfer prices. During the Mutual Agreement Procedure process, it is advisable for the taxpayer and its associated enterprise to provide inputs to respective competent authorities on an ongoing basis so that an effective and acceptable settlement is expeditiously reached. The taxpayer is at liberty to accept the agreement reached by the competent authorities or decline the arrangement (and by consequence revert to remedies under domestic law). The taxpayer may also withdraw its reference to the competent authorities during the negotiation process.

## **EUROPEAN UNION ARBITRATION CONVENTION**

### **1103 Background**

On 23 July 1990, the representatives of Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and the UK jointly approved a convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (Convention 90/436). This multilateral convention represented a unique attempt to solve some of the difficulties faced by multinational enterprises in the transfer pricing area.

There were a number of procedural difficulties that made its use difficult, due to the modifications required to ratify the original treaty, to reflect the accession of Finland, Sweden and Austria, and also to the ratifications needed to extend the life of the original treaty beyond 31 December 1999. These procedural difficulties have now been overcome, thanks to the work of the EU Joint Transfer Pricing Forum. In November 2006, the Council Convention was amended with the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and the Slovak Republic in the European Union and entered into force on 1 November 2006.

**1104 The scope of the Convention**

The Convention is designed to apply in all situations in which profits subject to tax in one Member State are also subject to tax in another as a result of an adjustment to correct non-arm's length pricing arrangements. The Convention also provides that relief will be available under its terms where there is a risk of losses being doubly disallowed. However the Convention will not be applicable in any circumstance in which the authorities consider that the double taxation arises through deliberate manipulation of transfer prices. Such a situation arises in any instance where a revenue authority is permitted to levy a 'serious penalty' on the business concerned. This is considered in more detail in Section 1109 below.

The businesses that can benefit from the Convention are those that constitute 'an enterprise of a contracting state' and this specifically includes permanent establishments of any enterprise of a contracting state. No further definition of these terms is included in the Convention, although it is stipulated that, unless the context otherwise requires, the meanings will follow those laid down under the double taxation conventions between the states concerned. The intention was undoubtedly that all businesses of any description, which have their home base within the European Union (EU) should receive the protection of the Convention, regardless of their legal form. Thus, a French branch of a German company selling goods to an Italian affiliate would be covered. However, a French branch of a US company selling goods to an Italian affiliate would not be covered. It is important to note that the Convention is drawn up in terms that recognise not just corporations but also other forms of business, subject to tax on profits.

**1105 The required level of control**

In drafting the Convention on transfer pricing, the European Commission recognised that Member States use widely varying definitions of the level of control required between affiliated businesses before anti-avoidance law on transfer pricing can apply. The Convention's definition of control for these purposes is accordingly very widely drawn indeed. It merely requires that one Member State enterprise 'participates directly or indirectly in the management, control or capital of an enterprise of another contracting state' and that conditions are made or imposed between the two enterprises concerned such that their commercial and financial relationships differ from those that would have been made between independent enterprises. A similar definition deals with the situation where two or more Member State businesses are 'controlled' by the same person.

Regarding the profits to be attributed to a permanent establishment, the Convention follows the OECD Model Treaty, requiring that the permanent establishment be taxed on profits that it might be expected to make if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

**1106 Adjustments to profits**

The Convention makes no attempt to interfere with the processes by which the tax authorities of any one Member State seek to make adjustments to the profits declared by a business operating in their country. However, where a contracting Member State

does intend to make an adjustment on transfer pricing grounds, it is required to give notice to the company of its intended actions in order that the other party to the transaction can give notice to the other contracting state. Unfortunately, there is no barrier to the tax adjustment being made at that stage. Thus, Member State businesses still face the cash flow problems associated with double taxation until such time as the authorities agree to make offsetting adjustments. If this double taxation cannot be eliminated by agreement between the two countries concerned, then the remaining provisions of the Convention may be used to gain relief. To address these issues, the Council of the European Union adopted a Code of Conduct for the effective implementation of the Convention wherein it has recommended Member States to take all necessary measures to ensure that tax collection is suspended during the cross-border dispute resolution procedures under the Arbitration Convention. As of September 2006, sixteen Member States had allowed the suspension of tax collection during the dispute resolution procedure and other States were preparing revised texts granting this possibility.

### **1107 Mutual agreement and arbitration procedures**

The Convention provides for an additional level of protection to Member State businesses over and above anything available under the domestic laws of the states concerned or through the existing bilateral treaties. The protection available begins with the presentation of a case to the competent authority of the contracting state involved. This presentation must take place within three years of the first notification of the possible double taxation. The procedures require that all the relevant competent authorities are notified without delay and the process is then underway to ensure the resolution of the problem, regardless of any statutory time limits prescribed by domestic laws.

In the event that the competent authorities find themselves unable to reach an agreement within two years of the case first being referred to them, they are obliged to establish an advisory commission to examine the issue. The Convention provides that existing national procedures for judicial proceedings can continue at the same time as the advisory committee meets and that if there is any conflict between the procedures of the arbitration committee and the judicial procedures in any particular Member State, then the Convention procedures will only apply after all the others have failed.

### **1108 Serious penalty proceedings**

There is no obligation on Member States to establish an arbitration commission to consider pricing disputes if 'legal and administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of transfers of profits ... one of the enterprises concerned is liable to a serious penalty'. Where any proceedings are currently underway, which might give rise to 'serious penalties', the normal due date for the establishment of the arbitration committee will be deferred until the other proceedings are settled.

The term 'serious penalty' is somewhat subjective and has different meanings from one country to another. However, the Member States have included, as part of the treaty, unilateral declarations on their view of the meaning of 'serious penalty' for these purposes.

**1109 The advisory commission**

As and when an advisory commission is needed, it will be established under the chairmanship of an individual possessing the qualifications required for the highest judicial offices of his/her country. The other members of the commission will include a maximum of two individuals from each of the competent authorities involved and an even number of independent persons of standing, to be selected from a list of such people drawn up for the purpose by each contracting state. The task of the advisory commission is to determine, within six months, whether or not there has been a manipulation of profits, and, if so, by how much. It will take its decision by simple majority of its members, although the competent authorities concerned can agree together to set up the particular detailed rules of procedure for any one commission. The costs of the advisory commission procedure are to be divided equally between all the contracting states involved.

In reaching its decision, the advisory commission may use any information, evidence or documents received from the associated enterprises concerned in the transactions. The commission can also ask the competent authorities of the contracting states involved to provide it with anything else it requires but there is no obligation on the contracting states to do anything that is at variance with domestic law or normal administrative practice. Furthermore, there is no obligation on them to supply information that would disclose any trade secret, etc, which might be contrary to public policy. There are full rights of representation for the associated enterprises involved to speak before the advisory commission.

**1110 Resolution of the problem**

Once the advisory commission has reported, the competent authorities involved must take steps to eliminate the double taxation within six months. They retain the discretion to resolve matters as they see fit but if they cannot agree on the necessary steps to be taken, they must abide by the decision of the advisory commission.

**1111 Term of the Convention**

The Convention came into force on 1 January 1995 for an initial period of five years. However, it was agreed in May 1998 that the Convention would be extended for at least a further five year period. During this time Austria, Finland and Sweden joined the EU and became parties to the Convention. The original protocol for accession of new Member States required that all parties had to satisfy each accession and thus extensions to membership required lengthy procedures to ensure the continued life of the Convention. As a result of the work with the EU Joint Transfer Pricing Forum, it is anticipated that, as new countries join the EU, they will accede to the Arbitration Convention by a simpler process.

**1112 Interaction with non-member states**

The Convention recognises that countries other than the Member States of the EU may be involved in transfer pricing disputes with EU businesses. The convention simply notes that Member States may be under wider obligations than those listed in the Convention and that the Convention in no way restricts these obligations. There is no comment on the way in which third-country disputes might be resolved.

**1113 Experience of the Convention**

While the Convention is already perceived by the Union members as being a major step forward in the development of worldwide tax policies designed to resolve pricing issues, there is at present little practical experience of its use (the first ever advisory commission set up under the Convention only met on 26 November 2002, to begin looking at a Franco–Italian matter). It is understood that there is now a backlog of over 100 cases that might go to arbitration, following the resolution of the procedural problems faced by the Arbitration Convention. The EU Joint Transfer Pricing Forum will be monitoring the work, to make sure matters are followed through on a timely basis.

**1114 Further EU developments in transfer pricing**

Within Europe, the EU Commission struggled for many years to attain agreement on a common tax base for European businesses or common tax rates across the Union states. This is politically highly difficult to achieve and there remains little likelihood of substantial agreement in this area in the foreseeable future. However, the Commission convinced Member States that there was no political logic in favour of continuing the problems experienced by multinationals when they faced double taxation as a result of transfer pricing adjustments being made by tax authorities. The Arbitration Convention represents the statement that, from a purely pragmatic point of view, it must be reasonable to eliminate such double taxation of profits.

The European Commission would like to go much further. Instead of rectifying double taxation after it has occurred, the Commission would like to see a mechanism for preventing it in the first place. A number of Commission officials have stated their wish to see possible transfer pricing adjustments being discussed among the competent authorities before they are made, such that any offsetting adjustment could be processed at the same time as the originating adjustment. Some Commission officials want to go even further than this and create a regime for multilateral advance pricing agreements on pricing issues within the EU.

It is clear that the European authorities firmly support the use of the arm's length principle in transfer pricing. They are on record, via the Convention, as stating that they do not approve of double taxation. Most of the Member State tax authorities have privately expressed the view that, however desirable, advance pricing agreements represent an unacceptably high administrative burden. Information on the use of the Convention within Europe has been lacking. However, this was remedied in October 2001 when a Commission working paper published a summary for 1995 to 1999. During this period, 127 intra-EU transfer pricing cases were referred either to the Arbitration Convention or a bilateral treaty mutual agreement procedure (it is interesting to note the total number of cases rises to 413 when non-EU country counterparties are brought in). The paper estimated that 85% of the cases had been satisfactorily resolved, removing double taxation in an average timescale of 20 months. In its recent communication in February 2007, the European Commission revealed that none of the 24 cases for which the taxpayer had made the request for mutual agreement procedure prior to January 2000 was sent to Arbitration Commission.

Recognising that considerable numbers of transfer pricing cases are never referred to competent authorities for resolution, the Commission identified transfer pricing as a major concern for cross-border business. To review the tax position on transfer

pricing in the EU and to consider pragmatic ways in which the burden on business could be relieved, in early 2002 the Commission proposed the establishment of the EU Joint Transfer Pricing Forum. This was a radical step, in that membership would include both government personnel and representatives from business. In addition to the Chair, the Forum now includes 25 Member State representatives and 10 business representatives (the author is one of the 10) together with Commission membership and observers from the OECD and EU accession states.

The forum's work resulted in two formal reports. The first was published on 27 April 2004 and was adopted by the ECOFIN Council on 7 December 2004. The material is available on the Commission websites and contains detailed guidance on the operation of the Arbitration Convention, including practical matters relevant to time limits and the mutual agreement procedures. The Council adopted the Code of Conduct recommend by the EU Joint Transfer Pricing Forum in full.

The second report of the EU Joint Transfer Pricing Forum in full was completed in mid-2005 and set out a proposal for documentation standards across all Member States. The Commission adopted the proposal on 10 November 2005. In June 2006, the Council of the European Union adopted a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union. This Code of Conduct will standardise the documentation that multinationals must provide to tax authorities on their pricing of cross-border, intra-group transactions.

Considering the recent achievements within the EU and the need to ensure a monitoring of implementation of Codes of Conduct and Guidelines and the examination of several issues, the EU Joint Transfer Pricing Forum has been renewed for a new mandate of two years. The Commission has endorsed the Joint Transfer Pricing Forum's suggestions and conclusion on Advance Pricing Agreements and on this basis released guidelines for Advance Pricing Agreements in the EU. Going forward, the Joint Transfer Pricing Forum will continue to examine penalties and interest related to transfer pricing adjustments and focus on the important area of dispute avoidance and resolution.

### **1115 International updates in cross-border dispute resolution**

Taking a cue from the EU Arbitration Convention, OECD countries have agreed to broaden the mechanisms available to taxpayers involved in cross-border disputes over taxation matters by introducing the possibility of arbitration if other methods to resolve disagreements fail. The background for this initiative goes back to February 2006, when the OECD released a public discussion draft entitled 'Proposals for improving mechanisms for resolution of tax treaty disputes'. This public discussion draft essentially dealt with the addition of an arbitration process to solve disagreements arising in the course of mutual agreement procedure and the development of a proposed online manual for effective mutual agreement procedure.

The OECD received numerous comments on the public discussion draft and followed it up with a public consultation meeting in March 2006. As a result of these comments and meeting, the Committee of Fiscal Affairs of the OECD approved a proposal to add to the OECD Model Convention an arbitration process to deal with unresolved issues that prevent competent authorities from reaching a mutual agreement.

The proposed new paragraph to the Mutual Agreement Procedure Article of the



Model Convention (Paragraph 5 of Article 25) provides that in the event the competent authorities are not able to reach any agreement in relation to a case presented to the competent authority for resolution within a period of two years from the presentation of the case, it may be submitted to arbitration at the request of the taxpayer. It is left to the discretion of the member countries as to whether the open items may be submitted for arbitration if a decision on these issues is already rendered under domestic law.

Issues of treaty interpretation would be decided by arbitrators in the light of principles incorporated in the Vienna Convention on the Law of Treaties whereas the OECD Guidelines would apply in respect of transfer pricing matters.

Finally, the OECD has recently developed a Manual on Effective Mutual Agreement Procedure explaining the various stages of the Mutual Agreement Procedure, discussing various issues related to that procedure and where appropriate, bringing out certain best practices.

PART II  
COUNTRY-SPECIFIC ISSUES

# 12 Africa Regional transfer pricing<sup>1</sup>

## 1201 Introduction

Transfer pricing continues to be a major concern to fiscal authorities around the world and Africa is no exception. Revenue authorities in the African countries are sceptical of the tax compliance levels of multinationals operating in the African continent and more often tend to view inter-company pricing policies as profit extraction techniques. In some African countries the revenue authorities have requested assistance from more developed tax authorities with transfer pricing training. Transfer pricing is therefore one of the hot topics that is developing in the African tax arena and is seen by many tax authorities as a mechanism to protect their tax base.

### *Southern and Central Africa*

In Southern Africa, South Africa continues to be the most active country in legislating transfer pricing matters. Section 31(2) of the South African Income Tax Act requires connected parties to deal at arm's length in respect of cross-border transactions. A detailed Practice Note 7 has been issued that provides guidelines on how companies should conduct their cross-border related party dealings. Companies that do not comply with section 31(2) will face an adjustment to their taxable income. The adjusted amount will be subject to 28% corporate income tax and 10% secondary tax on companies. Furthermore, the taxpayers may be liable to interest on the underpayment of taxes and penalties, of up to 200% of the tax on the adjusted amount. Finally, the assessment may have a significant impact on the company's cash flow as the principle of 'pay now fight later' applies.

Transfer pricing legislation was introduced in Namibia during May 2005, and a Practice Note on the application of the transfer pricing legislation was issued in September 2006. While Namibia's Directorate of Inland Revenue is not yet fully geared to conduct full scope transfer pricing compliance investigations, the Directorate has indicated that it will work closely with the South African Revenue Services and if necessary will request task teams from the South African Revenue Service to assist in carrying out transfer pricing audits.

In Zambia transfer pricing legislation exists. Section 97A of the Income Tax Act introduces the arm's length principle. The Income Tax (Transfer Pricing) Regulations 2000 also provide further definitions regarding the extent of application of the transfer pricing provisions contained in the Income Tax Act. In March 2005, a draft practice note was issued by the Zambia Revenue Authority (ZRA) which provides detail on how the ZRA would apply the transfer pricing rules. The enforcement of the legislation by the ZRA has however not been as aggressive as expected. However, it would be difficult to mount a defence of 'non-existence of transfer pricing legislation' when the ZRA begins to actively police the legislation.

There have not been many transfer pricing issues highlighted in Zimbabwe. This is probably due to the fact that there are strict exchange controls in Zimbabwe which are

---

<sup>1</sup> Prepared by Jacques van Rhyen (PwC Africa Transfer Pricing Leader)

used to control the movement of funds out of Zimbabwe. In Mozambique, Lesotho, Swaziland and Malawi, transfer pricing, does not appear as yet to be a prominent issue. In Botswana the revenue authority is applying the general anti-avoidance provision to attack cross-border transactions between connected parties. We are aware of a number of ongoing audits and assessments issued by the Botswana revenue authority.

### *East Africa*

In East Africa, the Kenya Revenue Authority (KRA) has been most active in policing the transfer pricing practices of multinationals. It has engaged two Kenyan multinationals in the High Court of Kenya in transfer pricing litigation. Tanzania and Uganda tend to follow Kenya's example when it comes to dealing with novel areas of tax enforcement. In February 2005, the KRA released draft TP regulations for comment by the industry and it is expected that Tanzania and Uganda will adopt the same regulations as soon as they are adopted as law in Kenya. Although Tanzania has not issued detailed transfer pricing regulations, there are specific transfer pricing provisions in the main part of the tax legislation (section 33 of Tanzania Income Tax Act) and the Tanzania Revenue Authority (the 'TRA') has in the past raised transfer pricing audit queries in respect of multinationals operating in Tanzania.

Each of the African jurisdictions implementing specific transfer pricing regulations is discussed in more detail below.

## **SOUTH AFRICA, REPUBLIC OF<sup>2</sup>**

### **1202 Introduction**

Transfer pricing legislation has been in South African law since 1995; however it has only been in recent years that the South African Revenue Service ('SARS') has focussed on this area of taxation. The rules require those liable to tax in South Africa to follow arm's length principles in their dealings with *inter alia* connected persons that are not tax residents of South Africa. Whilst exchange control regulations continue to regulate the flow of funds out of South Africa, the gradual relaxation of the exchange control rules have provided greater flexibility and freedom for the movement of funds offshore, as such the authorities are becoming more reliant on the successful implementation of transfer pricing rules. In this regard we have seen increased activity by the specialist Transfer Pricing unit within SARS with growing focus on industry sectors, notably retail and automotive. What is of great concern is that most of the SARS audits are focused on the initial years up to 2002 when very few companies were compliant. SARS is applying today's knowledge and general practice with hindsight which stands in stark contradiction to the provisions of the Practice Note and the OECD Guidelines.

### **1203 Statutory rules**

Section 31 of the South African Income Tax Act 58 of 1962 ('Income Tax Act') combines transfer pricing and thin capitalisation measures. Section 31(2) gives the commissioner the power to adjust the consideration of a transaction to an arm's

---

<sup>2</sup> Prepared by Jacques van Rhyn PwC South Africa

length price for the purposes of computing the South African taxable income of a taxpayer. This rule applies to both goods and services, both terms being defined in section 31(1) as well as to direct and indirect financial assistance. Section 31 is a discretionary section which means that whilst the taxpayer can place some comfort on the fact that the Commissioner must have applied due care and reasonableness in raising a transfer pricing adjustment, the onus of proof for rebutting such an adjustment rests squarely with the taxpayer.

In terms of section 64C SARS may, in certain circumstances, also deem an adjusted amount to be a dividend on which Secondary Tax on Companies ('STC') is payable (currently 10%). It should be noted however that STC will be abolished in favour of a dividend withholding tax. The actual date of implementation is uncertain at this point in time. How this will impact adjustments made under the transfer pricing rules is unclear. There also remains unresolved contention regarding the application of the current STC charge on adjustments made voluntarily and whether this should attract a STC charge.

Additional taxes include interest and penalties. For instance, in the event of the underpayment of taxes due to transfer pricing, a taxpayer may in terms of section 89 also be liable to interest on the underpayment of tax as well as to the payment of penalties in terms of section 76, which may be as much as 200% of the underpaid taxes.

Although there are no explicit transfer pricing documentation requirements in the Income Tax Act, SARS may in terms of section 74 read with section 74A, require a taxpayer to furnish 'information, documents or things as the Commissioner may require for the administration of the Income Tax Act'. In practice, SARS may require detailed transfer pricing information to be supplied within seven days from the date of request. Furthermore, SARS exercises its authority in terms of section 74 read with section 74A by requiring a taxpayer to submit its transfer pricing policy with its corporate income tax return. Failure to comply with this, could arguably lead to prosecution under section 75 of the income Tax Act.

What is of interest is the requirement (introduced in 2004 and clarified in the addendum to the practice note) to furnish the transfer pricing documentation with the tax return if held. It is arguable that this inherently introduces a requirement to complete documentation although SARS maintains there is no statutory requirement to do so. What is critical is that where such documentation has been prepared it must adequately reflect the current transfer pricing policies being implemented and be up to date, since erroneous, out of date or incorrect documentation could, and has been argued to, represent incomplete disclosure thus resulting in prescription not applying to the years in which the incorrect disclosure was made. This represents a significant risk to taxpayers who could remain open to a transfer pricing review from SARS for an indefinite period going back as early as 1995.

*Note:*

An important point to note at this point is that SARS are amending the IT14 statutory income tax return. Under the new requirements no supporting documentation is to be submitted until such time as required by SARS. Uncertainty exists as to how this will impact the above disclosure obligation and the requirements of the Practice Note and its addendum. Taxpayers are cautioned to keep abreast of developments in this

regard and seek advice before deciding not to prepare contemporaneous documentation or file supporting documentation.

Section 31(3) is more specifically aimed at thin capitalisation and is discussed in more detail below.

#### **1204 Controlled foreign companies**

The Income Tax Act deems any transaction undertaken between a controlled foreign company (CFC) and any connected person to such CFC, to be a transaction to which the transfer pricing provisions contained in section 31 apply. CFCs are non-resident companies of which more than 50% of the total participation rights or voting rights in the company are held directly or indirectly by one or more South African residents. The result is that in effect the Act is deeming the CFC party to the transaction to be a resident for transfer pricing purposes.

This is increasingly becoming an area of scrutiny for SARS as many multinationals based in South Africa omit to identify the potential risk that transactions between CFCs pose if not supportable as arm's length. The stringent anti-diversionary rules, which generally provide exemptions to imputation under the CFC rules, can apply where the transactions between CFCs are not conducted at arm's length resulting in imputation to the South African holding company of an arm's length return.

#### **1205 Other regulations**

SARS issues practice notes which provide guidance on its interpretation and application of the Income Tax Act. Practice Note 2 was issued in May 1996 and focuses on the interaction of the thin capitalisation rules and the transfer pricing rules. Practice Note 2 relates to the provision of financial assistance given by an overseas connected party to a South African resident, but not vice versa. The practice note assists taxpayers to identify levels of excessive loan debt under the thin capitalisation rules as well as excessive interest rates under the transfer pricing rules.

The Practice note strictly only applies to inbound financial assistance and taxpayers need to be wary if relying on this for outbound financial assistance, notably as SARS is aggressively focussing on this area.

Practice Note 7 was issued in 1999 and is aimed at providing more specific guidance to the workings of the legislation on transfer pricing. It is a very comprehensive practice note following a similar approach to the Australian and New Zealand guidance on implementing transfer pricing rules and documentation requirements.

Under accounting statement AC126 (and the new IRFS requirements) companies are required to disclose all transactions with related parties. This provision applies for financial years commencing on or after 1 July 1998. Due to the rather wide definition of related parties, the financial statements will now provide information to SARS on cross-border transactions with connected persons. What is becoming of increasing importance is the requirements under the accounting standards to be able to support any statement made in the financial statements. Thus if the statement is made in the financial statements that all related party transactions are conducted at arm's length, the auditor needs to satisfy himself that this statement can be suitably supported. In the current climate of risk adversity this is placing a greater onus on the auditors and in turn greater pressure on multinationals to ensure the transfer pricing house is in

order. It is also noted that a copy of the financial statements is required to be attached to the taxpayer's annual tax return for disclosure purposes. (See note above). Accordingly, if a general statement is made that the related party transaction takes place at arm's length and this is not in fact the case, SARS could claim that the taxpayer made a fraudulent misrepresentation, resulting in prescription not applying to the years in which the incorrect disclosure was made.

The introduction of legislation surrounding reportable irregularities for auditors and tax practitioners is also placing strain on transfer pricing compliance. Transfer pricing in South Africa is discretionary and therefore identifying the existence of a transfer pricing exposure and quantifying this, without undertaking extensive analysis, is problematic and raises considerable concerns for auditors, tax practitioners and taxpayers.

### **1206 Legal cases**

There have not as yet been any court cases on this issue. As a result of the increased focus of SARS on transfer pricing, various transfer pricing assessments have been issued in which adjustments have been made. Some of these adjustments have been appealed against and are likely to be tested through the courts.

### **1207 Burden of proof**

As mentioned above, Section 31 is a discretionary section and therefore in making any transfer pricing adjustment, SARS must demonstrate that it has applied its mind and paid due care and attention to the issue. Notwithstanding this, the burden of proof lies with the taxpayer to demonstrate that the transfer pricing policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's length standard.

### **1208 Tax audit procedures**

SARS follows the OECD Guidelines in conducting a transfer pricing investigation and all multinationals are potential targets, both inbound investors as well as South African based. Companies which fall within the provisions of section 31 should take transfer pricing seriously and develop and maintain properly documented and defensible transfer pricing policies. Such documentation must be contemporaneous and regularly updated. Previously SARS' practice generally accepted a document be updated only every three years and for changes in the operations. Recent experience with SARS however suggests that this is no longer the case and taxpayers need to ensure the documentation is updated annually.

SARS is currently aggressively auditing taxpayers on their transfer pricing and has indicated that they will place greater scrutiny on multinationals that have connected party entities situated in low tax jurisdictions. This line of enquiry tends to combine a challenge of residence together with transfer pricing.

SARS is becoming much more aggressive in its audit activity and is focussing on industry areas. SARS has demonstrated its ability to research an industry and is being selective in targeting audits. We have seen increased activity in the retail and automotive sectors and are aware of a build up of activity in mining. In addition, SARS has stated in its 2007 budget that intellectual property is a focus area, and since then there has already been a number of queries issued in relation to this and we can expect to see this increase.

SARS, as in South Africa generally, is experiencing a resource issue which means many of the audits commenced are taking a long time to conclude. In addition, where transactions are with African countries which do not have a transfer pricing regime, solutions through the normal channels of mutual agreement procedures (MAP) are unlikely to yield success.

### **1209 Resources available to the tax authorities**

Within SARS there is a specialist unit conducting transfer pricing audits. This comprises highly skilled individuals who have previously been employed by the professional firms. In addition, in order to assist with training of personnel in the unit, SARS has sought advice and training from Revenue specialists in the USA, UK and Australia. SARS' transfer pricing representatives also regularly attend OECD conferences and training sessions presented by the OECD.

### **1210 Use and availability of comparable information**

#### *Use*

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Within the context of these guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

#### *Availability*

Information on the performance of public companies in South Africa is only readily available in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies are generally not available publicly. The result is that the search for comparables in South Africa is not an easy one.

SARS has indicated that it will accept the use of financial databases used elsewhere in the world, but all comparables will need to be adjusted for the South African market. Our understanding is SARS uses Amadeus One Million to conduct comparable studies relying largely on European companies for comparability.

We have seen limited evidence of SARS relying on secret comparable information they have access to when determining adjustments under audit. Although such supporting evidence could never be used in a court of law, it nevertheless places greater emphasis on the need for multinationals to have robust benchmarking to support the related party transaction in order to be able to rebut such proposed adjustments.

### **1211 Risk transactions or industries**

South African companies that have related companies situated in lower tax jurisdictions remain at a high risk of investigation. Such investigation is often two pronged testing residency together with transfer pricing. Although SARS attacks taxpayers in all industries, it has recently started focussing on certain industries, namely the automotive, retail and mining industries. SARS arguably has a stricter requirement for documentation and supporting evidence than many other countries.



For instance global documentation prepared by a group and rolled out throughout that group will not be acceptable without a sufficient level of localisation. SARS focus is very much on the transactional level and it does not readily accept analyses undertaken on a whole of entity basis, commonly adopted in the US and Australia. Further, SARS is at odds with the OECD in some respect, notably on the use of multiple year data. SARS views tax as an annual event and adjustments for transfer pricing are viewed on a year by year basis irrespective of the longer term picture.

SARS does not look favourably upon transfer pricing adjustments, as SARS often views such adjustments as a profit stripping mechanism and as such, any TP adjustments by offshore holding companies are deemed to raise a 'red flag' for SARS to raise queries or perform an audit. SARS also states that the taxpayer cannot use hindsight and that year-end transfer pricing adjustment is made based on hindsight.

### **1212 Competent authority**

Little information is available on the process for competent authority claims. Experience suggests that competent authority has not been widely used in South Africa. The lack of experience coupled with potentially difficult administrations in wider Africa means that reliance on MAP to resolve disputes will be problematic.

### **1213 Advance pricing agreements (APAs)**

There are no procedures in place at present by which a taxpayer might achieve an advance agreement to its transfer pricing policy, and is not expected for some time. In Practice Note 7, SARS specifically states that it is not in favour of adopting APAs. Furthermore, experience has proved that SARS does not accept unilateral APAs, that a taxpayer's connected parties may have agreed with other tax authorities. There may be limited opportunity to obtain a private ruling from SARS on transfer pricing practices, but as yet this is largely untested.

### **1214 Anticipated developments in law and practice**

#### *Law*

South Africa operates a worldwide basis of taxation. Further the introduction of capital gains tax and new anti avoidance provisions highlights the vast changes the Income Tax Act has undergone in the last six years. No legislative changes have been made to section 31 since 2001, when the definition of 'permanent establishment' was moved from the section and added to the list of definitions contained in section 1 of the Income Tax Act.

The definition of a connected person in Section 1 of the Income Tax Act underwent significant changes in the 2006 amendments with the tie to the Company's Act finally removed. The new definition now follows closely the definition of a group of companies with minor variations.

'The definition of a group of companies means two or more companies in which one company (hereinafter referred to as the '**controlling group company**') directly or indirectly holds shares in at least one other company (hereinafter referred to as the '**controlled group company**'), to the extent that —

- (a) at least 70% (50% for the connected person definition) of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) the controlling group company directly holds at least 70% (50% for the connected person definition) of the equity shares in at least one controlled group company.

The effect is that the transfer pricing rules now apply in a manner consistent with most other OECD member countries and will catch any cross-border transactions entered into by group companies where the shareholding is controlling i.e. greater than 50%, irrespective of the location of the parent entity. It is noted however, that the above is only one of the connected person definitions that apply in relation to companies. The South African connected person definition contained in section 1 of the Income Tax Act also states that an offshore company that individually or jointly with any connected person in relation to itself, holds directly or indirectly at least 20% of the company's equity share capital or voting rights will be a connected person in relation to such company. This definition is therefore wider than the related party definition applied in most other OECD member countries.

2004 saw a significant change in tax return disclosure requirements. The initial interpretation was that a requirement to complete transfer pricing documentation was created. This was tempered with the release of the addendum to Practice Note 7 which maintains there is no statutory requirement to prepare documentation. With SARS current aggressive stance on transfer pricing it remains however, in the taxpayer's best interest to ensure documentation is prepared to support all the cross-border transactions with connected persons. 2005 saw a definite requirement for taxpayers to actually submit transfer pricing documentation together with the tax return where such documentation has been prepared. The tendency for taxpayers not to adhere this and wait for SARS to call is dangerous and could be construed as not making full disclosure.

There have been no further practice notes issued since 1999 concerning transfer pricing, although there is speculation that Practice Note 7 may be updated some time soon.

### *Practice*

SARS has continued its drive to implement the transfer pricing legislation and all multinational companies remain the focus of the authorities' attention. It should be noted that SARS is not restricting its focus to the larger groups but is taking a much wider view. For this reason, it is important for multinational companies to formulate and document transfer pricing policies in line with OECD Guidelines and the Practice Note as soon as possible. All companies with international agreements are at high risk and should review the structure of their transactions.

In the 2007 budget, SARS acknowledged the potential economic value locked in intellectual property and the tendency of multinationals to shift the value offshore. In response to this, SARS intends imposing measures to correct this.

In addition, SARS plays an active role in its observer status at the OECD and has been involved significantly with the new releases on the attribution of profits to permanent establishments and conversion matters. Whilst strictly speaking the

transfer pricing rules do not capture transactions between a branch and its head office, without doubt SARS is focussing on this area and using transfer pricing principles to review such transactions.

### **1215 Liaison with other authorities**

Although customs and income tax authorities are under the same authoritative body, as a general rule, no information is shared between the two authorities as yet. However, SARS is on a general drive to improve its systems and better co-operation between the various authorities is to be expected in the near future.

What has been seen is the cooperation between SARS and the Reserve Bank. Generally a South African resident needs reserve bank approval to remit monies outside of South Africa, the extent of the approval and vigilance of the banks depends largely on the nature of the payments. Payment for the use of intellectual property and inbound services have always been a focus of the reserve bank and they are now including a SARS review in many cases prior to granting approval, to ensure any payments are in accordance with the arm's length principle. Two notable changes have been the requirement to not only demonstrate a benefit to the recipient of an inbound service, but also to South Africa as a whole, and, the recent move towards ensuring the inbound as well as outbound licence fees for intellectual property are arm's length.

### **1216 OECD issues**

South Africa is not a member of the OECD, but enjoys observer status and actively participates in and provides input to OECD discussions and discussion papers. South Africa does follow the OECD Guidelines and models although SARS' stance on the recent update on attribution of profits to permanent establishments remains unclear.

### **1217 Joint investigations**

It is possible for the South African tax authorities to join with the authorities of another country to jointly investigate a multinational group.

### **1218 Thin capitalisation**

Thin capitalisation is dealt with primarily by section 31(3). Guidance on thin capitalisation and the charging of excessive interest is provided in Practice Note 2 issued on 14 May 1996.

Thin capitalisation rules apply where financial assistance is granted, directly or indirectly, by a non-resident to:

- (a) any connected person who is a resident; or
- (b) any person (in whom the non-resident has a direct or indirect interest) other than a natural person who is a resident, where the non-resident is entitled to 25% or more of the company's profits, dividends or capital, or is entitled to exercise, directly or indirectly, 25% or more of the voting rights of the recipient.

Back-to-back loans are included in the financial assistance provisions.

Practice Note 2 of 1996 provides for an acceptable debt to equity ratio of 3:1, within

which the commissioner will not generally apply thin capitalisation restrictions. This 3:1 'safe harbour' ratio reflects the previous approach adopted by the Exchange Control Authorities. It should be noted that this is a safe harbour and not a statutory ratio and taxpayers are free to apply to the Commissioner for a relaxation in this ratio where sound commercial reasons for the variance exist. As with transfer pricing, the thin capitalisation rules are discretionary.

Taxpayers who comply with the safe harbour ratio are not required to justify shareholder loans but are still required to supply information as requested on the annual tax return. Furthermore, in determining the interest rates applicable for Rand denominated loans, an interest rate of the weighted average of South African prime rate plus 2% is accepted as arm's length. For foreign denominated loans, an interest rate of the weighted average of the relevant interbank rate plus 2% is considered as arm's length. This provides a 'safe harbour' for determining arm's length interest rates to be applied to inbound cross-border loans.

Subject to clearance (see below), interest charged on that part of the loan which exceeds the permissible ratio of 3:1 is not deductible for tax purposes. It is also deemed to be a dividend under section 64C(2)(e) of the Income Tax Act, and STC will be payable on the excessive amount.

These safe harbour provisions only apply to inbound financial assistance and not financial assistance provided by a South African entity. Reliance on these provisions for outbound financial assistance is dangerous for this reason.

A literal interpretation of section 31 would lead to the conclusion that the concept of financial assistance would extend beyond to interest-bearing loans, to interest free loans. However, the purpose of section 31(3) is to enable the commissioner to determine an acceptable debt to equity ratio in order to disallow a tax deduction for interest paid in relation to any excessive part of the debt, and thus the application of section 31(3) is limited, in practice, to interest-bearing debt only. Notwithstanding this, the provision of an interest free loan may be subject to the transfer pricing regulations contained in section 31(2) resulting in SARS imputing and taxing a deemed interest flow to the lending company.

## **KENYA<sup>3</sup>**

### **1219 Introduction**

Kenya has always had a general provision within its tax legislation requiring transactions between non-resident and resident related parties to be at arm's length. However, until 2006, no guidance had been provided by the revenue authorities on how the arm's length standard was to be achieved. This failure to provide guidance had led to protracted disputes between taxpayers and the Kenya Revenue Authority (KRA) culminating in a landmark case involving the Commissioner of Income Tax and Unilever Kenya Limited (the Unilever Case). The judgment of the High Court in the Unilever Case led to the introduction of Transfer Pricing Rules in July 2006 providing guidance on the application of the arm's length principle.

---

<sup>3</sup> Prepared by J Kabiru PwC Nairobi

**1220 Statutory rules**

Section 18 (3) of the Income Tax Act, Chapter 470 of the Laws of Kenya (the Act) requires business carried on between a non-resident and a related Kenya resident to be conducted at arm's length and gives the Commissioner the power to adjust the profits of the Kenya resident from that business to the profits which would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length. The Income Tax (Transfer Pricing) Rules, 2006, Legal Notice No. 67 of 2006 (TP Rules) published under Section 18 (8) of the Income Tax Act (the Act) with an effective date of 1 July 2006, provide guidance on the determination of arm's length prices.

Under Section 18 (3) of the Act and the TP Rules apply, persons or enterprises are related if either of them participates directly or indirectly in the management, control or capital of the other or if a third person participates directly or indirectly in the management, control or capital of both. No minimum threshold for participation in control or capital is prescribed. However, as Kenya follows IFRS, it is expected that similar considerations to those in the definition of a related party in IAS 24 would apply.

The TP Rules state that they apply to transactions between branches and their head office or other related branches. There are doubts as to the legitimacy of this provision in light of the restrictive application of Section 18 (3) to 'resident persons' which excludes branches. This notwithstanding, the widely held view is that it would be prudent for branches to apply the TP Rules in their dealings with their head offices and other branches for two reasons. Firstly, the intention, both at the local level and at the international level in the OECD that the arm's length principle should be extended to branches is clear and it is very likely that the KRA will seek an amendment to Section 18 (3) to include branches. Secondly, the arm's length principle is an implicit requirement in other sections of the Act, for instance with respect to the requirement of reasonableness of head office costs incurred by branches.

Transactions subject to adjustment include the sale or purchase of goods, sale, transfer, purchase, lease or use of tangible and intangible assets, provision of services, lending or borrowing of money and any other transactions which affect the profit or loss of the enterprise involved.

The TP Rules do not make it an express statutory requirement for taxpayers to complete supporting transfer pricing documentation. However, Rule 9 (1) gives the Commissioner permission to request information, including documents relating to the transactions where the transfer pricing issues arise and a non-comprehensive list of the documents which the Commissioner may request is provided in Rule 9 (2). Rule 10 similarly requires a taxpayer who avers the application of arm's length pricing to avail documentation evidencing the taxpayer's analysis upon request by the Commissioner. The requirement for taxpayers to complete transfer pricing documentation is therefore implied in the Rules and it is in the taxpayers' best interest to complete and maintain such documentation.

The documents which the Commissioner may request are required to be prepared in or to be translated into English and include documents relating to:

- The selection of the transfer pricing method and the reasons for the selection;
- The application of the method including the calculations made and price adjustment factors considered;

- The global organisation structure of the enterprise;
- The details of the transactions under consideration;
- The assumptions, strategies and policies applied in selecting the method; and such other background information as may be necessary regarding the transaction.

In providing guidance on the nature of documentation required, Rule 9 (2) does not lay down any hard and fast rules for compiling documentation or for the process that taxpayers should follow.

The rules specify that the five primary methods specified in the OECD Guidelines may be used to determine the arm's length nature for goods and services in transaction between related parties. In circumstances in which the five methods cannot be used, another method approved by the Commissioner of the Kenya Revenue Authority can be applied.

No special penalties apply in respect of additional tax arising from a transfer pricing adjustment. However, the usual penalty, currently 20% of the principal tax and late payment interest of 2% per month applies.

The KRA has seven years from the year in which the income in question was earned in which to make an assessment. For years in which fraud, intentional negligence or gross negligence on the part of the taxpayer is suspected, there is no time limit in which the KRA must make an assessment in respect of transfer pricing.

### **1221 Controlled foreign companies**

The concept of controlled foreign companies (CFCs) is not a feature of Kenyan tax law and Kenya does not have any rules which would deem a foreign company controlled by Kenya residents to be resident for transfer pricing purposes.

### **1222 Other regulations**

For financial years ending on or after 31 December 1999, companies are required to disclose all transactions with related parties under IAS 24. The wide definition of related parties in IAS 24 ensures that financial statements prepared in accordance with IFRS will provide the KRA with information concerning related party transactions and this will likely be the starting point for KRA enquiries into transfer pricing.

### **1223 Legal cases**

Of the two transfer pricing cases instituted before the courts in Kenya, the only one on which a judgment was delivered was the Unilever case. In this case, the High Court of Kenya endorsed the use of OECD Guidelines in the absence of detailed guidance from the KRA. The Government's response to this judgment was the introduction of the TP rules which are largely based on the OECD Guidelines. There have been no court cases since the introduction of the TP Rules.

### **1224 Burden of proof**

In Kenya the burden of proof is on the taxpayer to demonstrate that the controlled transactions have been conducted in accordance with the arm's length standard.

**1225 Tax audit procedures**

Beyond the requirement to produce documentation in support of an averred application of the arm's length principle, the TP Rules do not contain any guidance to taxpayers as to what they may expect in connection with a transfer pricing investigation and nothing is known of such guidance communicated internally within the KRA. However, the KRA appears to be taking guidance on transfer pricing from the OECD Guidelines and the expectation is that KRA officers will be guided by the OECD Guidelines in conducting a transfer pricing investigation.

The indications are that the KRA regards transfer pricing as a potentially major revenue earner and it is expected that it will be taking an aggressive approach. At present, the KRA is not conducting special transfer pricing audits but since the introduction of the TP Rules, questions about cross-border related party transactions and requests for supporting transfer pricing documentation have been included in the information request which the KRA sends to taxpayers ahead of the regular tax audits conducted, presently, every three years. All multinationals are potential targets for a transfer pricing audit and those with transactions which fall within the provisions of Section 18 (3) and the TP Rules should take transfer pricing seriously and develop and maintain properly documented and defensible transfer pricing policies. The present recommendation is that documentation should, where possible, be contemporaneous and regularly updated. Until KRA practice in this respect is clearly established, taxpayers are advised to update their transfer pricing documents at least every three years and in the event of changes in the operations.

**1226 Resources available to the tax authorities**

The Domestic Taxes Department within the KRA is responsible for conducting corporate tax enquiries and there has been no move yet towards the establishment of a specialist unit for conducting transfer pricing audits. However, investment has been made in developing specialist expertise within the KRA through training both locally and abroad.

**1227 Use and availability of comparable information***Use*

The TP Rules, which are based on the OECD Guidelines, are the basis for determining an acceptable transfer pricing methodology. Within the context of these rules and guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

*Availability*

Information on the performance of public companies in Kenya is only readily available in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available publicly. Practically therefore, the search for comparables in Kenya is an almost impossible task.

The KRA has recently confirmed that it will accept the use of financial databases

used elsewhere in the world, and specifically Amadeus/ Orbis, provided justification for their use is provided. It is considered that the absence of information on local comparables would provide adequate justification.

### **1228 Risk transactions or industries**

There is no indication at present that certain types of transactions or that multinationals operating in particular industries are at higher risk of investigation than others. All multinationals are considered to be at a high risk of investigation.

### **1229 Competent authority**

The lack of experience coupled with potentially difficult administrations in wider Africa means that competent authority claims and/ or reliance on MAP to resolve disputes will be problematic.

### **1230 Advance pricing agreements (APAs)**

There are no procedures in place at present by which a taxpayer might achieve an advance agreement to its transfer pricing policy. In general terms, the KRA is reluctant to give binding rulings regarding practices or policies adopted by a particular taxpayer or group of taxpayers and this same reluctance is to be expected in connection with agreements or rulings on transfer pricing matters.

### **1231 Anticipated developments in law and practice**

The introduction of the TP Rules is very recent and it is likely to take some time to identify the gaps or areas of difficulty in the TP Rules and in Section 18 (3) which may lead to further developments in the law. One such gap identified is that relating to branches and it is anticipated that Section 18 (3) may soon be amended to include branches. The drafting of the TP Rules in broad terms ensures however that Kenya will be able to keep pace with developments in practice on the international front without, in most cases, the need for specific amendments to the legislation or the TP Rules.

### **1232 Liaison with other authorities**

Although customs and income tax are under the same authoritative body, they are administered by distinct and separate departments within the KRA and there is very little sharing of information between the two departments. However, KRA is on a general drive to improve its systems and better co-operation between the various authorities is to be expected in the near future.

### **1233 OECD issues**

Kenya is not a member of the OECD, but Kenya does follow the OECD Guidelines and models.

### **1234 Joint investigations**

The KRA has not teamed up with any other tax authorities for the purposes of undertaking a joint investigation into transfer pricing.



### 1235 Thin capitalisation

The relevant sections of the Income Tax Act that deal with thin capitalisation are sections 4A (a), 16(2)(j) and 16(3).

Thin capitalisation rules apply where financial assistance is granted to a resident company by a related non-resident company which alone or together with no more than four other persons controls the resident company, and the loan exceeds the greater of

- three times the sum of the revenue reserves and the issued and paid up capital of all classes of shares of the company; or
- the sum of all loans acquired by the company prior to the 16<sup>th</sup> June 1988, and still outstanding at the time of determining the thin capitalisation status of a company.

An interest payments on that part of the loan that exceeds the permissible ratio of 3:1 is not deductible for tax purposes.

Thin capitalisation rules are typically designed to prevent erosion of the tax base through excessive interest deductions in the hands of companies that obtain financial assistance from non-resident affiliates.

## NAMIBIA<sup>4</sup>

### 1236 Introduction

Namibia introduced transfer pricing legislation on 14 May 2005. The legislation in the form of Section 95A to the Namibian Income Tax Act is aimed at enforcing the arm's length principle in cross-border transactions carried out between connected persons. During September 2006, the Directorate of Inland Revenue issued Practice Note 2 of 2006 (PN 2/2006) containing guidance on the application of the transfer pricing legislation.

### 1237 Statutory rules

Section 95A of the Namibian Income Tax Act (Income Tax Act) is essentially aimed at ensuring that cross-border transactions by companies operating in a multi-national group are fairly priced and that profits are not stripped out of Namibia and taxed in lower tax jurisdictions. This, Section 95A achieves by giving the Minister of Finance (who essentially delegates to the Directorate of Inland Revenue) the power to adjust any non-market related prices charged or paid by Namibian entities in cross-border transactions with related parties to arm's length prices and to tax the Namibian entity as if the transactions had been carried out at market-related prices.

While Section 95A requires that international transactions between connected persons must be fairly priced, the section is silent on the mechanisms that may be used for the determining arm's length prices. Further, the section also does not provide a definition for 'connected persons', nor does it prescribe any acceptable thin capitalisation ratios. The former two matters were satisfactorily addressed in PN 2/2006, but no guidance in respect of an acceptable thin capitalisation ratio has been

---

<sup>4</sup> Prepared by Patty Karuaihe-Martin PwC Namibia

provided by the Directorate of Inland Revenue to date.

In terms of the normal penal provisions of the Income Tax Act, the Directorate of Inland Revenue may levy penalties of up to 200% on any amount of tax underpaid. Consequently, Inland Revenue may invoke such provisions in the event where a taxpayer's taxable income is understated as a result of the fact that prices charged in affected transactions were not carried out at arm's length. Further, interest will be charged on the unpaid amounts at 20% per annum.

### **1238 Controlled foreign companies**

Namibia does not currently have controlled foreign company legislation.

### **1239 Other regulations: Practice Note 2 of 2006**

As mentioned above, PN 2/2006 was issued during September 2006. The objective of this Practice Note is to provide tax payers with guidelines about the procedures to be followed in the determination of arm's length prices, taking into account the Namibian business environment. It also sets out the Minister's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.

The Practice Note includes definitions for the following terms which were not initially defined in Section 95A of the Income Tax Act:

- Advance pricing arrangement
- Connected person
- Controlled transaction
- Uncontrolled transaction
- Multinational
- OECD Guidelines
- Transfer prices

The Practice Note is based on and acknowledges the principles of the OECD Guidelines. Nothing in the Practice Note is intended to be contradictory to the OECD Guidelines and in cases where there is conflict, the provisions of the OECD Guidelines will prevail in resolving any dispute. Any amendments made to the OECD Guidelines will be deemed to be incorporated into the Practice Note.

A 'connected person' is defined in PN2/2006. In relation to a company, the following are regarded as 'connected persons':

- (1) its holding company,
- (2) its subsidiary,
- (3i) any other company, where both such companies are subsidiaries of the same holding company,
- (4) any person, who individually or jointly with any connected person in relation to such person, holds (directly or indirectly) at least 20% of the company's equity share capital or voting rights,

- (5) any other company, if at least 20% of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company and
- (6) any other company, if such other company is managed or controlled by:
  - (a) any person who or which is a connected person in relation to such company;  
or
  - (b) any person who or which is a connected person in relation to such company

Even though it is accepted that section 95A by definition can only apply between separate legal entities, the contents of the Practice Note will also apply to transactions between a person's head office with the branch of such person or a person's branch with another branch of such person. The OECD Guidelines interpretation of arm's length will be followed in the application of the Practice Note.

In terms of the Practice Note, a taxpayer is required to be in possession of transfer pricing documentation. If the Minister, as a result of this examination, substitutes an alternative arm's length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Minister or in the Courts.

The Practice Note expressly states that a taxpayer needs to demonstrate that it has developed a sound transfer pricing policy in terms of which transfer prices are determined in accordance with the arm's length principle by documenting the policies and procedures for determining those prices.

There is currently no statutory requirement that the transfer pricing policy should be submitted to the Directorate of Inland Revenue as part of the Annual Income Tax Return. Taxpayers are thus merely required to prepare and maintain a transfer pricing policy and present it as a motivation for the prices adopted under international transactions in the event that Inland Revenue conducts a transfer pricing audit. It must however be stressed that PN 2/2006 clearly states that in the event that the taxpayer cannot present a transfer pricing policy, it will be very difficult for the taxpayer to successfully object against any transfer pricing adjustments made and corresponding assessments issued by the Directorate of Inland Revenue.

### **1240 Legal cases**

There have not been any court cases on this issue as yet.

### **1241 Burden of proof**

The burden of proof is on the tax payer. However, in accordance with PN 2/2006, the tax payer may be assured that the burden of proof will not be misused by the Directorate of Inland Revenue through groundless or unverifiable assertions about transfer pricing.

### **1242 Tax audit procedures and resources available to the tax authorities**

The Ministry of Finance is aware that transfer pricing cases can present special challenges to the normal audit or examination practices. Transfer pricing cases are fact-sensitive and may involve difficult evaluations of comparability, markets, and

financial or other industry information. The Ministry of Finance is still in the process to set up a special unit that will specifically deal with transfer pricing. Technical assistance will also be provided to the Ministry of Finance by OECD and the South African Revenue Services.

### **1243 Use and availability of comparable information**

#### *Use*

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Within the context of these guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

#### *Availability*

Information on the performance of public companies in Namibia is only readily available in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available publicly. Consequently, a search for comparables in Namibia is more often than not a futile exercise.

South African Revenue Services (SARS) uses the database, Amadeus One Million, to conduct comparable studies relying largely on European companies for comparability. It is envisaged that the Directorate of Inland Revenue in Namibia will also follow this approach.

### **1244 Risk transactions or industries**

Apart from the primary sector, Namibia's economy is largely import driven and major players in the Namibian private sector economy are subsidiaries of multi-national companies. These Namibian subsidiaries often have limited capacity in terms of financial administration, product development and administration, and strategic management and consequently import these services from head offices or shared service centres situated elsewhere in the world. The remuneration for these imported services is often reflected as 'management fees' in the financial statements of the Namibian subsidiary.

It is envisaged that the Directorate of Inland Revenue in their transfer pricing investigations (once the transfer pricing unit is operative) will initially focus on the arm's length nature of these 'management fees'. It is thus imperative that taxpayers prepare and maintain sufficient contemporaneous documentation in order to be able to justify the arm's length nature of management fees.

### **1245 Advance pricing agreements (APAs)**

The Directorate of Inland Revenue has indicated in PN 2/2006 that due to various factors, the APA process will not in the foreseeable future, be made available to Namibian taxpayers.

**1246 Anticipated developments in law and practice***Law*

Due to the fact that Namibia only recently introduced transfer pricing legislation, it is not foreseen that significant further laws or amendments will be introduced in the near future. It is however important to note that in terms of PN/2/2006 Namibia fully adopts the principles laid in the OECD Guidelines and that the OECD Guidelines have preference over the Practice Note. As a consequence, any changes to the OECD Guidelines will be relevant to and be adopted in Namibia as part of the Practice Note.

*Practice*

It is foreseen that the Directorate of Inland Revenue will in due course establish its own transfer pricing unit and will commence with transfer pricing audits.

**1247 Liaison with other authorities**

As mentioned above, the Namibian Directorate of Inland Revenue will work closely with SARS and the OECD. It is also envisaged that SARS will assist the Namibian Revenue authorities in the performance of transfer pricing audits, especially in situations where the audited multinational entity has affiliates or establishments in both countries.

**1248 OECD issues**

Namibia is not a member of the OECD, but enjoys observer status and does follow the OECD Guidelines and models.

**1249 Joint investigations**

As indicated above, it is possible for the Namibian Inland Revenue authorities to join with the authorities of South African or any other country to jointly investigate a multinational group.

**1250 Thin capitalisation**

Section 95A deals with thin capitalisation and prescribes that the Minister may, if any amount of financial assistance provided by a foreign connected person is excessive in relation to a company's fixed capital, disallow the deduction for income tax purposes of any interest or other charges payable by the Namibian person on the excessive portion of the financial assistance provided by the foreigner. Unfortunately, no guidance is provided by either Section 95A or PN2/2006 as to what excessive would mean. It is thus submitted that each case should be considered on the basis of the facts provided and that taxpayers should be careful in adopting a general assumption that a ratio of for example 3:1 should be acceptable to Inland Revenue.

## TANZANIA<sup>5</sup>

### 1251 Introduction

Transfer pricing legislation was included in the previous Income Tax Act 1973 but applied only to transactions with a non-resident. The new Income Tax Act 2004 introduces transfer pricing rules that apply to transactions with either a resident or a non-resident. The new rules are still largely untested, and there is currently a lack of issued guidance from the Tanzania Revenue Authority (“TRA”) on how the rules will be applied in practice.

### 1252 Statutory rules

Section 33 of the Income Tax Act 2004 requires that any arrangement between associates must be conducted at arm’s length, and where the Commissioner considers a taxpayer has failed to meet this standard, he has wide powers to make adjustments or re-characterise any amount. The Act does not specify any methodology for determining what constitutes an arm’s length price.

There is no explicit requirement in the legislation for the taxpayer to prepare transfer pricing documentation, although section 33 does require that the persons who are involved in the relevant transaction should *“quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have arisen for them if the arrangement has been conducted at arm’s length”*. This could be taken to imply that adequate documentation must be available to support the pricing of transactions between associates.

Regulation 6 of the Income Tax Regulations 2004 provides that section 33 “shall be construed in such a manner as best secures consistency with the transfer pricing guidelines in the Practice Notes issued by the Commissioner pursuant to section 130 of the Act”.

To date, the TRA has not issued a Practice Note to clarify what approach it will follow to give effect to the transfer pricing provisions (although it has indicated that a Practice Note will be issued in due course).

In the meantime, the TRA has stated that it will apply internationally agreed arm’s length principles as set out in the UN and OECD Transfer Pricing Guidelines. Furthermore, the TRA has indicated that it will follow the ruling in the Kenyan tax case on transfer pricing (Unilever Kenya Limited – see Kenya section), which applied the OECD transfer pricing principles.

In addition to section 33, the general deductibility section within the Act, section 11, provides that expenditure must be incurred wholly and exclusively in the production of income from the business. It would also be possible for the TRA to challenge the deductibility of an expense under this section if, for example, it considered the amount to be excessive or unsupported by suitable evidence.

### 1253 Controlled foreign companies

A controlled foreign company may trigger the Tanzanian transfer pricing rules if it is

---

<sup>5</sup> Prepared by J Butler PwC Tanzania

deemed to be an associate of the local entity, according to the definition of associate. However, a controlled foreign corporation is not itself deemed to be a resident of Tanzania for tax or transfer pricing purposes.

#### **1254 Other regulations**

As noted above, the TRA has indicated that it will issue a practice note to provide guidance on the application of the transfer pricing legislation, but no such guidance has yet been issued.

The tax return form does require a taxpayer to disclose transactions with related parties, although this information tends to mirror the details already provided in a company's financial statements.

#### **1255 Legal cases**

There have not yet been any legal cases based on the current legislation. A number of TRA challenges are currently under objection and these may end up being tested through the courts.

#### **1256 Burden of proof**

Under the provisions of section 33, and the self assessment regime, the burden of proof is on the taxpayer to ensure that transactions are carried out on an arm's length basis.

#### **1257 Tax audit procedures**

No specific procedures have been laid down by the TRA in relation to transfer pricing investigations, and currently queries on transfer pricing issues form part of the normal TRA audit process.

#### **1258 Resources available to the tax authorities**

There is as yet no dedicated transfer pricing unit within the TRA and queries are handled by the Large Taxpayers Department or Domestic Revenue Department as part of the normal process of reviewing a taxpayer's income tax affairs.

#### **1259 Use and availability of comparable information**

##### *Use*

The transfer pricing rules are the basis for determining an acceptable transfer pricing methodology (although no specific methodologies are prescribed). As mentioned above, the TRA has indicated that it will apply internationally agreed arm's length principles as set out in the UN and OECD Transfer Pricing Guidelines.

##### *Availability*

Information on the performance of companies in Tanzania is only readily available in the form of published or filed financial statements, with practical observance being more consistently followed by public companies and financial institutions. More detailed information is not generally available publicly. As a result, the use of Tanzanian comparables is not possible.

The TRA has not indicated whether it will accept the use of financial databases used elsewhere in the world, and given the lack of practice in this area, it is possible that this issue has not yet been considered.

### **1260 Risk transactions or industries**

There is no indication at present that certain types of transactions or industries are at higher risk of investigation than others. However, to date, the key area of focus by the TRA has been intra-group management fees (basis of calculation of the fee and evidence of services actually being provided) and interest free funding.

### **1261 Competent authority**

The lack of experience coupled with potentially difficult administrations in wider Africa means that competent authority claims and/or reliance on MAP to resolve disputes will be problematic.

### **1262 Advance pricing agreements (APAs)**

Regulation 33 of the Income Tax Regulations 2004 provides for the Commissioner to enter into a binding agreement on the manner in which an arm's length price is determined. However, in practice, the TRA is reluctant to issue binding rulings, and this reluctance is likely to also apply to transfer pricing matters. We are not aware that any APA agreements have been made to date.

### **1263 Anticipated developments in law & practice**

Given that the transfer pricing legislation in Tanzania is still relatively new and untested, it can be expected that over time the TRA's policy on how the law will be applied and what evidence is required will become clearer and one would hope that a practice note will be issued to give guidance to taxpayers.

### **1264 Liaison with other authorities**

Although customs and income tax are under the same authoritative body, they are administered by separate departments within the TRA and there is currently limited direct sharing of information between the two. However, it can be expected that this may change in the future.

### **1265 OECD issues**

The TRA has indicated that it will follow OECD and UN Transfer Pricing Guidelines.

### **1266 Joint investigations**

The TRA has not teamed up with any other tax authorities for the purpose of undertaking a joint investigation into transfer pricing. On rare occasions, they have taken advantage of the information sharing provisions in double tax treaties.

### **1267 Thin capitalisation**

There is no specific thin capitalisation legislation in Tanzania.

However, section 12 of the Act provides for a deferral of interest deductions in



certain cases, including where a resident entity is held at least 25% by a non-resident. In such circumstances, the total amount that may be deducted in respect of interest incurred during the year is limited to the sum of:

- Interest income derived during the year and included in taxable income;
- 70% of the entity's total taxable income for the year, excluding interest income and expense.

Any interest for which a deduction is denied is carried forward and treated as incurred during the next year of income, subject to the same rules again.

## ZAMBIA<sup>6</sup>

### 1268 Introduction

Transfer pricing legislation was first introduced in Zambia in 1999 and was subsequently amended in 2001 and 2002 respectively. The scope of the transfer pricing provisions for Zambia is contained in sections 97A to 97D of the Zambia Income Tax Act 1966 (Zambia Income Tax Act) read together with the Transfer Pricing Regulations, 2000 (the Regulations) as well as the final draft Practice Note (Zambia draft Practice Note) issued by the Zambia Revenue Authorities (ZRA). The enforcement of the legislation by the ZRA has however not been as aggressive as expected. Conversely, it would be difficult to mount a defence of 'non-existence of transfer pricing legislation' when the ZRA begins to actively police the legislation.

### 1269 Statutory rules

Section 97A of the Zambia Income Tax Act introduces the arm's length principle. The Income Tax (Transfer Pricing) Regulations 2000 also provide further definitions regarding the extent of application of the transfer pricing provisions contained in the Income Tax Act. In March 2005, a draft practice note was issued by the ZRA which provides detail on how the ZRA would apply the transfer pricing rules. As Zambia does not tax on a world wide basis, the legislation aims to counter tax losses brought about by non arm's length pricing. Furthermore, the transfer pricing legislation only applies in situations where the effect of the associated party pricing is to understate Zambian profit or overstate Zambian losses.

Zambia's transfer pricing policy does not only apply to cross-border transactions but also to transactions between Zambian taxpayer residents who are wholly and solely within the Zambian tax jurisdiction (i.e. domestic transactions). This is to ensure losses are not effectively shifted between taxpayers or between sources by applying non arm's length pricing. In addition, the transfer pricing legislation applies to companies as well as partnerships and individuals.

Section 97A (2) of the Zambia Income Tax Act states that the provisions relating to transfer pricing apply

*'where actual conditions having being imposed instead of the arm's length conditions there is, except for this section, a reduction in the amount of income taken into account in computing the income of one of the associated persons*

<sup>6</sup> Prepared by T Van der Merwe PwC South Africa & J Harley PwC Zambia

*referred to in subsection (1), in this section referred to as the first taxpayer, chargeable to tax for a charge year, in this section referred to as the income year’.*

The phrase ‘actual conditions’ is defined in section 97A(1) of the Zambia Income Tax Act as ‘conditions made or imposed between any two associated persons in their commercial or financial relations.’

‘Associated persons’ is defined as in section 97 (C) of the Zambia Income Tax Act. The section states that one person associates with another if –

- (a) One participates directly or indirectly in the management, control or capital of the other; or
- (b) The same persons participate directly or indirectly in the management, control or capital of both of them.

The Zambia draft Practice Note states that in relation to a body corporate one participates directly in the management, control or capital of the body corporate if they have ‘control’ over the body corporate. ‘Control’ means the power of a person to secure that the affairs of the body corporate are conducted in accordance with the wishes of that person. Such power would be derived from shareholding or other powers conferred by the constitutional documents of the body corporate.

The Zambia draft Practice Note states that a person indirectly participates in a second person corporate if the first person would be a direct participant (hereinafter referred to as the ‘potential participant’) due to:

- (a) Rights and powers which the potential participant, at a future date, is entitled to acquire or will become entitled to acquire;
- (b) Rights and powers that are, or may be required, to be exercised on behalf of, under the direction, of, or for the benefit of the potential participant;
- (c) Where a loan has been made by one person to another, not confined to rights and powers conferred in relation to the property of the borrower by the terms of any security relating to the loan.
- (d) Rights and powers of any person with whom the potential participant is connected;
- (e) Rights and powers which would be attributed to another person with whom the potential participant is connected if that person were himself the potential participant.

The draft Practice Note further includes in its definition of ‘indirect participation’ joint ventures that are able to use non arm’s length prices to shift profits overseas for their mutual benefit. The rules only apply to transactions between at least one of the joint venture parties (referred to as the ‘major participant’) and the joint venture itself and not between two joint ventures themselves unless they are under common control.

The Zambia draft Practice Note states that although section 97A – 97D of the Zambian Income Tax Act are inapplicable to transactions between branches and their head offices, the provisions are applicable to transactions between a Zambian branch of an overseas head office and associated companies of the overseas head office (wherever resident) or overseas branches of a Zambian head offices and a person associated to the Zambian head office wherever located. Section 97 C (3) of the

Zambian Income Tax Act states that conditions are taken to be imposed either by an arrangement or series of arrangements, or agreement or series of agreements. The definition is wide and includes:

- (a) Transactions; understandings and mutual practices, and
- (b) An arrangement or agreement whether or not it is intended to be legally enforceable.

Further the arrangement or agreement or series of arrangements or agreements may not have to take place between two related parties e.g. 'thinly capitalised' taxpayers paying interest to third parties under finance arrangements guaranteed by associates. Section 97AA of the Zambia Income Tax Act is more specifically aimed at thin capitalisation and is discussed in more detail below.

Financial arrangements extend to interest, discount and other payments for the use of money whether these are receivable or payable by the person under review.

### **1270 Controlled foreign companies**

Zambia does not currently have controlled foreign company legislation.

### **1271 Other regulations**

#### *Penalties and interest*

If the ZRA makes a legitimate and reasonable request in relation to a tax return that has been submitted, or should have been submitted, a taxpayer may be exposed to the risk of penalties if the primary records, tax adjustment records, or records of transactions with associated entities are not made available. In addition the taxpayer may be exposed to further risk if no evidence is made available within a reasonable time to demonstrate appropriate arm's length results of transactions to which transfer pricing rules apply or if the evidence made available by the taxpayer is not a reasonable attempt to demonstrate an arm's length result.

When considering whether a reasonable attempt has been made to demonstrate an arm's length result, the ZRA will observe the same principles of risk assessment that it observes when considering whether to initiate a transfer pricing enquiry i.e. The ZRA would expect a taxpayer acting reasonably to go to greater lengths in relation to making records and evidence available where risks are higher than it would where the risks are lower.

In terms of the general penal provisions, section 98 of the Zambia Income Tax Act, the Commissioner-General of Inland Revenue may levy a fine not exceeding ten thousand penalty units<sup>7</sup> or subject the taxpayer to imprisonment for a term not exceeding twelve months, or may levy and subject the taxpayer to both the fine and imprisonment. Further, under section 100 of the Zambia Income Tax Act, a penalty for an incorrect return may be levied on the amount of income understated or expenses overstated. The penalty charged on the amount of income understated or expenses overstated may be levied at 17.5% in the event of negligence, 35% in the event of wilful default and 52.5% in the event of fraud. In addition, the late payment of tax will attract a penalty of 5% per month or part month from payment due date plus interest

---

<sup>7</sup> One penalty unit equates to Kwacha 180

will be levied on the outstanding tax payable amount at the Bank of Zambia discount rate plus 2% (currently approximately 12% per annum).

### *Documentation*

The Zambia draft Practice Note states that the following records should be kept to avoid exposure to penalties:

- (a) Primary accounting records;
- (b) Tax adjustment records; or
- (c) Records of transactions with associated businesses.

### **1272 Legal cases**

PwC is not aware of any court cases on this issue as yet.

### **1273 Burden of proof**

In accordance with section 97C of the Zambia Income Tax Act, the burden of proof lies with the taxpayer to demonstrate that the transfer pricing policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's length standard.

Furthermore, as per the Zambia draft Practice Note, the ZRA considers that as a step towards discharging the burden of proof, it is in the taxpayer's best interests to:

- develop and apply an appropriate transfer pricing policy;
- determine the arm's length conditions as required by section 97A of the Zambia Income Tax Act;
- maintain contemporaneous documentation to support the policy and the arm's length conditions in points (a) and (b) above; and
- voluntarily produce the documentation when asked.

### **1274 Tax audit procedures**

As per the Zambia draft Practice Note, the ZRA has adopted the arm's length principle and will refer to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in conducting a transfer pricing investigation.

OECD Guidelines are followed by the ZRA and all Multinational Enterprises are potential targets. The ZRA have no specific procedure to follow when conducting a tax audit; generally the company is notified and requested to provide supporting documentation etc. The ZRA prefer for the company under enquiry to also provide the comparables. The ZRA will then look at the information provided and the comparables and negotiate accordingly.

### **1275 Resources available to the tax authorities**

The Domestic Taxes Department within the ZRA is responsible for conducting corporate tax enquiries and there has been no move yet towards the establishment of a specialist unit for conducting transfer pricing audits. However, investment has been made in developing specialist expertise within the ZRA through training both locally and abroad (i.e. UK, Australia and South Africa).

**1276 Use and availability of comparable information***Use*

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Therefore (within the context of the OECD Guidelines), any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

It must however be noted that the ZRA do prefer comparable information to be in respect of Zambian companies with the view that the companies will be operating under the same economic circumstances etcetera.

*Availability*

Information on the performance of public companies in Zambia is only readily available in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available publicly. Consequently, a search for comparables in Zambia is more often than not a futile exercise.

As per the Zambia draft Practice Note, the ZRA will accept the use of foreign comparables such as data from the United Kingdom, United States and Australian markets. However, taxpayers using this approach are required to adjust for the expected effect on the price due to geographic and other differences in the Zambian market.

The South African Revenue Services (SARS) uses the database, Amadeus One Million, to conduct comparable studies relying largely on European companies for comparability. It is envisaged that the Commissioner-General of Inland Revenue in Zambia will also follow this approach.

The ZRA does not have access to the Amadeus One Million database nor does it have access to any similar database. As previously noted the ZRA prefer for the company under enquiry to provide comparables and if possible those comparables should be with other similar companies in Zambia. It is not clear at this time whether, in the absence of suitably local comparables, the ZRA will accept foreign comparables.

**1277 Risk transactions or industries**

There is no indication at present that certain types of transactions or that multinationals operating in particular industries are at higher risk of investigation than others. All multinationals are considered to be at a high risk of investigation.

It must be noted that the particular transactions that the ZRA may examine are management fees, royalties and purchases of trading goods.

**1278 Competent authority**

The lack of experience coupled with potentially difficult administrations in wider Africa means that competent authority claims and/ or reliance on MAP to resolve disputes will be problematic.

**1279 Advance pricing agreements (APAs)**

As per the Zambia draft Practice Note, the ZRA does not currently intend to adopt an APA procedure but will keep this decision under review as experience is gained by both taxpayers and the ZRA in light of transfer pricing.

**1280 Anticipated developments in law and practice**

It is not foreseen that significant further laws or amendments will be introduced to transfer pricing legislation in the near future. It is however important to note that in terms of the Zambia draft Practice Note, Zambia fully adopts the principles laid in the OECD Guidelines. Thus any changes to the OECD Guidelines will be relevant to and be adopted in Zambia as part of the Zambia draft Practice Note.

**1281 Liaison with other authorities**

As the ZRA applies the OECD Guidelines on transfer pricing as the basis for determining acceptable transfer pricing methodology, it is envisaged that the ZRA will work closely with the OECD.

In addition, when conducting an investigation, the ZRA may liaise with the foreign revenue authority of the foreign company involved in the related party transaction. The ZRA may further seek advice and guidance from the revenue authorities in the UK and Australia.

**1282 OECD issues**

Zambia is not a member of the OECD, but enjoys observer status and does follow the OECD Guidelines and models.

**1283 Joint investigations**

As indicated above, it is possible for the ZRA to join with the authorities of South African or any other country to jointly investigate a multinational group.

**1284 Thin capitalisation**

Thin capitalisation is dealt with primarily by section 97A and 97AA of the Zambia Income Tax Act. Guidance on thin capitalisation and the charging of excessive interest is provided in the Zambia draft Practice Note.

Thin capitalisation commonly arises where a company is funded by another company in the same group or by a third party, such as a bank, but with guarantees or other forms of comfort provided to the lender by another group company or companies (typically the foreign parent company).

The ZRA will seek to establish the terms and conditions that a third party lender would have required if it had been asked to lend funds to the borrower. This will involve the consideration of, for example, the type of business; the purpose of the loan; the debt:equity ratio of the borrower; the income cover, profits cover or cash flow cover; and any additional security available. This list is not exhaustive; the governing factor is what would have been considered arm's length.

If the borrowing under consideration would not have been made at arm's length on the terms that were actually applied, the ZRA may seek to adjust those terms to those that would have been applied at arm's length. This may involve the adjustment of the rate of interest payable, the amount of the loan and any other terms of the loan that would not be found in an arm's length borrowing. Furthermore, the ZRA may limit the interest deduction on interest actually incurred to that which a Zambian borrower would have incurred at arm's length.

Section 97AA of the Zambia Income Tax Act makes provision for determining the arm's length conditions when the actual conditions include the issue of a security.

# 13 Argentina

## 1301 Introduction

Argentine transfer pricing regulations have existed, in some form, since 1932. Prior to 1998 the rules focused on the export and import of goods through application of the Wholesale Price Method, comparing the price of imports and exports to the Wholesale Price of comparable products in the markets of origin or destination. This methodology was applied unless the parties to the transaction could demonstrate that they were not related parties (Article eight of the Income Tax Law).

Article 14 of the Income Tax Law reflected the need for all transactions to comply with the arm's length standard: Transactions between a local enterprise of foreign capital and the individual or legal entity domiciled abroad that either directly or indirectly control such enterprise shall, for all purposes, be deemed to have been entered into by independent parties, provided that the terms and conditions of such transactions are consistent with normal market practices between independent entities, with limits to loans and technical assistance. However, the rules did not include any methodologies for supporting inter-company transactions or outline any documentation requirements.

On 30 December 1998, pursuant to Law 25,063, Argentina adopted general guidelines and standards set forth by the Organisation for Economic Co-operation and Development (OECD), including the 'arm's length' standard, and applied to tax years ending on or after 31 December 1998. As a result of the adoption of the OECD standards, the computation of a taxpayer's income tax liability, including provisions governing the selection of appropriate transfer pricing methodologies for transactions between related parties, could be impacted.

On 31 December 1999, Law 25,063 was updated by Law 25,239, which introduced Special Tax Return and documentation requirements in relation to inter-company transactions. Under the transfer pricing reform process, the old Wholesale Price Method was only applicable to transactions involving imports or exports of goods between unrelated parties.

On 22 October 2003, Law 25,784 introduced certain amendments to the Income Tax Law effecting on transfer pricing regulations. One of the amendments relates to one of the points of an Anti-evasion Programme, with one of its objectives being to control evasion and avoidance in international operations as a result of globalisation. On the one hand, Law 25,784 replaces regulations on the import and export of goods with related and unrelated parties (replacement of Article eight of the Income Tax Law), eliminating the concept of Wholesale Price at the place of destination or origin as a parameter for comparison. Now, in the case of imports or exports of goods with International Prices known through commonly traded markets, stock exchanges or similar markets, the new parameter establishes that those prices will be used to determine net income. On the other hand, a new transfer pricing method is introduced for the analysis of exports of commodities (amendments to Article 15 of the Income Tax Law).

Presently, taxpayers have two important transfer pricing related obligations: to prepare, maintain and file transfer pricing documentation; and to file an information

return (Special Tax Return) on transactions with non-resident related parties. In addition, taxpayers are required to maintain some documentation on import or export of goods between unrelated parties.

On 14 November 2003, Law 25,795 was published in the Official Gazette (modifying Procedural Law 11,683) establishing significant penalties for failure to comply with transfer pricing requirements.

Finally, it is important to remark that tax authorities are conducting an aggressive audit programme, which includes a high level of activity with over two dozen transfer pricing audits already well under way.

### **1302 Statutory rules**

Effective 31 December 1998, Argentine taxpayers must be able to demonstrate that their transactions with related parties outside of Argentina are conducted at arm's length. Transfer pricing rules are applicable to all type of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions and licensing of intangible property). Under Argentine legislation, there is no materiality factor applicable and all transactions must be supported and documented.

Transfer pricing rules shall be applied to:

- (a) Taxpayers that carry out transactions with related parties organised, domiciled, located or placed abroad and are encompassed by the provisions of Article 69 of the Income Tax Law, 1997 revised text, as amended (mainly local corporations and local branches, other type of companies, associations or partnership) or the addendum to clause d) of Article 49 of the Income Tax Law (trusts or similar entities).
- (b) Taxpayers that carry out transactions with individuals or legal entities domiciled, organised or located in countries with low or no taxation, whether related or not.
- (c) Taxpayers resident in Argentina, who carry out transactions with permanent establishments abroad, owned by them.
- (d) Taxpayers resident in Argentina who are owners of permanent establishments located abroad, for transactions carried out by the latter with related parties domiciled, organised or located abroad, under the provisions of Articles 129 and 130 of the Income Tax Law.

#### *Related parties*

The definition of 'related party' under Argentine transfer pricing rules is rather broad. The following forms of 'economic relationship' are covered:

- One party that owns all or a majority of the capital of another;
- Two or more parties that share: (a) one common party that possesses all or a majority of the capital of each, (b) one common party that possesses all or a majority of the capital of one or more parties, and possesses significant influence over the other or others, and (c) one common party that possesses significant influence over the other parties;
- One party that possesses the votes necessary to control another;



- One or more parties that maintain common directors, officers, or managers/administrators;
- One party that enjoys exclusivity as agent, distributor or licensee with respect to the purchase and sale of goods, services and intangible rights of another;
- One party that provides the technological/intangible property or technical know-how that constitutes the primary basis of another party's business;
- One party that participates with another in associations without a separate legal existence pursuant to which such party maintains significant influence over the determination of prices;
- One party that agrees to preferential contractual terms with another that differ from those that would have been agreed to between third parties in similar circumstances, including (but not limited to) volume discounts, financing terms and consignment delivery;
- One party that participates significantly in the establishment of the policies of another relating to general business activities, raw materials acquisition and production/marketing of products;
- One party that develops an activity of importance solely in relationship to another party, or the existence of which is justified solely in relationship to such other party (e.g. sole supplier or customer);
- One party that provides a substantial portion of the financing necessary for the development of the commercial activities of another, including the granting of guarantees of whatever type in the case of third party financing;
- One party that assumes responsibility for the losses or expenses of another;
- The directors, officers, or managers/administrators of one party who receive instructions from or act in the interest of another party; and
- The management of a company is granted to a subject (via contract, circumstances, or situations) who maintains a minority interest in the capital of such company.

### *Methodology*

For the export and import of goods between unrelated parties the International Price is applicable. In the event that the International Price cannot be determined or is not available, the taxpayer – the exporter or importer of the goods – must provide the tax authorities with any information available to them to confirm if such transactions between unrelated entities have been analysed according to the arm's length principle. (Article eight of the Income Tax Law).

For related party transactions, both transactional and profit-based methods are acceptable in Argentina. Article 15 of the Income Tax Law specifies five transfer pricing methods. An additional method has been established dealing with specific transactions.

- (1) Comparable uncontrolled price method (CUP)
- (2) Resale price method (RPM)

- (3) Cost plus method (CP)
- (4) Profit split method (PSM)
- (5) Transactional net margin method (TNMM)
- (6) New method for export transactions involving grain, oilseed and other crops, petroleum and their derivatives and, in general, goods with a known price in transparent markets.

This new method will only be applied when: (i) the export is made to a related party; (ii) the goods are publicly quoted on transparent markets; and (iii) there is participation by an international intermediary that is not the actual receiver of the goods being sold.

It should be noted that this method will not be applicable when the international intermediary complies with all the following conditions: (i) Actual existence in the place of domicile (possessing a commercial establishment where its business is administered, complying with legal requirements for incorporation and registration, as well as for the filing of financial statements); (ii) its main activity should not consist of the obtaining of passive incomes nor acting as an intermediary in the sale of goods to and from Argentina; and (iii) its foreign trade transactions with other members of the group must not exceed 30% of the annual total of its international trading transactions.

The method consists of the application of the market price for the goods being exported on the date the goods are loaded, regardless of the type of transport used for the transaction and the price that may have been agreed with the intermediary, unless the price agreed with the latter were to be higher than that determined to be the known price for the good on the date of loading, in which case the higher of the two prices should be used to determine the profit of Argentine source.

Under the above-mentioned circumstances, the Argentine tax authorities are disregarding the date of transaction for these types of operations and will consider the date of loading, assuming the date of the transactions could be manipulated by the related parties.

#### *Best method rule*

There is no specific priority of methods. Instead, each transaction or group of transactions must be analysed separately in order to ascertain the most appropriate of the five methods to be applied (i.e. the 'best method' must be selected in each case). The transfer pricing regulations provide that in determining the best method to apply in a given circumstance, consideration will be given to:

- The method that is most compatible with the business and commercial structure of the taxpayer;
- The method that relies upon the best quality/quantity of information available;
- The method that relies upon the highest level of comparability between related and unrelated party transactions; and
- The method that requires the least level of adjustments in order to eliminate differences existing between the transaction at issue and comparable transactions.

*Tested party*

The regulations established by the tax authority have stated that the analysis of the comparability and justification of prices – when applying the methods of Article 15 – must be made on the basis of the situation of the local taxpayer.

*Documentation requirements*

The Argentine tax reform law requires that the Administración Federal de Ingresos Públicos (AFIP) promulgate regulations requiring the documentation of the arm's length nature of transactions entered into with related parties outside of Argentina. In this regard, the transfer pricing regulations require that taxpayers prepare and file a Special Tax Return detailing their transactions with related parties. These returns must be filed along with the taxpayer's corporate income tax return.

In addition to filing the Special Tax Return, the Argentine transfer pricing regulations require that taxpayers maintain certain contemporaneous supporting documentation (i.e. such documentation must exist as of the filing date of the Special Tax Return). This requirement was applicable to fiscal years 1999 up to fiscal year ended on 30 November 2000.

However, on 31 October 2001, the AFIP issued new regulations regarding information and documentation requirements. This required certain contemporaneous documentation to be filed and submitted together with the Special Tax Return. This applies to periods ending on or after 31 December 2000.

**1303 Other regulations***Information returns*

Import and export transactions between unrelated parties

- Requirements have been established for information and documentation regarding import and export of goods between unrelated parties (Article eight of the Income Tax Law) covering International Prices known through commonly traded markets, stock exchanges or similar markets, which will be used to determine the net income. A semi-annual tax return must be filed in each half of the fiscal year (Form 741).
- In the case of import and export transactions of goods between unrelated parties for which there is no known internationally quoted price, the tax authorities shall be able to request the information held in relation to cost allocation, profit margins and other similar data to enable them to control such transactions, if they, altogether and for the fiscal year under analysis, exceed the amount of ARS1 million. A yearly tax return must be filed for those import and export of goods between unrelated parties for which there is no known internationally quoted price (Form 867).
- In the case of transactions with parties located in countries with low or no taxation, the methods established in Article 15 of the Law must be used and it will be necessary to comply with the documentation requirements described for the transactions covered by transfer pricing rules. The obligation to document and preserve the vouchers and elements that justify the prices

agreed with independent parties is laid down, and minimum documentation requirements are established.

For related party transactions, compliance requirements are as follows:

- (1) Six-monthly tax return – for the first half of each fiscal period (Form 742).
- (2) Complementary annual tax return covering the whole fiscal year (Form 743). The return and any appendices must be signed by the taxpayer and by an independent public accountant whose signature must be authenticated by the corresponding professional body. This tax return must be accompanied by:
  - (a) A report containing the information detailed below; and
  - (b) A copy of the financial statements of the taxpayer for the fiscal year being reported. Additionally, financial statements for the previous two years must be accompanied to the first tax return presentation.

#### *Contents of the report*

- (a) Activities and functions performed by the taxpayer;
- (b) Risks borne and assets used by the taxpayer in carrying out such activities and functions;
- (c) Detail of elements, documentation, circumstances and events taken into account for the analysis or transfer price study;
- (d) Detail and quantification of transactions performed covered by this general resolution;
- (e) Identification of the foreign parties with which the transactions being declared are carried out;
- (f) Method used to justify transfer prices, indicating the reasons and grounds for considering them to be the best method for the transaction involved;
- (g) Identification of each of the comparables selected for the justification of the transfer prices;
- (h) Identification of the sources of information used to obtain such comparables;
- (i) Detail of the comparables selected that were discarded, with an indication of the reasons considered;
- (j) Detail, quantification and methodology used for any necessary adjustments to the selected comparables;
- (k) Determination of the median and the interquartile range;
- (l) Transcription of the income statement of the comparable parties corresponding to the fiscal years necessary for the comparability analysis, with an indication as to the source of the information;
- (m) Description of the business activity and features of the business of comparable companies; and
- (n) Conclusions reached.

*General due dates*

| Form | Period                        | Due date                                       |
|------|-------------------------------|--|
| 741  | 1st six months of fiscal year | 5th month following the end of the half-year   |
| 741  | 2nd six months of fiscal year | General due date for filing Income Tax Return  |
| 867  | Full fiscal year              | 7th month following the end of the fiscal year |
| 742  | 1st six months of fiscal year | 5th month following the end of the half-year   |
| 743  | Full fiscal year              | 8th month following the end of the fiscal year |

**1304 Legal cases**

Since the tax reform introduced in 1998, several cases have been and are currently being discussed before the courts. It is expected that the Tax Courts will address several issues related to transfer pricing in the coming years. Below, certain transfer prices cases heard in court are summarised.

*S.A. SIA*

The Supreme Court applied Article eight for the first time in the S.A. SIA, decided on 6 September 1967. The taxpayer, a corporation resident in Argentina, had exported horses to Peru, Venezuela and the United States of America. It was stated in the corporation's tax return that these transactions had generated losses because the selling price had been lower than the costs. The tax authority decided to monitor such transactions under the export and import clause; that is according to the Wholesale Price at the place of destination. The tax authority concluded that, contrary to what had been argued by the taxpayer, such transactions should generate profits. It based this statement on foreign magazines on the horse business (that explicitly referred to the horses of the taxpayer and the transactions involved in this case).

The Supreme Court maintained that since the evidence on which the tax authority based its argument was not disproved by the taxpayer, it had to be deemed that they correctly reflected the wholesale price of the horses. Thus, the adjustment was considered valid.

*Eduardo Loussinian S.A.*

Loussinian S.A. was a company resident in Argentina that was engaged in importing and distributing rubber and latex. It concluded a supply contract with a non-resident subsidiary of a foreign multinational. Under this contract the parent of the multinational group, ACLI International Incorporated (ACLI), would provide Loussinian such goods from early January 1974 up to the end of 1975.

After the contract was agreed, the international market price of rubber and latex fell substantially. However, Loussinian kept importing the goods from ACLI in spite of the big losses derived from it. The tax authority argued that there was overcharging

under the contract and that Article eight should be applied in this case. Thus, it considered that the difference between the wholesale price of the goods at the place of origin and the price agreed on the contract was income sourced in Argentina that Loussinian should have withheld when it made the payments to ACLI. Both the Tax Court and the Court of Appeals upheld the tax authority decision.

The Supreme Court said that despite the fact that the purchasing price was higher than the wholesale price, the latter could not be applied to this case to determine the income sourced in Argentina. This was because it considered that Loussinian had rebutted the presumption under which both parties had to be deemed associated due to this gap between prices.

### *Laboratorios Bagó S.A.*

On 16 November 2006, the members of Panel B of the National Fiscal Court (NFC) issued a ruling in the case 'Laboratorios Bagó S.A. on appeal – Income Tax'. The matter under appeal was the taxpayer's position to an official assessment of the Income Tax for the fiscal years 1997 and 1998.

Even though the current transfer pricing legislation was not in force during those periods (Wholesale Price Method was applicable in 1997 and 1998), the case was closely related to that legislation. Specifically, the ruling addresses issues such as (i) comparability of selected companies, (ii) the use of secret comparables (non-public information) for the assessment of the taxpayer's obligation, and (iii) the supporting evidence prepared by the tax authorities.

Laboratorios Bagó S.A., a pharmaceutical company based in Argentina, exported finished and semi-finished manufactured products to foreign subsidiaries. The tax audit was focused on the differences in prices between the different markets involved, both international and domestic.

In this case, the taxpayer argued that, with regard to its export transactions, it only performed 'contract manufacturer' activities, focusing its efforts only on manufacturing. Foreign affiliates performed research and development, advertising, sales and marketing activities, among others.

Firstly, the Tax authorities confirmed the lack of publicly known wholesale prices in the country of destination. Afterwards, they conducted a survey of other similar companies located in Argentina, requesting segmented financial information on export transactions. The main purpose of that request was to obtain the profitability achieved by independent companies in the same industry.

Since the taxpayer's results were below the profitability average of independent companies, the Tax Authority adjusted the taxable basis for Income Tax purposes.

The ruling 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; and
- 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 arrived.

The analysis conducted by the tax authority contained conceptual mistakes that affected the comparability of the transactions (e.g. differences in volume of net sales as well as of export sales, verification of economic relationship or otherwise between the selected companies and their importers, unification of criterion for the different selected companies' allocation of financial information, among others).

It is also remarkable that in this case, the Tax Court accepted the use of 'secret comparables', being understood as information obtained by the tax authority through audits or other information-gathering procedures.

The taxpayer presented several scenarios and other related evidence that supported its current position.

Eventually, it was the evidence presented by the parties that allowed for the ruling in this case to be favourable to the taxpayer. Specifically, the tax court held in this case that under domestic law, the tax authority has a significant burden of proof when adjusting transfer prices. Since the tax authority did not offer enough evidence to support its position, the Tax Court ruled in favour to the taxpayer.

### **1305 Burden of proof**

The general rule is that the taxpayer has the burden of proof as it is obligated to file a report with certain information related to transfer pricing regulations together with the income tax return. If the taxpayer has submitted proper documentation, the AFIP must demonstrate why the taxpayer's transfer prices are not arm's length and propose an amount of transfer pricing adjustment in order to challenge the transfer prices of a taxpayer. Once the AFIP has proposed an alternative transfer pricing method and adjustment, it is then up to the taxpayer to defend the arm's length nature of its transfer prices.

### **1306 Tax audit procedures**

Selection of companies for audit

The AFIP has a specialised group that performs transfer pricing examinations. This group is part of the División de Grandes Contribuyentes, a division of the AFIP that deals with the largest taxpayers. At present, the Argentine tax authorities investigate transfer pricing issues under four main categories:

- (1) In the course of a normal tax audit;
- (2) Companies that undertake transactions with companies located in tax havens;
- (3) Companies that registered any technical assistance agreement or trademark or brand name licence agreement with the National Industrial Property Institute; and
- (4) Specific industrial sectors such as the automotive, grain traders and pharmaceutical industries. The oil industry is also expected to be subject to transfer pricing scrutiny in the future.

Controversial issues include, among others, the use of multiple-year averages for comparables or for the tested party, the application of extraordinary economic adjustments according to the present situation of the country (e.g. extraordinary excess capacity, extraordinary discounts and accounting recognition of extraordinary bad debts).

### **1307 The audit procedure**

The audit procedure must follow the general tax procedure governed by Law 11,683. Transfer pricing may be reviewed or investigated using regular procedures such as on-site examination or written requests. Written requests are the most likely form of audit.

During the examination, the tax authorities may request information and must be allowed access to the accounting records of the company. All findings must be documented in writing and witnesses might be required. In the course of the examination the taxpayer is entitled to request information and the audit cannot be completed without providing the taxpayer a written statement of findings. Upon receipt of this document, the taxpayer is entitled to furnish proofs and reasoning that must be taken into account for the final determination.

### **1308 Reassessments and the appeals procedure**

Additional assessment or penalties applied by the Dirección General Impositiva (DGI) may be appealed against by the taxpayer within 15 working days of receipt of the notification of assessment. The appeal may be made to either the DGI or the Tax Tribunal. An unsuccessful appeal before one of these bodies cannot be followed by an appeal before the other but an appeal before the competent courts of justice may be filed against the findings of either.

If appeal is made before the DGI or the Tax Tribunal, neither the amount of tax nor the penalty appealed against need to be paid unless and until an adverse award is given. For an appeal to be made before the courts of justice, the amount of tax must first be paid but not the penalties under appeal.

Overpayments of tax through mistakes of fact or law in regular tax returns filed by the taxpayer may be reclaimed through submission of a corrected return within five years of the year in which the original return was due. If repayment is contested by the DGI the taxpayer may seek redress through either the Tax Tribunal or the courts of justice but not both. Overpayments of tax arising from assessments determined by the DGI may be reclaimed only by action before the Tax Tribunal or the courts of justice. Upon claim for overpayments of tax, interest is accrued as from the time when the claim is filed.

### **1309 Additional tax and penalties**

The passing of Law 25,795 increases existing penalties and introduces new penalties covering noncompliance by taxpayers in relation to international transactions, as follows:

- Omitted filing of informative tax returns regarding international import and export operations on an arm's length basis will be penalised with a fine amounting to ARS1,500 (USD480) or ARS10,000 (USD3,200) in the case of entities owned by foreign persons. Failure to file returns for the remaining operations will be penalised with a fine of ARS10,000 (USD3,200) or ARS20,000 (USD6,400) in the case of entities belonging to foreign persons.
- A fine ranging between ARS150 (USD50) and ARS45,000 (USD14,400) will be set in the event of failure to file data required by AFIP for control of international



operations and lack of supporting documentation for prices agreed in international operations.

- A fine ranging between ARS500 (USD160) and ARS45,000 (USD14,400) has been established for noncompliance with the requirements of AFIP on filing of informative returns corresponding to international operations and information regimes for own or third party operations. Taxpayers earning gross annual income equal to or higher than ARS10 million (USD3.2 million) not observing the third requirements on control of international operations will be fined up to ARS450,000 (USD144,000), 10 times the maximum fine.
- A fine on tax omission has been established between one and four times the tax not paid or withheld in connection with international operations. In addition, the taxpayer will be liable for interest, currently 3% per month of the additional tax due.

If the tax authorities consider that a taxpayer has manipulated its results intentionally, the fine can climb to 10 times the tax amount evaded, in addition to the penalties established by the Penal Tax Law 24,769. The tax authorities have the discretion to analyse the transfer pricing arrangement(s) by consideration of any relevant facts and application of any methodology it deems suitable.

### **1310 Use and availability of comparable information**

#### *Availability of comparables*

Comparable information is required in order to determine arm's length prices and should be included in the taxpayer's transfer pricing documentation. Argentine companies are required to make their annual accounts publicly available by filing a copy with the local authority (e.g. Inspección General de Justicia in Buenos Aires). However, the accounts would not necessarily provide much information on potentially comparable transactions or operations since they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign comparables.

The tax authorities have the power to use third parties' confidential information.

#### *Use of comparables*

To date, there have been a few cases where the tax authorities have attempted to reject a taxpayer's selection or use of comparables. Any discussion in this context is focused on the comparability of independent companies. In this connection, the tax authority has requested additional information related to the final set of comparables.

### **1311 Limitation of double taxation and competent authority procedure**

Most of the tax treaties for the avoidance of double taxation concluded by Argentina include provisions for a mutual agreement procedure. In Argentina, a request to initiate the mutual agreement procedure should be filed with the Argentine Ministry of Economy. There are no specific provisions on the method or format for such a request.

No information is available on the number of requests made to the Ministry of Economy. It is understood that the competent authority procedure is not well used in

Argentina as there is no certainty for the taxpayer that the relevant authorities will reach an agreement.

### **1312 Advance pricing agreements (APAs)**

There are no provisions enabling taxpayers to agree APAs with the tax authorities.

### **1313 Anticipated developments in law and practice**

#### *Law*

New transfer pricing rules are not expected in the near future.

#### *Practice*

The tax authorities are expected to become more aggressive and more skilled in the area of transfer pricing. Transfer pricing knowledge of the 'average' tax inspector is expected to increase significantly as training improves and they start to gain experience in transfer pricing audits.

As the number of audits increases, some of the main areas that are likely to be examined include inter-company debt, technical services fees, commission payments, royalty payments, transfers of intangible property and management fees.

### **1314 Liaison with customs authorities**

The DGI and customs authority (*Dirección General de Aduanas, DGA*) are both within the authority of the AFIP. Recent experience suggests that exchange of information between DGI and DGA does occur. Nevertheless, there is no prescribed approach for the use of certain information of one area in the other area (e.g. transfer pricing analysis for customs purposes).

Recently, there has been a change in the customs legislation and the information that must be provided to the DGA, in relation with foreign trade, is now required in an electronic form. As a result of this, DGI could have better and easy access to that information.

### **1315 OECD issues**

Argentina is not a member of the OECD. The tax authorities have generally adopted the arm's length principle and use as guidance the methodologies endorsed by the OECD Guidelines for transfer pricing that give effect to the arm's length standard.

### **1316 Joint investigations**

Even though there have been some information requests to other tax authorities (e.g. Brazil) for specific transactions or companies, there is no regular procedure for joint investigations.

### **1317 Thin capitalisation**

The thin capitalisation rules are primarily focused on interest stemming from loans granted by foreign related parties (entities having any type of direct or indirect control of the borrower). Interest will be deductible considering, at the year-end closing date, the total amount of the liability generating the interest (excluding any liability

corresponding to interest whose deductibility is not conditioned) may not exceed two times the amount of the net worth at that date.

When the above circumstance arises, any excess interest that cannot be deducted will be treated as a dividend.

# 14 Australia

## 1401 Introduction

Australia's transfer pricing legislation was introduced with effect from 27 May 1981 and remains a key focus area for the Australian Taxation Office (ATO), indicative of the ongoing globalisation of the Australian economy.

Since the introduction of the transfer pricing legislation, the ATO has issued a series of rulings providing guidance in applying the legislation. The ATO is vigilant in policing compliance by taxpayers and continues to work closely with tax authorities in other jurisdictions and international bodies (i.e. OECD, PATA) focusing on reducing double taxation and solving transfer pricing disputes. The views of the ATO are largely consistent with the views expressed by the OECD.

## 1402 Statutory rules

### *Division 13 – Transfer pricing legislation*

Division 13 of Part III of the Income Tax Assessment Act 1936 (ITAA) (SS136AA to 136AF), contains Australia's domestic law dealing with transfer pricing. It is an anti-avoidance division aimed at countering international profit-shifting techniques.

Section 136AD deals with circumstances where a taxpayer has 'supplied' or 'acquired' 'property' (all of these terms are widely defined in Section 136AA(1)) under an 'international agreement', as defined in Sec 136AC. Sec 136AD contains four subsections:

- (1) supplies of property for less than arm's length consideration;
- (2) supplies of property for no consideration;
- (3) acquisition of property for excessive consideration; and
- (4) determination of the arm's length consideration in circumstances where it is neither possible nor practicable to ascertain.

Section 136AD does not require that the parties to an international agreement be related; it requires that there be any connection between the two.

In relation to branches of the same enterprise, between which the non-arm's length international related party transactions take place, Division 13 authorises the Commissioner of Taxation (The Commissioner) to reallocate income and expenditure between the parties and thereby to redetermine the source of the income or the income to which the expenditure relates.

Division 13 will notionally apply for the calculation of the income attributable to a controlled foreign company (CFC). An exemption from attribution should apply to income that is sourced in a listed country, is otherwise included in the tax base of the listed country, or if the income passes an 'active income' test. The listed countries are the United States, the United Kingdom, New Zealand, Japan, Germany, France and Canada.

The legislation does not impose a time limit for the Commissioner to make transfer

pricing adjustments. Therefore, adjustments are technically possible commencing from 27 May 1981, the date of introduction of Division 13 into Australian tax legislation.

### *Double tax agreements*

The domestic legislation is supplemented by the provisions in Australia's double tax agreements (DTAs) with a wide range of countries. Applicable Articles in the DTAs include those relating to mutual agreement procedures, associated enterprises and business profits. The relevant application of the DTA Articles is to allocate tax revenue between the two tax jurisdictions in the event a taxpayer experiences double taxation. In this regard, the DTA Articles will generally prevail over Division 13. Paragraph 1414 below contains further details on the application of Australia's DTAs to provide relief from double tax.

The ATO has traditionally held the view that the Associated Enterprises Articles of the DTAs also give the Commissioner the ability to impose tax; however, there have been some recent Australian court decisions which suggest that this may not be correct. Rather, the Commissioner must base any tax assessments on the provisions of Division 13.

### **1403 Other regulations**

In addition to the statutory rules referred to above, the ATO has issued various public rulings concerning transfer pricing. These both interpret the application of the statutory rules and provide guidance on other issues not specifically covered by statute. There are two types of rulings:

- (1) Final public taxation rulings (TR), which represent authoritative statements by the ATO of its interpretation and administration of the legislation and may be relied on by taxation officers, taxpayers and practitioners; and
- (2) Draft taxation rulings, which represent the preliminary, though considered views of the ATO. Draft rulings may not be relied on as authoritative statements by the ATO.

A public ruling must be applied by the Commissioner, the Administrative Appeals Tribunal (AAT) and the courts in order to give a taxpayer the benefit of the treatment provided for in the ruling if that treatment produces less final tax under the assessment. On the other hand, if the law (apart from the public ruling) is found to be more favourable to a taxpayer in the determination of final tax, the law will prevail.

Rulings applicable to transfer pricing include:

- Basic concepts underlying the operation of Division 13 – Taxation Ruling 94/14;
- Arm's length transfer pricing methodologies – Taxation Ruling 97/20;
- Documentation and practical issues associated with setting and reviewing transfer pricing – Taxation Ruling 98/11;
- Intra-group services – Taxation Ruling 1999/1;
- Loan arrangements and credit balances – Taxation Ruling 92/11;
- Permanent establishments – Taxation Ruling 2001/11;

- Penalty tax guidelines – Taxation Ruling 98/16;
- Procedures for bilateral and unilateral APAs – Taxation Ruling 95/23;
- Consequential adjustments – Taxation Ruling 1999/8;
- Meaning of arm's length for the purpose of dividend deeming provisions – Taxation Ruling 2002/2;
- International transfer pricing and profit reallocation adjustments, relief from double taxation and the mutual agreement procedure – Taxation Ruling 2000/16;
- Addendum: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and mutual agreement procedure – Taxation Ruling 2000/16A;
- Thin capitalisation, applying the arm's length debt test – Taxation Ruling 2003/1;
- Cost contribution arrangements – Taxation Ruling 2004/1;
- Branch funding for multinational banks – Taxation Ruling 2005/11; and
- Consequential adjustments – Taxation Ruling 2007/1 (replaces Taxation Ruling 1999/8).

In addition to taxation rulings, the ATO also releases taxation determinations (TD). While also a type of public ruling, determinations are generally shorter than rulings and deal with one specific issue rather than a comprehensive analysis of the overall operation of taxation provisions. Final taxation determinations may also be relied upon by taxpayers.

The ATO has issued a suite of publications about international transfer pricing. The publications in the suite are:

- International transfer pricing: introduction to concepts and risk assessment;
- International transfer pricing: advance pricing arrangements;
- International transfer pricing: applying the arm's length principle;
- International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses;
- International transfer pricing: marketing intangibles – Examples to show how the ATO will determine an appropriate reward for marketing activities performed by an enterprise using trade marks or trade names it doesn't own (see 1420 Marketing & other intangibles); and
- International transfer pricing: attributing profits to a dependent agent permanent establishment.

The ATO has indicated that these guides do not replace, alter or affect in any way the ATO interpretation of the relevant law as discussed in the various taxation rulings.

Finally, in addition to the ATO publications, taxpayers may also be guided by publications by the Pacific Association of Tax Administrators (PATA), of which the ATO is a member. The other PATA members are the revenue authorities of the USA, Canada and Japan. Recent PATA publications relevant to transfer pricing are:

- Transfer pricing documentation package: a uniform transfer pricing documentation package that satisfies the documentation requirements of all member countries;
- Mutual Agreement Procedure (MAP) operational guidance: guidelines intended to facilitate consistent and timely resolution of MAP cases amongst PATA members; and
- Bilateral Advance Pricing Arrangement (BAPA) operational guidance: guidelines intended to establish a common, consistent approach to BAPAs amongst PATA members.

#### **1404 Legal cases**

There have been very few cases relating to transfer pricing brought before the Australian courts. In most cases, the courts have found in favour of the ATO, with the exception of the Roche Products case which is discussed below. The cases are:

- San Remo Macaroni Pty Ltd 1999 (question of issue of assessments in bad faith);
- Daihatsu Australia Pty Ltd 2001 (challenging transfer pricing adjustments on the basis of a lack of bona fide attempt by the ATO);
- Syngenta Crop Protection Pty Ltd and American Express International 2006 (requests for the Commissioner to provide details of its transfer pricing assessments); and
- WR Carpenter Holdings Pty Ltd & Anor 2007 (request for Commissioner to provide particulars of matters taken into account in making transfer pricing determinations).

Importantly, all of these cases involved an administrative law challenge to processes adopted by the Commissioner in issuing transfer pricing based assessments.

April 2008 saw a preliminary judgment in the first Australian case dealing with substantive transfer pricing issues, the case of Roche Products Pty Ltd. See comments in paragraph 1412 below for a summary of the key implications of the preliminary judgment.

#### **1405 Burden of proof**

In the event of an audit by the ATO, the burden of proof to satisfy the ATO and the courts that transfer prices are arm's length lies with the taxpayer. The weight of this burden has been affirmed by the recent judicial decisions in the Syngenta and WR Carpenter Holdings cases. In these judgments, the Court declined to allow taxpayers to examine and challenge the Commissioner's reasons underlying transfer pricing determinations on the grounds that this was not a relevant consideration to the case. The Court found that the provisions of Division 13 do not require the ATO to establish the validity of its transfer pricing assessments. Rather, the burden rests entirely on the taxpayer to establish that its prices were arm's length or the Commissioner's assessments were excessive.

## 1406 Tax audit procedures

### *Tax return – Schedule 25A*

Taxation in Australia is based on a self assessment system. Essentially, taxpayers are responsible for correctly assessing their tax obligations. Filed tax returns are deemed to be notices of assessment. Taxpayers are expected to take reasonable care in the preparation and documentation of their tax returns and are expected to ensure that arm's length prices are applied to international transactions.

In filing a tax return, every taxpayer that engages in international transactions with connected parties with an aggregate amount greater than AUD1 million is required to submit a Schedule 25A with their tax return, detailing the nature and value of these transactions. The ATO uses information from Schedule 25A to categorise a taxpayer into risk categories, a factor in determining transfer pricing review targets. If scored in the high-risk categories as a result of such a review, a transfer pricing review may take place.

### *Tax return – permanent establishment (PE)*

For the purposes of Schedule 25A, the responses should be provided on a notional basis that a PE is a separate but related entity.

### *Tax return – public officer's duties*

The public officer's duties in relation to the income tax return also apply in respect of the Schedule 25A. The public officer is required to sign the declaration on the company's income tax return, certifying disclosures in the company income tax return and Schedule 25A to be true and correct. Misleading and incorrect answers on Schedule 25A could result in prosecution by the ATO of the public officer.

### *Recent ATO activity*

#### **Large Business**

The ATO releases on an annual basis a report that details its proposed compliance program for the coming year in relation to large businesses (i.e. enterprises with a turnover of around AUD250 million or more), identifying risk areas and strategies it plans to implement to deal with those risks.

The compliance program provides an insight into the key concerns and the strategic focus of the ATO in dealing with compliance by the large business segment. It also provides 'checklists' of factors the ATO will take into account in identifying audit cases and matters taxpayers can 'expect' the ATO to challenge.

With respect to large business, the ATO completed 40 Client Risk Reviews (CRRs) and four new audits during the 2006/07 financial year. An additional 23 Advance Pricing Arrangements (APAs) were completed, and two mutual agreement procedure cases (MAP) concluded. There are presently 41 APA cases outstanding with the ATO at various stages of completion.

#### **Small to Medium Enterprises (SMEs)**

SMEs are classified as those taxpayers with a turnover of between AUD2 million and AUD250 million. This represents an expansion from the 2006/07 classification which defined SMEs as taxpayers with a turnover of between AUD2 million and



AUD100 million. In recent years, the ATO has heightened its review of the SME sector based on evidence that the level of transfer pricing documentation and compliance in the sector has historically been poor. There is a particular focus by the ATO on 'double zero' and 'triple zero' companies, i.e. those that have not paid tax in the two or three most recent years. Additional focus areas of the ATO with respect to SMEs are identified in the annual compliance program.

#### **The ATO completed nine APAs with SMEs in the 2006/07 financial year.**

It is likely that the ATO will conduct more income tax reviews and audits across small to medium businesses in the short term. In particular, it has been made known that the ATO has identified 30 SMEs with an annual turnover between AUD100 to AUD250 million that it intends to review as a matter of priority.

The ATO has recently completed an internal project aimed at measuring the success of its compliance activities relating to transfer pricing over the period 1998 to 2006. While conducting the project, the ATO has found evidence of convergence between the profit performance of companies with related party dealings and the whole market since 1998. The ATO has concluded that this demonstrates a measure of the success of its transfer pricing compliance program.

#### **The provision of information and duty of the taxpayer to co-operate with the tax authorities**

A taxpayer must retain documents that are relevant for the purposes of ascertaining the taxpayer's income and expenditure, etc, for at least five years (calculated from the date the records were prepared or obtained, or from the date the transactions or acts to which the records relate were completed, whichever is the later). As the burden of proof rests with the taxpayer in some circumstances, particularly in relation to transfer pricing related matters, retention for a longer time period is prudent (see also paragraph 1402).

The Commissioner, or any duly authorised taxation officer, has the right of full and free access to all buildings, places, books, documents and other papers for the purposes of the ITAA. The Commissioner may also require any person to attend and give evidence or produce any documents or other evidence relating to a taxpayer's assessment. The provisions of the ITAA also empower the Commissioner to require a person produce documents held outside Australia. Compliance with this latter requirement is not mandatory, but where a taxpayer fails to comply with such a requirement, the taxpayer may not rely on those documents in the event it wishes to challenge the Commissioner's assessment.

#### **1407 The audit procedure**

As mentioned above, when reviewing the tax affairs of a taxpayer, the ATO uses an approach known as the CRR process to undertake a risk assessment of material tax issues, including transfer pricing. Material examined by the ATO includes Schedule 25A, compliance history, latest collections, latest news or media articles and other publicly available information such as that available on the internet. The CRR process involves:

- understanding the taxpayer's business and the environment in which it operates;

- analysing available information and comparing similar businesses in the market;
- developing hypotheses to build a clear focus on the material risk issues;
- visiting the taxpayer to further understand the business and its environment and to test the ATO preliminary risk assessment of the material issues; and
- recommending compliance strategies to treat the risks, which can be taxpayer-specific or broadly-based and include legislative change or other law clarification, such as rulings, maintaining watching briefs, or conducting audits.

When transfer pricing is identified as a significant risk, the CRR may proceed to a Transfer Pricing Record Review (TPRR). Taxpayers subject to a TPRR will receive a risk rating at the completion of the risk review. A higher 'risk' rating does not necessarily mean that the company will be selected for audit but with such a risk rating, the taxpayer is likely, at a minimum, to be placed on a 'watching brief'.

Where a company is selected for audit, the audit process usually commences with an ATO request for a meeting with the company. At this meeting the ATO will carry out an inspection of the taxpayer's premises and interview key operational personnel. The approach that the ATO takes broadly follows the first three steps of the 'four step' process set out in TR 98/11 as follows:

- Step 1: Characterise the international dealings with related parties in the context of the taxpayer's business;
- Step 2: Select the most appropriate transfer pricing methodology; and
- Step 3: Apply the most appropriate methodology and determine the arm's length outcome.

At the completion of this process, the ATO would consider all information gathered (including a review of the taxpayers transfer pricing documentation) and issue a position paper outlining its findings and proposed adjustments to taxable income over the review period.

While verbal communications between the ATO and the taxpayer will generally continue throughout the process, the taxpayer is offered an opportunity to respond in writing to the ATO's position paper which would involve correcting any factual errors made by the ATO and, where available, providing additional information and arguments to counter the ATO's arguments. Following a review of the taxpayer's response, the ATO will issue its final position paper followed by Determinations and notices of assessment or amended assessments giving effect to the Determinations. The assessments are 'due and payable' at the time of the assessments being issued. Any delay in paying the assessments incurs additional interest costs.

### **1408 Revised assessments and the appeals procedure**

Australia has a comprehensive objection and appeals procedure for disputing an amended assessment raised by the Commissioner. Under these provisions, the taxpayer may object against an amended assessment issued by the Commissioner to give effect to a Division 13 determination. A taxpayer that is dissatisfied with such an assessment has the later of four years from the date of the original assessment

(which is shortly after filing the relevant income tax return) or 60 days from receiving the notice of amended assessment to lodge an objection in writing, setting out the grounds relied upon in support of the claim. In practice, most transfer pricing audits are not completed until more than four years after the original assessment, so in most cases taxpayers are required to object within 60 days of receiving an amended assessment. The Commissioner is required to consider the objection and may either allow it in full, or in part, or disallow it. The Commissioner is then required to give notice to the taxpayer of his/her decision on the objection. A taxpayer dissatisfied with such a decision may either refer it to the AAT for review or refer the matter to the Federal Court of Australia.

Where the notice of assessment includes additional tax for incorrect returns, it is generally prudent to remit the matter to the AAT, which has the discretion to reconsider the level of additional tax imposed and may substitute its own decision for that of the Commissioner. In contrast, on appeal to the Federal Court, that court can only decide whether the Commissioner has made an error in law in imposing the additional tax. If no error of law has occurred, then the penalties will remain unadjusted. Decisions of the AAT may be appealed to the Federal Court but only on a question of law.

### **1409 Additional tax and penalties**

#### *Penalties for 1992/93 onwards*

Penalty rates applying to transfer pricing adjustments under Division 13 and double tax agreements are outlined in TR 98/16 – issued in November 1998.

The penalties generally range from 10% of the additional tax where the taxpayer has documented a reasonably arguable position and had no purpose of avoiding Australian tax, to 50% where there was an intention to avoid Australian tax and a reasonably arguable position had not been documented. Broadly speaking, a position will be considered to be ‘reasonably arguable’ if it is ‘about as likely as not’ to be correct. In order to demonstrate that a position is reasonably arguable, the taxpayer must retain documentation to support arm’s length pricing.

The ATO has the discretion to remit penalties in full if special circumstances exist. Penalties may be increased by 20% where:

- a taxpayer takes steps to prevent or hinder the ATO from discovering that a transfer pricing provision should be applied. It is noteworthy that unreasonable time delays in responding to ATO enquiries or failure to notify the ATO of errors within a reasonable time could amount to ‘hindrance’; or
- where the taxpayer has been penalised under a scheme section in a prior year of income.

#### *Penalties may be reduced:*

- by 20% of the penalty if the taxpayer makes a voluntary disclosure to the ATO after it has been informed of an impending audit; or
- by 80% of the penalty if the taxpayer makes a voluntary disclosure to the ATO before it has been informed of an impending audit.

In addition to penalties the taxpayer is liable to pay a shortfall interest charge (SIC) on

the value of any increase in the tax assessment arising from an ATO adjustment. The SIC rate is set by reference to a base interest rate plus three percentage points. The SIC rate was 10.15% for the quarter January-March 2008.

#### *Penalties for 1991/92 and prior years*

Prior to the introduction of the self assessment regime there was a two-tier structure for penalties – 200% for schemes designed to avoid tax and 25% per annum in other cases. Where voluntary disclosures are made the penalty may be restricted to 10% per annum, subject to a maximum of 50% of the tax avoided in any year.

#### **1410 Resources available to the tax authorities**

A specialist transfer pricing unit has been established within the ATO comprising of individuals dedicated to transfer pricing. This group is responsible for providing high level technical advice to members of the various business lines (e.g. large business and international, small business income) in relation to TPRRs, CRRs and audits.

This unit serves as a reference point and is not directly engaged in conducting record reviews or audits. Actual TPRRs/audits are carried out by members of the relevant industry segment of the various business lines with assistance provided by the specialist Transfer Pricing Practice and Field Economist Practice within the International Strategy and Operations group of the ATO.

The ATO, as a matter of standard practice, engages local economists in transfer pricing audits. In addition, other international economists have been engaged from time to time to assist with policy and specific audits.

#### **1411 Use and availability of comparable information**

##### *Availability of comparable information*

Public companies and large private companies must lodge financial statements with the Australian Securities and Investments Commission (ASIC). This information is publicly available. However, despite the information lodged with ASIC, reliable comparable data is difficult to locate in the Australian market. While databases are available (for example IBIS World, Business Who's Who, OSIRIS) which identify organisations on an industry and activity basis, the particularly small Australian market makes identification of reliable comparables difficult. In addition, some Australian entities are exempt from lodging full financial statements with ASIC and many Australian companies are members of multinational groups and thus themselves are engaged in controlled transactions such that reliable comparisons often cannot be made. Given the limitations of Australian data, the ATO is increasingly turning to overseas markets to identify comparables. It is of note that the ATO has a strong preference for use of listed companies in comparability analyses.

##### *Australian Bureau of Statistics data*

In the conduct of TPRRs, the ATO sometimes uses publicly available data from the Australian Bureau of Statistics (ABS) in order to form an opinion on the commercial realism of a taxpayer's financial performance, relative to the performance of a market segment as a whole. The ATO's use of ABS statistics is limited to this situation and not used in comparability analyses, since the data includes details of companies

engaged in controlled transactions and the categories may be wide enough to include companies that may be functionally dissimilar.

#### *Use of controlled data*

A disturbing aspect of TR 97/20 is the ATO's intention to use controlled data in circumstances where there is insufficient publicly available information on which to base a comparison. While this contravenes the OECD Guidelines with respect to the use of controlled data, the ATO does not consider it inappropriate to use the data, notwithstanding the fact that the taxpayer facing a possible adjustment does not have access to the same information.

More recent experience indicates that the ATO's use of controlled data has 'softened' and that where possible, it endeavours to work with methodologies put forward by the taxpayer and publicly available information.

### **1412 Anticipated developments in law and practice**

As mentioned earlier, 2008 will see the determination of two transfer pricing cases; that of Roche Products Pty Ltd and an appeal from the case of WR Carpenter Holdings.

#### *Roche Products Pty Ltd*

The preliminary ruling in the AAT case of Roche Products Pty Ltd v The Commissioner is the first Australian judgment on substantive transfer pricing issues. While the AAT found that the Commissioner's amended assessment was excessive, its judgment still resulted in uplift of the taxpayer's assessable income of almost AUD60 million.

The case concerned the transfer price of goods acquired by Roche Products (an Australian company) from its Swiss parent. The AAT found that the transfer prices of Roche's ethical pharmaceutical products were excessive and made adjustments accordingly. No adjustments were made to the transfer prices of other product lines.

In its judgment the AAT made a number of comments that have implications for all Australian taxpayers with transfer pricing issues. They include:

- The operation of DTAs. Although the President of the AAT was not required to decide on this issue, he commented that there is a lot to be said for the proposition that Australia's DTAs do not give the ATO the ability to impose tax and that Division 13 must form the base that supports any assessment. This is consistent with a recent decision in a non-transfer pricing case heard in the Federal Court of Australia;
- Transfer pricing methodologies. Although the ruling acknowledges the difficulty in finding available comparable data, and uses a uniform gross margin to price the transfers of all pharmaceutical products, the AAT's preference for transactional methods over profit methods (such as TNMM) is clear;
- Loss making companies. In noting the weaknesses of profit methods the judge pointed out their tendency to attribute any losses to incorrect transfer pricing. The AAT rejected this inference. The ruling accepted the taxpayer's commercial reasons for the losses in this division, despite their occurring over a number of years, and ordered no transfer pricing adjustments; and

- Separate years. The ruling clearly stated that the provisions of Division 13 require that arm's length prices be determined for each separate year under consideration, rather than a multiple year average.

It is worth noting that the ruling in the Roche case was a preliminary ruling in which the President sought submission from both parties prior to handing down his final ruling. The final judgment is expected in May 2008. Both the taxpayer and the Commissioner have the option of seeking leave to appeal the decision.

#### *WR Carpenter Holdings Pty Ltd*

In July 2007 the Full Court of the Federal Court of Australia upheld an earlier decision to deny the taxpayer the right to request particulars of how the ATO arrived at its transfer pricing determination. Affirming the precedent set in the case of Syngenta Crop Protection, the Court found that the provisions of Division 13 do not make the Commissioner's reasoning process in making a transfer pricing determination a relevant consideration. Therefore the Court declined to give the taxpayer an opportunity to view and challenge these reasons, removing a potential avenue by which the taxpayer could challenge the ATO's transfer pricing adjustment.

The taxpayer has sought, and has been granted, leave to appeal to the High Court of Australia. The appeal is scheduled to be heard in May 2008.

In addition to the developments in law, the ATO is also due to release a number of rulings and publications in 2008. These include the following:

#### *Division 13 and Australia's Thin Capitalisation Provisions*

In November 2007 the ATO released a draft tax determination (TD 2007/D20) intended to provide guidance on the interaction between Australia's transfer pricing rules and thin capitalisation provisions (Division 820 ITAA1997). The thin capitalisation rules apply to deny a proportion of the taxpayer's deductions for interest payments if the taxpayer's debt exceeds a maximum allowable amount. Generally, the taxpayer may determine its maximum allowable debt as the 'safe harbour' debt amount (a debt to equity ratio of 3:1) or by reference to an arm's length debt amount.

The ATO's position is that it may use transfer pricing principles to adjust the interest rate on the taxpayer's debt, even when the level of debt falls within the 'safe harbour' debt amount. However, the ATO will not use transfer pricing principles to adjust the amount of debt where it falls within the 'safe harbour' amount.

TD 2007/D20 introduced the concept of a 'financially independent' borrowing entity. The ATO asserts that the interest rate should not exceed the rate that would apply to the level of debt which the taxpayer would be able to borrow if it was 'financially independent'. The implication of this is that the level of debt and interest rate identified using the 'financially independent' test may be lower than the safe harbour amount of debt and the interest rate that would apply to the safe harbour amount. The ATO does not clearly define the term 'financially independent'.

#### *Division 13 and Australia's debt/equity rules*

In March 2008 the ATO released a draft tax determination (TD 2008/D3) intended to provide guidance on the interaction between Australia's transfer pricing and debt/equity provisions (Division 974 ITAA1997).

Division 974 provides tests to determine whether a particular arrangement whereby

property is supplied or acquired gives rise to a debt or an equity interest for specific tax purposes; including whether a return on the interest is deductible. The draft determination considers whether the characterisation of an interest under Division 974 has any bearing on the characterisation of that interest for the purpose of assessing whether the arrangement is consistent with the arm's length principle of Division 13.

The ATO's position is that the tests in Division 974 have no bearing on classifying arrangements for transfer pricing purposes. The final determination is due in May 2008.

In addition to the draft tax determinations, the ATO has also recently released the following draft discussion papers:

### *Business restructuring*

In late 2007 the ATO released a draft discussion paper setting out its preliminary views on the application of Australia's transfer pricing rules to business restructures within a multi-national group. The draft paper also discussed potential the application of Australia's anti-avoidance tax provisions (Part IVA).

The draft paper's focus was on considering the extent to which independent parties would be likely to engage in such a restructure. Considerations of particular interest to the ATO included the business objectives behind the restructure, pre tax and post tax profit outcomes, and a possible requirement for exit payments in compensation for the relocation of functions, assets and risks.

The ATO sought feedback on the paper and has revised the draft accordingly. Importantly, the revised draft focused entirely on the application of transfer pricing provisions and excludes any analysis of possible Part IVA implications.

The revised draft is not yet publicly available and is due to be published by the end of 2008. It is worth noting that the OECD also intends to release a discussion paper on this issue by the end of 2008.

### *Guarantee fees*

The ATO has identified guarantee fees as a particular focus area for its large business segment. The ATO has drafted a discussion paper outlining its preliminary views of the application of Australia's transfer pricing rules to financing and guarantee fees. This paper is due to be publicly released in May 2008.

The ATO has also foreshadowed a list of issues that it may address by way of a ruling or booklet. They include:

- the interest paid adjustment in relation to offshore branches of banks;
- an update of TR 92/11 (loan agreements and credit balances);
- consideration of Part IVA of the ITAA – looking at financial restructures that take advantage of law changes;
- attribution of profits to PEs;
- Division 13 and high value services; and
- banking and financial institutions.

### *Administrative developments*

The ATO is reviewing its approach to public rulings. Due to the cost and process involved in issuing public rulings, the ATO is looking to set clear guidelines for what issues should be subject to a public ruling.

A further anticipated development the ATO has foreshadowed is a potential new general tax compliance program for large taxpayers, known as 'Annual Compliance Arrangements'. Under this program, participating taxpayers will be able to streamline their tax compliance through ongoing dialogue with the ATO highlighting events and issues as they emerge throughout the year. In addition, the Commissioner would remove culpability for penalties in exchange for a commitment to true and full disclosure from the taxpayer. As at the time of writing this development is only at the stage of an internal ATO draft.

### **1413 Risk transactions or industries**

There is a likelihood that all related party international dealings may be reviewed by the ATO in the context of a transfer pricing review. There are no transactions, situations or industries that are excluded from an ATO transfer pricing review.

The ATO has signalled in its 2007-08 compliance program that specific areas targeted for closer attention are:

- SME taxpayers with annual turnovers between AUD2 million and AUD10 million;
- taxpayers making losses that engage in international related party transactions;
- related party dealings with tax haven jurisdictions;
- global corporate restructures that shift assets, functions and risks offshore;
- transactions involving services, guarantee fees or intangibles; and
- taxpayers involved in aggressive tax planning structures for large infrastructure projects.

### **1414 Limitation of double taxation and competent authority proceedings**

In the event that a transfer pricing audit results in an adjustment, mechanisms exist whereby the taxpayer may be able to limit the resulting effective double taxation.

#### *Resident taxpayers*

If an Australian taxpayer is likely to suffer double taxation, the following possibilities are available:

(a) Where there is a double tax treaty.

A resident taxpayer may present their case to the Australian competent authority. Each of Australia's DTAs have a mutual agreement procedure (MAP) Article that enables competent authorities of the relevant countries to meet and consult with each other with a view to seeking to resolve potential double taxation issues. The MAP does not compel an agreement to be reached and does not relieve the Australian taxpayers from penalties or interest charged by the ATO.



The Commissioner of Taxation has released TR 2000/16, which outlines the procedures to be followed and circumstances in which a case will be considered.

In circumstances where the profits of an Australian resident company are taxed by another country and in the opinion of the ATO it is in contravention of the double tax treaty but the competent authorities fail to resolve the case, it may result in double tax.

(b) Where there is no double tax treaty.

In circumstances where a transfer pricing adjustment is made by the authorities of a country with which Australia does not have a DTA (such as Hong Kong), there is no mechanism for providing relief from double taxation, other than pursuing domestic relief through the Australian appeals process.

### *Non-resident taxpayers*

The non-resident party to certain transactions may also obtain some relief from double taxation through the operation of domestic legislation in Australia.

Division 13 of Pt III of the ITAA allows for 'consequential adjustments' to be made to the income or deductions of the non-resident party to a transaction, where a transfer pricing adjustment has been made in relation to that non-resident taxpayer. For example, where withholding tax has been paid on interest, the provision prevents double taxation by allowing the withholding tax to be recalculated based on the adjusted interest, i.e. as revised for the transfer pricing agreement.

### **1415 Advance pricing arrangements (APAs)**

A formal APA process is available in Australia. APAs represent an agreement between a taxpayer and the tax authority to establish the transfer pricing methodology to be used in ensuring arm's length transfer prices are achieved for tax purposes. The ATO continues to support and promote its APA program as part of its transfer pricing compliance program. The APA program is well established within the ATO, with over 100 APAs completed or renewed since its inception. It is also a relatively flexible program, with limited procedural requirements concerning the form and timing of applications and a willingness to negotiate on the part of the ATO.

It is noteworthy that the ATO is becoming more selective in entering into APA discussions with taxpayers. The ATO has discouraged a number of APA applications where it believes one or more of the following factors exist:

- timely agreement was unlikely to be reached in relation to what is the appropriate transfer pricing methodology to apply, what is appropriate comparable data; and, what is an arm's length outcome;
- a lack of materiality in the dealings in the context of the business;
- insufficient complexity to warrant the level of certainty that is provided by an APA; or
- obtaining a tax benefit in either Australia or overseas was a principal element of the dealings.

Taxation Ruling TR 95/23 provides guidance in dealing with Australia's APA process.

The ATO is also currently seeking ways to streamline the APA process and is

exploring the possibility of a more cost effective alternative to an APA which would assist companies to limit or quantify their risk from a transfer pricing perspective. In particular, an alternative to an APA would award a level of comfort to taxpayers that do not have the resources to pursue an APA (for instance, certain taxpayers in the SME market) or were denied access to the APA process.

In 2007, the ATO commissioned PricewaterhouseCoopers Legal to complete an independent review of the APA program. The ATO has recently received a draft report from the review that gathered feedback on the program from taxpayers, advisers and ATO staff. As at the time of writing, the ATO was reviewing the report and discussing internally how it would address the recommendations that were made. It is anticipated that the report will eventually be made publicly available but no indication has been given on when this is likely to happen.

#### *Interaction with the new laws on the provision of advice implemented under the Review of Self Assessment (ROSA)*

In April 2006, the ATO undertook a comprehensive review of key aspects of income tax self assessment, resulting in legislative changes to the Taxation Administration Act 1953 (TAA), applicable from 1 January 2006. The key change to the new private binding rulings regime (PBR) resulted in an expanded definition of matters on which taxpayers can seek a private ruling, which now includes administration, procedure and collection issues and ultimate conclusions of fact that must be determined in applying a tax law. In short, technically, PBRs may cover transfer pricing arrangements.

Following these legislative changes, the ATO has recognised the overlap between the PBR and the APA provisions. The ATO has stated that it has decided to retain the APA program in the belief that the APA program provides more flexibility and enables bilateral APAs to be obtained although in theory taxpayers could seek a PBR in relation to a transfer pricing matter. Whilst no further guidance has been published on the interaction between the PBR and the APA program, a new practice statement on the provision of advice is planned by the ATO.

### **1416 Liaison with customs and other authorities**

#### *Customs*

There is now an agreement in place between the ATO and the Australian Customs Service (ACS) to exchange information relating to transfer pricing issues. It is understood that the arrangement includes a database that enables members of the ATO and ACS to freely exchange product and company pricing data. In addition, the ATO and ACS have also begun undertaking joint audits on some taxpayers and developing joint training with a view to increasing the level of joint activity in the future.

The ATO, the ACS, tax practitioners and taxpayers have actively debated the treatment of customs duty when agreeing APAs or making transfer pricing adjustments for a number of years. In particular, a debate is ongoing as to whether notional adjustments should be made for overpayment of customs duty, resulting from an increase in taxable income, when audit settlements are reached. Currently, there is no convergence between ATO adjustment requirements, customs valuation methodology and any subsequent customs duty amendment/refund procedures.

Some taxpayers have individually approached the ACS to agree the customs treatment of any adjustments made under an APA.

There have been recent discussions between the ATO and the ACS regarding potential harmonisation of transfer pricing and customs valuation rules concerning transfer pricing adjustments. A conclusive outcome in this area would be an important development for taxpayers that have previously faced uncertainty regarding the customs duty implications of transfer pricing adjustments whether they are self assessed adjustments, adjustments resulting from an audit or compensating adjustments arising under an audit adjustment.

A draft practice statement on the interaction between customs valuation rules and transfer pricing was released in 2007, with the final statement to be published in 2008.

### *Other authorities*

In addition to its liaison with the ACS, it is understood that specialist transfer pricing and goods and services tax (GST) auditors within the ATO are also cooperating for the purposes of identifying case of particular concern to each other. For example, information in the Schedule 25A is sometimes used to identify taxpayers for GST reviews; and information such as invoices and other documentation reviewed in GST audits can sometimes identify issues that may trigger a transfer pricing review.

It is also understood that the ATO has had some similar cooperation with foreign revenue authorities. The ATO and overseas revenue authorities share information which may be relevant to particular industries or transaction types. Specifically, in its 2007/08 compliance program, the ATO stated that it completed 874 'exchange of information' requests with treaty partners during 2006/07. This has led to a number of simultaneous audits of taxpayers in multiple jurisdictions.

### **1417 OECD issues**

Australia is an OECD member and has a representative on the OECD Transfer Pricing Task Force. The ATO is an active participant in OECD working parties for emerging areas of transfer pricing such as business restructuring.

The ATO has generally followed the OECD Guidelines in relation to transfer pricing, the principles of which are reflected in Australia's tax rulings but is under no obligation to follow them.

### **1418 Thin capitalisation**

In calendar year 2001, substantial changes to Australia's thin capitalisation regime became effective. The legislation is both lengthy and complex.

The legislation has introduced a 'safe harbour' debt amount. An alternative test is the 'arm's length' debt amount, which potentially can increase the permissible interest deduction. The meaning of arm's length for the purposes of the thin capitalisation provisions is explained in TR 2002/16.

The application of IFRS from 1 January 2005 (December balances) impacted some taxpayers' thin capitalisation position, which is measured with reference to Australia's Generally Accepted Accounting Principles (AGAAP). To provide some short term relief to taxpayers who were impacted by the transition to IFRS, the government announced a three-year transitional period for thin capitalisation purposes. In summary,

taxpayers had the choice to apply 'old' AGAAP for another three years.

### **1419 Management services and other services**

Taxation Ruling TR 1999/1 sets out the ATO's position on whether prices for services, or dealings between associated enterprises in relation to the provision of services, conform to the arm's length principle.

According to the ruling, whether a service has been, or will be, provided by the performance of an activity, and whether a charge should be levied depends upon whether the activity has conferred, or is expected to confer, a benefit to a related party.

The ruling introduces administrative practices or a safe harbour, which allow for a 7.5% mark-up on non-core services provided or received where these service revenues/expenses are not more than 15% of the Australian group's total revenue/expenses. A mark-up of between 5% and 10% may be permitted if the services are provided to or received from another country which requires a different mark-up. Taxpayers relying on the administrative concession must apply a consistent mark-up for the relevant services globally.

Examples of 'non-core' services include administration and HR matters but specifically exclude technical and marketing services.

The ruling also allows for smaller companies that receive or provide services worth not more than AUD500,000 per annum, to apply the administrative practices to all services, i.e. core and non-core.

The adoption of a safe harbour mark-up does not remove the requirement for taxpayers to document their intra-group services transactions. The safe harbour mark-up will only remove the necessity for taxpayers to include benchmarking analysis of their intra-group services mark-ups within their documentation.

The ATO continues to focus on the pricing of management and other group services and has recently broadened its attention to include both inbound and outbound group services.

### **1420 Marketing and other intangibles**

Intangibles have been an area of focus for the ATO for a number of years. The ATO's position on the application of Australia's transfer pricing rules to marketing services provided by a Australian enterprise that uses trade marks and names it does not own is outlined in its 2006 publication entitled 'Marketing Intangibles'. The booklet is intended to be consistent with previous ATO rulings and with OECD Guidelines.

In determining whether an arrangement for the provision of marketing services is consistent with the arm's length principle, the ATO considers the following issues relevant:

- the nature of the contractual arrangements;
- the extent to which the activities are expected to benefit the trade name owner and/or the marketer;
- whether the level of marketing activities performed by the marketer exceeds that of comparable independent enterprises; and
- whether the marketer is properly compensated by a normal return on its activities or should receive an additional return on the trade name.

The ATO is likely to challenge an arrangement where a distributor pays a royalty yet receives no rights to use a trade name other than to distribute a branded product. Furthermore, if the ATO perceives that a distributor is performing a greater level of marketing than comparable independent distributors, it will expect the taxpayer to earn a higher level of profit than that of a 'routine' distributor.

In addition to marketing intangibles, the ATO is also focusing on transfers of intellectual property to international related parties. IP transfers must be separately disclosed on Schedule 25A and these are commonly a trigger for ATO reviews.

### **1421 Research and Development (R&D) tax concession rules**

Australia's tax rules provide additional tax deductions (at a rate of either 125% or 175%) for certain eligible R&D activities. Legislative changes in September 2007 to the R&D tax concession rules have extended the premium R&D concessions to companies belonging to a multinational group who choose to hold the resulting intellectual property outside Australia.

The concession allows an immediate 100% deduction for expenditure on eligible R&D expenditure and an additional 75% deduction on such expenditure above average expenditure on R&D over the previous three years.

Previously the rules generally excluded Australian companies that conducted R&D on behalf of a foreign company from claiming this additional deduction because the prior rules contained a test which required that the R&D was performed by the company on its own behalf.

# 15 Austria

## 1501 Introduction

Austria, while being a member of the OECD and subscribing to the principles contained in the 1995 OECD Guidelines on transfer pricing, has only general statutory rules on transfer pricing. No significant interpretative guidelines are available on transfer pricing. Transfer pricing is, however, becoming increasingly important and this is reflected by the increasing number of tax inspectors specialising in international transactions.

## 1502 Statutory rules

There are only general statutory rules in Austria which are aimed at dealing with transfer pricing. Thus the statutory authority for addressing transfer pricing issues is found in the application of general legal concepts, such as substance over form and anti-avoidance regulations, together with the requirement to apply the arm's length principle on inter-company dealings as well as the application of other regulations to deal with issues such as fictitious transactions, hidden capital contributions, and constructive dividends.

## 1503 Other regulations

The OECD Guidelines were published in Austria as administrative decrees. While an administrative decree does not have the force of law, this is nevertheless an important indication of the acceptance of the principles contained in the OECD Guidelines and the approach to transfer pricing that the Austrian authorities are likely to adopt.

No other binding regulations concerning transfer pricing have been published. If, however, guidance is required on a particular transfer pricing problem, then a taxpayer may submit the facts of that problem to the Austrian Ministry of Finance to obtain comment on its legal aspects (an Express Answer Service inquiry and Express Answer Service reply, respectively). It should be noted that, while the reply of the Ministry is not legally binding, these replies are published in professional journals and are referred to in practice.

## 1504 Legal cases

Information on legal cases and the legal aspects of transfer pricing issues is set out below.

### *Administrative High Court decisions*

Any decisions of this court are published without specific details that could identify the parties involved. Though court decisions on transfer pricing cases are scarce, some decisions are worth mentioning:

- (1) The Court ruled that a precise and detailed description of services rendered by a foreign group company to a domestic recipient is required for the service or licence fees to be tax deductible. Thereby, the more incomprehensible the services performed are, the more detailed the documentation has to be. Specifically,

consulting services, the transfer of know-how, and the procurement of business contacts require a very detailed description as well as documentation for the related expenses to be deductible for tax purposes.

- (2) The Court emphasised that inter-company service payments are tax deductible only if a willing to pay test is passed. If the services could have been obtained at lower cost from third party service providers, the willing to pay test is deemed to be failed.

#### *Tax Appeals Board decisions*

In one of its recent decisions, the Tax Appeals Board did not accept a flat rate remuneration for several services (marketing, financing, personnel, etc) determined as a percentage of the Austrian service recipients' turnover. Although the Board acknowledged that the Austrian company needed the services for its operation, the actual provision of these services was not proved credibly by the taxpayer. In addition, the Austrian service recipient should be in the position to provide evidence on the actual provision of services by the group companies and the benefit arising thereof.

#### *Replies from the Austrian Ministry of Finance (EAS-replies)*

EAS-replies are also published without company specific data but with a short summary of the relevant facts. Recently, there have been several EAS-replies that are of significant, details of which are as follow:

- (1) A company resident on the Virgin Islands holds intangibles (licences). These rights are administratively utilised via an affiliated company, resident in Guernsey. An Austrian company is responsible for public relations, launching products, and arranging licence agreements. The consideration for services performed is calculated according to the cost plus method. In the reply the Ministry of Finance pointed out that if the above facts are correctly stated, it cannot be required by the Austrian tax authority that the intangibles be transferred to Austria and that the royalties be taxed in Austria. This is valid provided the consideration received by the Austrian company from other affiliated companies corresponds with the functions performed, and the OECD Guidelines are adhered to.
- (2) An Austrian taxpayer acting as either contract manufacturer or commission agent must provide adequate documentation to show that its activities are subordinate to the principal, and in particular that it is not involved in the sale of the products in the Austrian market in its own name. This documentation requirement is especially onerous for a taxpayer that has previously been characterised as a fully-fledged manufacturer or distributor. In this case, the taxpayer must document how its new status as a contract manufacturer or commission agent is reflected by a corresponding decrease in its functions and risk profile. The Austrian Ministry has provided some legislation for determining the status of such taxpayers.
- (3) Also in the context of the reorganisation of an Austrian distribution company into a commission agent or commissionaire, the Ministry of Finance issued a letter ruling that deals with goodwill aspects. The Ministry stated that if the

subsidiary being transformed does not receive any compensation for investments with respect to customers, this might be deemed to deprive the subsidiary of the customer base it has created throughout the past, thus, constituting an infringement of the arm's length principle. This is the view conveyed by some OECD member countries in the course of an OECD working group on commissionaire arrangements. As long as these OECD working papers are not final, the Austrian Ministry of Finance, however, will not publish further general guidance on goodwill issues but explicitly refers such cases to the local tax office.

- (4) In connection with the reorganisation of an Austrian distribution company into a commissionaire, the Austrian Ministry of Finance stated that the Austrian distribution company downsized to a commissionaire constitutes a PE of the French parent company. Under the Austria-France DTA, a French production entity has a PE in Austria when it sells its products through a dependent agent which has binding authority for sales contracts. According to the Ministry, the dependent status is substantiated by the fact that the Austrian subsidiary performs the sales activity for the French parent company only and it has to follow the French producer's instructions with regard to the product sales.
- (5) In the absence of suitable comparables, an Austrian taxpayer providing procurement services to a Swiss affiliate may be remunerated on a cost plus basis. However, the taxpayer must show that it is providing pure procurement services rather than acting as a buy-sell intermediary.
- (6) If an Austrian parent makes a one-time payment as a consideration for intangible property (e.g. software) and associated technical support for the benefit of other group companies, the Austrian tax authorities may deem the parent and those affiliates to have entered into a cost-sharing arrangement. Any cost sharing payments received by the Austrian parent would not be regarded as licensing income and are thus not subject to withholding tax. However, this holds true only if economic ownership is transferred to the cost-sharing affiliates (the transfer or a mere usage right is not sufficient).
- (7) A Japanese company was active in the field of assisting in and enhancing of export activities of Austrian and other European-located manufacturing companies to Japan. One of the members of the board of directors located in Austria performed the following functions: assisting Japanese clients on their business trips to Austria, providing for translations, executing managing activities on behalf of the Japanese company, e.g. financing and management planning. This was deemed to be exceeding mere preparatory and/or auxiliary activities, thus, creating a PE, if performed from his dwelling in Austria. However, even if this Austrian-based member of the board of directors did not use his dwelling to carry out these activities, i.e. the Japanese company being deemed to dispose of a fixed place of business in Austria, the Austrian Ministry of Finance took the view that this Austrian-based member being entitled to form framework agreements on behalf of the Japanese company would be deemed to be a dependent agent, thus, creating a PE in Austria.

With respect to the allocation of profits to this Austrian-based PE, the Austrian Ministry of Finance deemed the cost plus method to be appropriate. However, in



view of the fact that this PE would be very small sized the Austrian Ministry of Finance explicitly stated that a mark up amounting to 5% to 10% should not be challenged, referring to a respective German decree regarding controlling and coordination centres (BStBl. I 1984, 458).

- (8) A server of an Austrian software company located in Liechtenstein is deemed to create a PE. In a comment to this letter ruling it was held that allocation of profit to this PE would be based on the cost plus method, whereas the main part of profit derived from the development and marketing of the software should be allocated to the respective department of the company as these functions, being essential for the company in deriving its profit, could in no case be attributed to a machine.
- (9) The resale minus method is deemed to be the most adequate method to deduce arm's length purchase prices for captive distribution companies. However, if this method cannot reasonably be applied in a given case, the transactional net margin method might be used. Generally, TNMM requires an examination on a transaction by transaction basis. However, if an enterprise performs only one kind of transactions (e.g. the distribution of cosmetics), the different transactions can for the sake of simplification be regarded as one transaction when applying TNMM.
- (10) In case of inter-company loans, the Ministry of Finance is of the opinion that the interest rate which should be paid to an independent bank is not suitable comparable since the credit risk borne by the independent bank is not comparable to that which arises within the inter-company financing. The applied group strategy can influence the creditworthiness of the group entity borrowing from a related party; however, this effect does not prevail in the same way if the lender is an unrelated bank. The Ministry also referred to a German court decision which stated that debit interest customary in banking cannot be applied as arm's length intra-group interest since the lender group company does not practise banking business and therefore does not have to bear the related costs (BStBl II 1990, 649).

Although in an EAS-reply it is not possible to determine the exact arm's length interest rate for an inter-company loan, the letter ruling suggests examining in detail whether the credit risk related to an inter-company loan is actually higher than that borne by inter-bank loans. If this is not the case, according to the Ministry, the inter-bank interest rate (e.g. EURIBOR) should be applied without mark-up.

- (11) If an Austrian company owned by an Austrian parent company has established a finance branch in Switzerland, the income of the Swiss branch is subject to Austrian corporate income tax by virtue of the Austrian company's unlimited tax liability. To decide whether, based on the Austria-Switzerland DTA, the income of the Swiss finance branch has to be exempt from Austrian tax, the following issues have to be examined:
  - (a) Does the Austrian company take the financing decisions? If this is the case, the income would be attributable to the Austrian headquarters.

- (b) Does the Swiss branch carry out merely holding activities? Should this be the case, an office of 20 meters squared would not constitute a PE in Switzerland since no operating function is carried out in it. Also in that case, the Austria-Switzerland DTA assigns the right of taxation of the interest income to Austria.
- (c) In case the Swiss branch can effectively be regarded as a PE, the allocation of the capital to the branch has to be examined. Under Swiss law, 10/11 of the interest income of finance branches are treated as tax deductible refinancing interests. According to the Austrian Ministry of Finance, the Swiss regulation acts on the assumption that a Swiss financing company of a group only needs an equity ratio of 1/11. To avoid Austrian tax evasion, the amount deducted as financing costs in Switzerland has to be considered as operating interest income of the Austrian head office.
- (12) SOX related costs arising in connection with the implementation of an internal control system in a US based group deem not to be deductible with the Austrian subsidiary. The Ministry of Finance stated that SOX related costs have to be seen in connection with the control function of the US parent company. Such costs can be borne by the Austrian subsidiary only if (and to that extent) it benefits from the internal control system. Such benefits have to be specifically measurable.

### **1505 Burden of proof**

As a matter of principle, the tax authorities carry the burden of proof: if the tax authorities challenge a tax return, the taxpayer does not have to prove the accuracy of the return; rather the tax authorities would have to prove the contrary. However, in international tax cases the taxpayer bears a special liability of co-operation (see below under 1506).

### **1506 Tax audit procedures**

In Austria it is not usual for the tax authorities to carry out an audit specifically in respect of transfer prices alone. However, recently it could be experienced that already at the beginning of a tax audit, inspectors request a description of the transfer pricing system in place. Typically, transfer prices represent one part of a tax audit. If transfer pricing or benchmarking studies exist, they have to be provided to the tax auditors. The tax authorities have special experts who are retracing and reviewing the correctness and comparability of such studies.

#### *Selection of companies for audit*

The tax authorities aim at auditing companies exceeding certain size thresholds on a three to five year basis.

For smaller companies, there are three possible ways for a company to be selected for a tax audit:

- (1) Time – those companies that have not been audited for an extended period are likely to be selected;

- (2) Industry group selection – tax authorities might focus on certain industries from time to time; and
- (3) Individual selection – some companies are selected individually, based on ‘professional judgment’ or exceptional fluctuations in key ratios.

The provision of information and duty of the taxpayer to co-operate with the tax authorities

There is a general duty for the taxpayer to co-operate with the tax authorities, although decisions of the Administrative Court indicate that there is a limit to this duty in so far as the tax authorities cannot demand impossible, unreasonable or unnecessary information from the taxpayer.

There is an increased duty to co-operate where transactions with foreign countries are involved. Under this increased duty to cooperate, there is a duty for the taxpayer to obtain evidence and submit this to the tax authorities. The possibility of administrative assistance from other (foreign) tax authorities does not suspend the duty of the taxpayer to co-operate with the Austrian authorities.

### **1507 The audit procedure**

There is no special procedure for transfer pricing investigations, which are seen as part of a normal tax audit. In this procedure, the tax auditors visit the company’s premises, interview the relevant company personnel and inspect the company’s books and records. As far as transfer pricing is concerned, tax inspectors increasingly request a summary of the transfer pricing system applied.

It should be noted that the conduct of the taxpayer during the tax audit can significantly affect both the outcome of the inquiry and the amount of any adjustment. If the taxpayer is able to maintain an objective approach and can provide good documentary evidence to support the transfer pricing scheme in place, s/he will have a much better chance of defending it against any adjustments proposed by the tax authorities.

### **1508 Revised assessments and the appeals procedure**

After the end of a tax audit, the tax inspector usually issues a ‘list of findings’, which is discussed with the company and/or the tax adviser. If the company agrees to the findings, the list forms the basis for the revised assessments covering the audited years. If, however, agreement could not be reached on any particular issues, then the tax office would still issue revised assessments in accordance with the inspector’s findings but the company could appeal against the assessments.

If an appeal is filed by the company, it will be heard by the Tax Appeals Board (Unabhängiger Finanzsenat). The company may file a further appeal against a decision of the Tax Appeals Board with the Administrative High Court.

### **1509 Additional tax and penalties**

If tax is paid late, a late payment surcharge will be imposed, amounting to 2% of the unpaid amount. An additional surcharge of 1% would be levied if tax is not paid within three months as of the date it has become due and an additional 1% in case of late payment of the second surcharge. This surcharge is not tax deductible and no supplementary interest will be charged. If, however, the tax liability relating to past

years is increased as a result of a tax audit, interest will be charged on the difference between the tax paid and the final tax assessed. The period for which interest is levied starts from October following the assessment year and lasts for 48 months at a maximum. The interest rate amounts to 2% above the base interest rate.

### **1510 Resources available to the tax authorities**

Within the tax audit department there are units that specialise in international transactions. The staff in these units receive special training, which includes participating in audits and training courses in other countries (e.g. the US). Indeed, the number of these specialised auditors has been constantly increasing in recent years. Inquiries are normally undertaken by tax inspectors from the tax audit department without the assistance of lawyers, economists or other kinds of experts. The tax authorities have access to the Orbis/Amadeus database. Mutual agreement procedures are conducted by the Ministry of Finance.

### **1511 Use and availability of comparable information**

#### *Use*

It is very important that the taxpayer prepares reasoned documentary evidence of the issues that were considered when determining the transfer prices. This documentation should be prepared before any transactions occur using those transfer prices.

#### *Availability*

If a company is legally obliged to publish its financial statements (such a requirement exists for all companies other than very small partnerships and individual enterprises), then there is access to the financial information contained therein; otherwise, access to such information is not normally publicly available.

If the transfer pricing policy of a company were being investigated by the tax authorities, it would be possible for advisers to use information on comparable companies in defence of the policy of the investigated company. Such information is, however, extremely difficult to obtain. Furthermore, tax advisers are bound to keep confidential any information obtained on other clients in the course of their work. Tax authorities certainly have access to more information than advisers and this would be obtained through investigations into other taxpayer's transfer pricing policies but the tax authorities too are bound to keep this information confidential.

### **1512 Risk transactions or industries**

There are no particular transactions that run a higher risk of being attacked than any other transactions. However, it can be stated that transactions with group companies based in low tax jurisdictions, cross-border transfer of functions and also financing transactions are regularly examined.

### **1513 Limitation of double taxation and competent authority proceedings**

If a double taxation treaty exists that contains provisions for mutual agreement procedures, it is very likely that these procedures would be used to avoid double taxation. According to information obtained from the Ministry of Finance, there are

only a few cases where such an agreement between the tax authorities involved could not be reached. In such cases, or where there is no double taxation treaty, settlement could be achieved under the Arbitration Convention. (The Convention re-entered into force retroactively as of 1 January 2000. Currently the Convention is applicable between Austria and the 14 other pre-2004 EU Member States except Greece). Otherwise, Section 48 of the Austrian Fiscal Code and a decree of the Ministry of Finance provide unilateral measures to avoid double taxation where no DTA is applicable. Under these provisions, foreign source income will be tax exempted if a taxpayer, who is subject to taxation on his/her worldwide income in Austria, achieves certain types of non-passive income (e.g. income from independent work from a foreign-based PE, income from immovable property, income from construction works) and the average foreign tax amounts to 15% at least. If these criteria are not met (i.e. passive income and/or average foreign tax rate below 15%), relief from double taxation is granted by means of a refund procedure. Taxpayers subject to taxation on Austrian sourced income may file an application for double taxation relief to the Ministry of Finance, which may be granted at the Ministry's discretion.

The competent authority procedure may be initiated by the taxpayer, too. In case no competent authority procedure clause is given under the respective DTA, double taxation may be avoided by administrative assistance proceedings (EC Administrative Assistance Directive and EC Administrative Assistance Act) carried out by the tax audit authorities.

#### **1514 Advance pricing agreements (APAs)**

There is no formal procedure for obtaining advance pricing agreements in Austria. As noted above, it is possible to obtain a ruling from the Ministry of Finance in connection with a particular transfer pricing issue, but such a ruling is not binding on either the tax authorities or the taxpayer. Furthermore, the Ministry provides guidance on legal questions only. Therefore, no ministerial ruling can be obtained on whether the transfer prices in a specific case comply with the arm's length principle. In this case, a ruling from the competent tax office can be obtained; however, it automatically releases a tax audit with the taxpayer in Austria.

#### **1515 Anticipated developments in law and practice**

Detailed transfer pricing guidelines are expected to be issued by the Austrian Ministry of Finance in 2009.

In practice, the increasing importance of transfer pricing issues with the tax authorities is noticeable. A further development is that negotiated settlements are becoming more difficult to achieve.

#### **1516 Liaison with customs authorities**

Tax authorities and customs authorities may exchange information. Experience suggests, however, that different authorities do not in fact deal very closely with each other where transfer prices are concerned.

Transfer pricing adjustments for direct tax purposes are not normally reflected in declarations and assessments, respectively, for customs or any other indirect taxes.

### **1517 OECD issues**

Austria is a member of the OECD. In our experience, the Austrian Ministry of Finance is very inclined to follow the positions of the OECD as expressed in the Model Commentary and the various OECD reports (e.g. partnership report, report on the attribution of profits to a PE).

### **1518 Joint investigations**

A joint investigation by Austria and another country's tax authority is possible, and it is expected that this would have the advantage of the avoidance of double taxation for the Austrian taxpayer.

Joint investigation is possible pursuant to:

- a clause in an applicable DTA; or
- EC Administrative Assistance Directive and EC Administrative Assistance Act.

### **1519 Thin capitalisation**

There are no statutory rules on permissible debt equity ratios. As a rule of thumb, debt to equity ratios of 3:1 would in principle not be challenged by tax authorities, provided the terms of the debt are otherwise at arm's length. A recent decision of the Tax Appeals Board indicates that even a much higher debt to equity ratio could be permissible provided that the ability of the company to pay the interest rates and to repay the loan principal at maturity date are supported by a business plan that is based on realistic assumptions. However, it is not clear whether the Administrative High Court will confirm this position. Where, for example, the interest rate is higher than an arm's length rate, the consequences are that a deduction would be denied for the excessive interest, and withholding tax would also be payable on that corresponding amount. (There is normally no withholding tax on interest payments to foreign lenders, whether related or unrelated, unless the loan is secured by real estate.)

### **1520 Management services**

Where the amount of a management charge has been calculated on an arm's length basis, the management fee would normally be tax deductible. The following issues should, however, also be considered where management services agreements are being concluded:

- A detailed contract should be drawn up;
- The terms of the agreement should not be retroactive;
- Documentary evidence to substantiate the provision of services and its benefits to the recipient should be maintained.

# 16 Azerbaijan

## 1601 Introduction

The transfer pricing concept is relatively new to Azeri tax law, although in the pre-Tax Code legislation there were some limited transfer pricing regulations focused principally on circumstances where goods, work, or services were sold at, or below cost or bartered/transferred without charge.

The current transfer pricing rules were introduced in the current Tax Code effective from 1 January 2001, and have been amended several times since then. These rules mainly focus on the determination of prices on the sale of goods, work, or services, and establish the principle of arm's length pricing for transactions between related parties and, in certain instances, the approach for making adjustments to transfer prices.

In practice, the tax authorities have limited experience in dealing with transfer pricing, mainly making adjustments to taxpayers' profits by disallowing certain deductible costs or challenging interest rates or the mark-up on services that were not, in their opinion, incurred or charged on an arm's length basis.

## 1602 Statutory rules

### *Scope*

Under the Tax Code, 'market price' is defined as the price for goods, works, or services, based on the relationship of demand and supply. A contractual price should be deemed the market price between counterparties for tax purposes, unless the contract or transaction falls under one of the exceptions below.

Under the Tax Code, the tax authorities may apply market price adjustments in the following cases:

- barter transactions;
- import and export operations;
- transactions between related persons, and;
- transactions where the prices within 30 days deviate by more than 30% either way from the prices set by the taxpayer for identical or homogeneous goods, works, or services.

### *Related parties*

Persons are considered 'related' in the following cases:

- if one person holds, directly or indirectly, 20% or more of the value or number of shares or voting rights in the other entity, or in an entity that actually controls both entities;
- if one individual is subordinate to the other with regard to official position;
- if persons are under the direct or indirect control of a third person, and/or;

- if persons have a direct or indirect control over a third person.

### *Pricing methods*

The Tax Code lists the following methods for determining the 'market price':

- Comparable Uncontrolled Price (CUP) method;
- Resale Price method, and;
- Cost Plus method.

The Tax Code establishes the priority of pricing methods to be used by the tax authorities to determine market prices, according to which the CUP method should be used first before all other methods.

If the determination of the market price is not possible under any of the methods above, the market price should be determined by an 'expert'.

### *Comparability factors*

In determining the market price, the tax authorities are required to take into account usual discounts from or mark-ups to prices. In particular, the Tax Code gives specific circumstances of how the discounts or mark-ups can be caused, such as deterioration of the quality of goods or the expiry of a product's life.

In addition, the Tax Code sets out the commonly accepted principle that, for the purposes of determining the market price, only transactions carried out under comparable conditions should be taken into account. In particular, the following factors should be evaluated:

- quantity (volume) of supply;
- quality level of goods and other consumption indicators;
- period within which liabilities should be fulfilled;
- terms of payment;
- change of demand for goods (works, services) and supply (including seasonal fluctuations of consumer demand), and;
- country of origin of goods and place of purchase or procurement.

In the Profits Tax Section of the Tax Code, there is a separate list of comparability factors that should be looked at to identify borrowings that can be treated as taking place under comparable circumstances. In particular, borrowings should take place in the same currency and be under the same terms and conditions.

### *Documentation requirements*

There is no statutory requirement in Azeri law that transfer pricing documentation be prepared, apart from a general requirement for taxpayers to maintain and retain accounting and tax records and documents. It is, however, clear that taxpayers that do not take steps to prepare documentation for their transfer pricing systems in general or for specific transactions will face an increased risk of being subject to an in-depth transfer pricing audit.



### *Other regulations*

Currently, besides linked provisions stipulated in the Tax Code, there are no other specific regulations in Azerbaijan relating to transfer pricing.

#### **1603 Legal cases**

There have been very few court cases related to transfer pricing in Azerbaijan.

#### **1604 Burden of proof**

Under the Tax Code, the burden of proof rests with the tax authorities to demonstrate that the price charged by a taxpayer significantly fluctuates from the market price. Unless otherwise proven, prices set by taxpayers are deemed to be the market prices; however, if, at the request of the tax authorities, the taxpayer does not have or has inappropriate documentation, then the tax authorities can determine the adequate pricing levels, therefore, the burden of proof would then be shifted to the taxpayer.

#### **1605 Tax audit procedures**

Currently, the tax authorities do not have specific procedures in the Tax Code for conducting separate transfer pricing audits. Control over prices is primarily made in the course of tax audits.

#### **1606 Revised assessments and the appeals procedure**

Taxpayers have the right to appeal to higher level tax authorities or court.

#### **1607 Additional tax and penalties**

There is no separate penalty regime for the violation of transfer pricing rules; however, transfer pricing adjustments made by the tax authority in the course of a tax audit that would increase the taxable revenue of the taxpayer (e.g., by disallowing the deduction of the costs in relation to excessive pricing levels) may lead to the underpayment of tax.

In case of a successful challenge by the authorities, a penalty of 50% of the underestimated tax may be imposed on the taxpayer. In addition, an interest payment of 0.1% per day would also accrue until the tax is paid in full.

#### **1608 Resources available to the tax authorities**

Although the arm's length principles have existed in the tax legislation since 2001, the enforcement of these principles is not yet common. Absence of statistical information for benchmarking purposes and the lack of modern information systems hamper the effective application of transfer pricing regulations in Azerbaijan.

#### **1609 Use and availability of comparable information**

The Tax Code provides that comparables for the determination of market prices are to be taken only from 'official and open' information sources. The Tax Code does not define or specify what sources are considered 'official and open', but gives some examples of such possible sources – databases of authorities in the specific market, information submitted by taxpayers to tax authorities, advertising.

In practice, in the majority of tax audits where transfer pricing issues have been raised, the tax authorities have relied on information collected themselves from other similar taxpayers, or directly from alternative producers or sellers of similar goods in the local market (primarily, state-owned concerns). Information published by the State Statistics Committee has not been commonly used.

Occasionally, the Azeri tax authorities undertake extensive data gathering involving comparables to obtain an in-depth knowledge of specific industry practices and pricing policies. The data obtained from comparables have been used in some cases to make transfer pricing adjustments on a single-transaction basis without regard to overall company profitability or multiyear data. In that situation, taxpayers have been faced with considerable difficulty in challenging the position, as no specific data is provided on the comparables to allow verification and submission of counterarguments.

### **1610 Risk transactions or industries**

The types of transactions typically scrutinised by the Azeri tax authorities in tax audits are the following:

- sale/purchase of goods, where the supplier is an overseas entity, even unrelated to the taxpayer;
- provision of centralised head office services, and technical / management fees;
- import transactions and recovery of related input VAT; and
- interest rates on inter-company loans.

All industries are subject to the transfer pricing regulations in Azerbaijan.

### **1611 Limitation of double taxation and competent authority proceedings**

Currently, there are 25 effective double tax treaties in Azerbaijan; however, there is no experience with the application of the transfer pricing provision in those treaties.

### **1612 Advance pricing agreements (APAs)**

Currently, there are no procedures in Azerbaijan for obtaining an APA; however, it is possible to obtain a written opinion from the tax authorities on transfer pricing issues. Such opinions are not binding.

### **1613 Anticipated developments in law and practice**

The Ministry of Taxes have started consultations with the OECD on adopting new, more detailed transfer pricing regulations. The general expectation is that the OECD-type guidelines and models will be adopted in Azerbaijan at some point in future, but the Government has not yet indicated any target date.

### **1614 Liaison with customs authorities**

The tax and customs authorities communicate with each other on various transfer pricing issues and have access to each other's respective data bases.

**1615 OECD issues**

Azerbaijan is not a member of the OECD; however, as mentioned, the general expectation is that the OECD-type guidelines and models are expected to be adopted in Azerbaijan sooner or later.

**1616 Joint investigations**

Usually, transfer pricing investigations are conducted by the tax authorities only; however, in some audits the tax authorities have engaged experts from other Governmental Bodies, such as the Ministry of Justice, the State Customs Committee, and others.

**1617 Thin capitalisation**

There are no thin capitalisation rules in Azerbaijan.

**1618 Management services**

Currently, there are no specific rules or unified practice with regard to the application of the transfer pricing rules to management service charges in Azerbaijan.

# 17 Belgium

## 1701 Introduction

The Belgian tax authorities turned their attention towards transfer pricing issues in the early 1990s. Belgium is now becoming more aggressive in the field of transfer pricing as it becomes increasingly aware of the active interest adopted (typically) in the surrounding countries and the risk of seeing Belgium's taxable basis being eroded. This resulted in the issuing of a Dutch translation of the 1995 OECD Guidelines (and the 1996, 1997 and 1998 additions thereto) and of a revenue document that comments on the 1995 OECD Guidelines and serves as an instruction to tax auditors. As of 1 January 2003 the Belgian government also introduced a new broadened ruling practice aimed at providing foreign investors upfront certainty regarding their ultimate tax bill. In 2004, further changes to the ruling procedure were made so as to enhance a flexible cooperation between taxpayers and the Ruling Commission. A specialist transfer pricing team has been established and in 2006 the Belgian tax authorities also installed a special transfer pricing investigation squad. Finally, during 2006 the Belgian government issued a second transfer pricing practice note endorsing the EU Code of Conduct.

## 1702 Statutory rules

The Belgian Income Tax Code (ITC) did not provide any specific rules on inter-company pricing until mid-2004, with the formal introduction of the arm's length principle in a second paragraph to Article 185 of the ITC.

In addition, the authorities can make use of other more general provisions in the ITC to challenge transfer prices. For example, in some cases where the Belgian tax authorities raise the issue of transfer pricing, the general rules on the deductibility of business expenses are applicable. Furthermore, the ITC contains provisions that tackle artificial inbound or outbound profit shifting. These are the so-called provisions on abnormal or gratuitous benefits.

### *Arm's length principle*

In 2004, article 185 of the ITC was expanded to include the arm's length principle in Belgian tax law for the first time. Article 185, paragraph 2 of the ITC now allows for a unilateral adjustment to the Belgian tax basis, similar to the corresponding adjustment of Article 9 of the OECD Model Double Taxation Treaty. The underlying assumption is that, in case of downward adjustment, the 'excess profit' forms part of the profits of the foreign related party. Which part of the profit is deemed to be derived from the related party dealings and how the 'part of the profits of the foreign related party' condition should be interpreted, needs to be agreed with the Ruling Commission. Various rulings on this topic have been issued in the meantime.

### *Deductibility of expenses*

#### General rules

The general rule concerning the deductibility of expenses is contained in Article 49 of the ITC. This article stipulates that a tax deduction is allowed only if an expense is incurred for the benefit of the taxpayer and is connected with the taxpayer's business activity. This connection must be demonstrated by the taxpayer. The expense itself must be real and necessary, incurred to obtain and retain taxable income, and either be paid, accrued, or booked as a definite and fixed liability during the taxable period.

Since 1 January 1997 this general rule on the deductibility of business expenses is more closely monitored before tax relief is granted with respect to fees paid to companies for conducting a director's mandate or other similar functions as well as for other management services. The burden of proof lies on the taxpayer, who must now justify the professional character of these fees. Furthermore, the fees which 'unreasonably' exceed the professional needs of the company will be taxed as disallowed expenses.

#### **Excessive expenses**

As a matter of principle, the tax authorities and courts may not test whether a business decision was expedient. Although the company bears the burden of proof that expenses are necessarily linked with its operations or functions, the authorities have no right to question whether the expenses are useful or appropriate. However, Article 53 of the ITC provides that relief may be denied for any excessive expenses incurred and this will be the case if the expense is not reasonable in the light of the activities carried out. No case law yet exists on the application of this Article in the context of transfer pricing.

#### **Interest payments**

Article 55 of the ITC provides that interest paid is a tax deductible business expense, provided that the rate of interest does not exceed normal rates after taking into account the specific risks of the operation.

#### **Abnormal or gratuitous benefits**

Article 26 of the ITC provides authority for the taxable profits of individual companies or enterprises in Belgium to be increased where the authorities can demonstrate that any profit transfers were 'abnormal or gratuitous benefits' granted to individuals or companies established in Belgium or abroad. This does not apply if the benefits transferred are subject to (Belgian) tax in the hands of the recipient(s). Although this Article seems to have become obsolete because of the formal introduction of the arm's length principle in Belgian tax law by Article 185, paragraph 2 of the ITC, this is not true for situations where the latter Article does not apply. This may for example be the case for pure Belgian transactions where the recipient of the benefit is not subject to taxation on said advantage.

The Belgian ITC does not define 'abnormal or gratuitous benefits' and, consequently, the issue has been subject to review in the courts. Case law suggests that 'abnormal' refers to 'that which is not consistent with common practice', while 'gratuitous' refers to the fact that a benefit is not granted in the course of the execution of a contractual obligation but is granted where there is not any or sufficient consideration (Court of Cassation, 31 October 1979, NV Regents Park Co Belgium, Bull. Bel. 590).

The Belgian legislator inserted in Article 26 paragraph 1 of the ITC the following wording "notwithstanding the application of article 49". This means that the application of Article 26 of the ITC does not exclude the application of Article 49 of the ITC. In other words, even if the abnormal or gratuitous benefit is taken into account for determining the taxable basis of the beneficiary, the tax deductibility of the related expenses can still be denied in the hands of the grantor. This could result in economic double taxation. This provision has come into play as from tax year 2008.

Article 207 of the ITC provides that a Belgian company which receives (directly or indirectly) abnormal or gratuitous benefits from a company upon which it is directly or indirectly dependent, may not use any current year losses or losses carried forward nor apply the participation exemption, investment deduction or notional interest deduction against the taxable income arising from the benefit. In an answer to a recent Parliamentary question (L. Van Campenhout, 2 April 2004) the Belgian Minister of Finance has given a very broad interpretation to this provision by declaring that in case of received abnormal or gratuitous benefits, the minimum taxable basis of the receiving company equals at least the amount of the benefit. The previous administrative tolerance under which abnormal or gratuitous benefits received from abroad were not tackled, has been abolished as from tax year 2004.

#### *Notional Interest Deduction*

On 22 June 2005 the Belgian tax law on the notional interest deduction was passed.

The new rules are intended firstly to ensure equal treatment of debt and equity funding and, secondly, to provide a successor to the Belgian coordination centres.

Companies liable to Belgian corporation tax (including Belgian branches of foreign companies) are granted a notional interest deduction equal to the 10-year state bond rate, on the equity shown in the company's individual Belgian financial statement. The equity requires slight alteration, e.g. holdings in subsidiary companies (inter-alia) are to be trimmed off in assessing the relevant equity figure.

To the extent that the interest deduction does not have a direct tax effect (e.g. in loss situations), the interest deduction can be carried forward for the next seven years. The measure thus allows obtaining tax relief for what is deemed an arm's length interest rate calculated on the adjusted equity for which no charge is reported in the profit and loss statement.

The legislation has come into force as from assessment year 2007 (i.e. financial years ending on or after 31 December 2006).

#### *Patent income deduction*

On 27 April 2007, the Belgian parliament approved the law introducing a tax deduction for new patent income (PID), amounting to 80% of the income, thereby resulting in effective taxation of the income at the maximum rate of 6.8%.

To benefit from the PID, the Belgian company or branch can exploit the patents owned by it, or licensed to it, in different ways.

A first option available to the Belgian company or branch is to licence the patents or extended patent certificates to related and unrelated parties.

Alternatively, the Belgian company or branch can exploit the patents by manufacturing, or having manufactured by a contract manufacturer, products in which the patents are used and supply the products to related or unrelated customers.

It may also use the patents in the rendering of services.

For patents licensed by the Belgian company or branch to any related or unrelated party, the PID amounts to 80% of the gross licence income derived from the patents and patent certificates, to the extent the gross income does not exceed an arm's length income. The PID applies to variable and fixed patent licence fees, as well as other patent income, such as milestone payments.

For patents used by the Belgian company or branch for the manufacture of patented products – manufactured by itself or by a contract manufacturer on its behalf – the PID amounts to 80% of the patent remuneration embedded in the sales price of patented products. In the case of services, the PID amounts to 80% of the patent remuneration embedded in the service fees.

The new tax measure is aimed at encouraging Belgian companies and establishments to play an active role in patent research and development, as well as patent ownership. The tax deduction is to apply to new patent income and has come into force as from financial years ending on or after 31 December 2007.

### **1703 Administrative guidelines**

#### *Initial guidelines*

On 28 June 1999, administrative guidelines were issued relating to transfer pricing. The guidelines are broadly based on the OECD Guidelines. The reason for issuing the guidelines is of a purely 'offensive' nature. The guidelines stipulate that Belgium risks being forced to make corresponding downward profit adjustments if no adequate measures are taken to counterattack aggressive revenue action in other countries.

Although no specific penalty rules are imposed, the guidelines urge tax inspectors to carry out in-depth transfer pricing audits where the taxpayer fails to show 'documentary evidence' that efforts have been made to fix arm's length inter-company prices. Consequently, taxpayers may benefit from preparing a defence file upfront substantiating their transfer pricing methodology. In addition, the guidelines underscore the importance of conducting a proper functional analysis and refer to a list of generic functional analysis questions.

#### *Guidelines on Arbitration Convention*

On 7 July 2000 the Belgian tax authorities issued administrative guidelines on the technicalities of applying the Arbitration Convention. The guidelines offer guidance to taxation officers and tax practitioners into how the tax authorities will apply the Convention. It is also an acknowledgement by the Belgian tax authorities of the need to develop an efficient practice to resolve issues of international double taxation.

#### *Guidelines on transfer pricing audits and documentation*

### **Introduction**

The Belgian tax authorities published in November 2006 administrative guidelines on transfer pricing audits and documentation.

In light of certain recent developments, such as the formal set-up of a specialist transfer pricing investigation squad and the approved EU Code of Conduct on transfer pricing documentation, the need had obviously arisen in Belgium for an update of the

previous transfer pricing administrative guidelines and for new guidance particularly on transfer pricing audits and documentation requirements. The new administrative guidelines fill this need and, at the same time, confirm the integration in Belgian tax practice of the EU Code of Conduct. The Code of Conduct is added as an appendix to the administrative guidelines.

### **Cases with a higher risk of prompting an audit**

The administrative guidelines contain a list of cases (which list is not exhaustive) where 'it may be advisable' to check the transfer pricing practices. Among the situations listed in the administrative guidelines are transactions with tax havens and low-tax jurisdictions, back-to-back operations, and so-called 'guidelines/conduit' structures, as well as situations that are much more frequent, i.e., entities that suffer structural losses, business reorganisations or migrations and the charge-out of management fees.

### **Pre-audit meeting**

The administrative guidelines acknowledge the fact that an investigation into the transfer pricing dealings of a business and the documentation relating thereto form a complex whole and are significantly affected by widely diverse company-specific factors. To this end, the administrative guidelines suggest the possibility of holding a 'pre-audit meeting' before issuing any transfer pricing documentation request. The purpose of this pre-audit meeting is to explore, in consultation with the taxpayer, what should be the appropriate scope of the tax audit, what documentation is relevant to the transfer pricing investigation, if there is any readily available documentation, etc.

### **Concept of 'prudent business manager'**

As to the question what pro-active effort is required when putting together transfer pricing documentation, the administrative guidelines refer to the concept of a 'prudent business manager', i.e., given the nature of the transactions that take place between related companies, it is only normal, as a 'prudent business manager', to maintain written documentation that underpins the arm's length character of the transfer pricing applied.

The administrative guidelines list the information that can be prepared to this end.

### **Flexibility as to the language of the documentation**

The administrative guidelines acknowledge the reality that a large part of the transfer pricing documentation may not be available in one of the official languages of Belgium, i.e. Dutch, French or German. Reasons for this inadequacy have to do, inter alia, with the multinational character of business, the growing tendency of organising transfer pricing studies at a pan-European or global level or the need to ask a foreign related company for information.

Inspectors are urged to apply the flexibility they feel 'in conscience' to be necessary when they evaluate the reasons given by the taxpayer for submitting documentation in a foreign language. This applies particularly to pan-European or worldwide transfer pricing studies, group transfer pricing policies and contracts with foreign entities.

### **Code of conduct on transfer pricing**

The administrative guidelines ratify the standardised and partly centralised approach



to transfer pricing documentation that is recommended in the Code of Conduct. This also means that concepts such as the 'master-file' and 'country-specific documentation' are now officially introduced into a Belgian context. The Resolution of the EU Council on this Code of Conduct is added to the administrative guidelines as an appendix.

### **Pan-European benchmarks**

The administrative guidelines confirm the current practice whereby the use of pan-European data cannot per se be rejected in the context of a benchmark analysis.

The use of pan-European analyses finds its justification not only in the often existing lack of sufficient points of reference on the Belgian market, but also in the fact that many multinational businesses prefer to spread the cost of investing in a benchmark analysis over various countries.

### **Accounting guidelines**

The Belgian Commission for Accounting Standards has caused some discussion in the accounting and tax field by issuing advices that deviate from current accounting practice. As Belgian tax law in principle follows accounting law (unless it explicitly deviates hereof), these recent evolutions may also impact the transfer pricing field. Broadly speaking, the discussion relates to the acquisition of assets for free or below market value.

Until now, Belgian accounting law basically referred to the historical cost to determine the acquisition value of assets provided the principle of fair image of the balance sheet is not impaired.

If the acquisition price is below fair value, the accounting standard stipulates that the difference between fair value and historical cost will be treated as an exceptional profit at the level of the acquiring company. Hence, intra-group acquisitions at low book value between Belgian companies may be reconsidered (whereas to date these would normally not fall within the scope of transfer pricing based on a same country exemption). However, the Minister of Finance has put forward that the tax authorities are not bound by the Accounting Standards and that the fiscal impact of the latter still needs to be examined.

### **1704 Legal cases**

The attention of the Belgian authorities did not turn significantly to transfer pricing until the beginning of the 1990s. In Belgium, there are relatively few important transfer pricing cases.

In 1995, the Supreme Court decided that the benefit of losses carried forward in a loss-making company is denied where there has been an abnormal transfer of profit from a profitable company to that loss-making entity (Supreme Court, 23 February 1995).

On 21 May 1997 the Liege Court of Appeal rendered a favourable decision recognising the acceptability of a set-off between advantages of transactions of related parties. In the case at hand, a Belgian distribution entity acquired the contractual rights (from a group affiliate) to distribute certain high-value branded products in the Benelux countries. However, this was subject to the Belgian entity contracting out the distribution of certain dutiable brands to a Swiss affiliate. The Belgian authorities stipulated that the Belgian-Swiss transaction granted abnormal

or gratuitous benefits to the Swiss entity. However, it was demonstrated that the transfer of profit potential to a foreign related party subsequently generated an inbound transfer of profit from another foreign related party. The court based its decision on the economic reality in a group context, and the fact that different companies were involved (and thus an indirect set-off was made) did not jeopardise the possibility to net the advantages against each other. The Ghent Court of Appeal has also confirmed the acceptance of some form of economic solidarity in April 1999. In this case, the Court ruled in favour of a Belgian company that had granted quality discounts to its UK affiliates to secure the going concern of the latter as this was done for its own commercial interest (contra Brussels Court of Appeal 12 April 2000). Also the Ruling Commission (see below) confirms the view of the Belgian courts by granting rulings over the acceptability of certain benefits being granted between related entities because of particular intra-group reasons.

The Ghent Court of Appeal ruled in November 2002 in a high-profile tax case that an advantage received by a Belgian company pursuant to the acquisition of shares at book value, which was lower than market value, may create a Belgian tax liability on the basis of Article 24 of the ITC.

Finally, in a case ruled by the Bergen Court of Appeal of (13 October 2006), the Court ruled in favour of analysing in detail why certain related party transactions take place under terms and conditions that might at first glance breach the arm's length standard. In the case at hand, the Court accepted the granting of interest free loans as otherwise the group might have faced adverse financial circumstances.

### **1705 Burden of proof**

In theory, taxpayers must demonstrate that business expenses qualify as deductible expenses in accordance with Article 49 of the ITC, while the tax authorities must demonstrate that profit transfers to an affiliate are 'abnormal or gratuitous benefits'. In practice, however, the tax authorities have actually requested taxpayers on several occasions to demonstrate that the transfer pricing methodology adopted is on an arm's length basis (see below).

Since 1997 the tax authorities have scrutinised the deductibility of management service fees in a more stringent way. The taxpayer is required to demonstrate that any services provided are both necessary to the business of the recipient and charged at market value.

### **1706 Tax audit procedures**

As noted above, the Belgian tax authorities have issued administrative guidelines on transfer pricing audits and documentation. Although these guidelines are not legally binding, they (will) play a pivotal role in current (and future) transfer pricing audits.

#### *Selection of companies for audit*

The administrative guidelines published in November 2006 contain a list of cases where it may be advisable to check the transfer pricing practices (see in this respect paragraph 1703).

Transfer pricing enquiries may also arise in the course of a 'routine' tax audit.

**1707 The audit procedure**

During the course of an audit the inspector would normally visit the company's premises. The 1999 administrative guidelines urge tax inspectors to interview as many people as possible, including staff with an operational responsibility, to get a fair idea of the functions, assets and risks involved.

The tax audit normally begins with a written request for information. The taxpayer must provide the data requested within (in principle) one month. However, the 2006 administrative guidelines preach flexibility as to this one month period. Any documentary evidence considered relevant to the audit can be requested and reviewed by the authorities. As to the issue of obtaining information from foreign companies, the approach of the administrative guidelines seems to be more demanding than the OECD Guidelines. Indeed, the fact that a Belgian subsidiary argues that it did not receive any information from its foreign parent on its transfer pricing policy can be deemed to reflect a lack of co-operation.

The 2006 administrative guidelines stimulate companies to have a pre-audit meeting with the authorities (i) to discuss the transfer pricing policy carried out with the group, (ii) to discuss the level of transfer pricing documentation already available, and (iii) to avoid having irrelevant questions raised which ask an unreasonable amount of work from the taxpayer. This focused approach should save a lot of time for both the taxpayer and the tax authorities.

**1708 Revised assessments and the appeals procedure**

Since assessment year 1999, new revised assessments and appeals procedures have been introduced. The main features can be summarised as follows:

Once the tax inspector has completed the analysis, any adjustment is proposed in a notification of amendment outlining the reasons for the proposed amendment. The company has 30 days either to agree, or to express disagreement. The tax inspector then makes an assessment for the amount of tax, which s/he believes is due (taking into account any relevant comments of the company with which the inspector agrees). Thereafter the company has three months within which to lodge any appeal with the Regional Director of Taxes. The decision of the Regional Director of Taxes may be appealed and litigated. In a number of circumstances, the intervention of the courts can be sought, prior to receiving the decision of the Regional Director of Taxes.

**1709 Additional tax and penalties**

Penalties may be charged in respect of any increased assessment. Typically this would be in the range of 10 to 50% of the increased tax. Penalties paid are not tax deductible.

In practice, discussion has arisen as to whether penalties can be levied in the context of abnormal or gratuitous benefits granted by a Belgian taxpayer. Although conflicting case law exists (e.g. Antwerp Court of Appeal, 17 January 1989), the Antwerp Court of Appeal ruled on 15 April 1993 that by its mere nature, abnormal and gratuitous benefits are always elements that are not spontaneously declared in the company's tax return and can therefore not give rise to an additional tax penalty.

It is unlikely that this reasoning can be upheld in cases where Article 185 §2 of the ITC is applicable.

### **1710 Resources available to the tax authorities**

Within the Central Tax Administration several attempts have been made to improve both the quality of transfer pricing audits and the search for comparable information. To this end, a specialist transfer pricing team (STPT) was established. The STPT is intended to ensure coherent application of the transfer pricing rules by the tax authorities with a view to achieving consistency in the application of tax policies.

In short, the mission statement of the STPT is:

- to act as the central point of contact for all tax authorities facing transfer pricing matters;
- to maintain contacts with the private sector and governmental bodies in the area of transfer pricing;
- to formulate proposals and render advice with respect to transfer pricing;
- to take initiatives and collaborate in the area of learning and education with a view to a better sharing of transfer pricing knowledge within the tax authorities; and
- to take initiatives and collaborate with respect to publications that the tax authorities have to issue with respect to transfer pricing.

Besides the STPT, in 2006 the Belgian tax authorities have also installed an experienced special transfer pricing investigation squad (special TP team) with a twofold mission:

- to build up TP expertise to the benefit of all field Tax Inspectors and to develop the appropriate procedure to conduct tax audits in this area according to the OECD principles; and
- to carry out transfer pricing audits of multinationals present in Belgium through a subsidiary or branch.

### **1711 Use and availability of comparable information**

#### *Use*

As indicated above, Belgium, in its capacity as an OECD member, has adopted the OECD Guidelines. Comparable information could, therefore, be used in defending a pricing policy in accordance with the terms of the OECD Guidelines. It should be noted, however, that the preferred method of the authorities is the comparable uncontrolled price (CUP) method, although, if it is not possible to find CUPs, it may be possible to use other transfer pricing, methods which are acceptable within the terms of the OECD Guidelines. Practice shows that in most of the cases, the TNMM is used to test the arm's length nature of inter-company transactions.

#### *Availability*

The search for comparables relies primarily upon databases, which provide financial data on the major Belgian companies. These databases provide comprehensive annual financial data, historical information and information on business activities, all of which is largely extracted and compiled from statutory accounts.

In addition, the Belgian National Bank (BNB) maintains a database, which contains all statutory accounts. Entries are classified according to NACE industry code (i.e. by type of economic activity in which the company is engaged).

Information on comparable financial instruments (such as cash-pooling, factoring, etc) can be obtained from banks. This information (e.g. market interest rates) can then be used to support or defend a transfer pricing policy.

The 1999 administrative guidelines acknowledge that Belgium is a small country so sufficient comparable data may be hard to obtain. Consequently, the use of foreign comparables is accepted provided proper explanation can be provided as to the validity of using surrogate markets. The 2006 administrative guidelines reconfirm that pan European data cannot per se be rejected in the context of a benchmark analysis.

### **1712 Risk transactions or industries**

Generally, there are no industry sectors, which are more likely to be challenged than any other and, since there are no excluded transactions, all transactions between related companies may be under scrutiny.

Furthermore, the authorities are more likely to question the price of services than the transfer of goods, and it is noticeable that some transactions are attracting increasing attention.

#### *Debt waivers*

According to Article 207 of the ITC, in some circumstances a Belgian company receiving abnormal or gratuitous benefits, whether directly or indirectly, is not allowed to offset amongst others current year losses or losses carried forward against these benefits. The circumstances in which this applies are those where the company receiving the benefits is directly or indirectly dependent on the company granting such benefits. This rule is being used stringently in cases where a loss-making company benefits from a debt waiver. In these circumstances, the waiver is treated as an abnormal or gratuitous benefit although certain court cases (and also rulings) confirm the acceptability of intra-group debt waivers under particular circumstances.

#### *Permanent establishments – transactions with head office*

The tax rules and administrative practices can be summarised as follows.

It is acceptable that, for tax purposes, a contractual relationship exists between a head office and its permanent establishment (PE). Hence, the arm's length principle applies to any transactions between the head office and the PE, such as the sale of goods, the provision of services and the licensing of intangibles. It is accepted that 'notional profits' can arise from internal transfers and that, in accordance with this treatment, these might be subject to taxation before any profit is actually realised by the enterprise as a whole.

#### *Services*

During a tax audit, particular attention would be paid to payments such as management fees or technical support fees to establish whether these payments should actually have taken the form of dividends.

### 1713 Advance pricing agreements (APAs)

#### *Unilateral*

As of 1 January 2003, the Belgian government introduced a new ruling practice that seeks to increase upfront legal certainty for investors, while taking into account both national and international tax standards.

Under the new regime, a ruling is defined as an 'upfront agreement', which is a legal act by the Federal Public Service of Finance in conformity with the rules in force with respect to the application of law to a specific situation or operation which has not yet produced a tax effect.

Previously, a taxpayer could only apply for a ruling in a limited number of cases. Now, a taxpayer may apply for a ruling in all cases unless there is a specific exclusion. Although the Ministry of Finance acknowledges that it is impossible to provide a comprehensive list of all excluded topics, the new Ruling Practice nevertheless explicitly excludes some ruling categories to demonstrate the open nature of the new ruling system. To this end, a specific Royal Decree confirming the exclusions was published in January 2003.

A taxpayer may not apply for a ruling involving: tax rates, computations, returns and audits; evidence, statutes of limitation and professional secrecy; matters governed by a specific approval procedure; issues requiring liaison between the Ministry of Finance with other authorities, whereby the former cannot rule unilaterally; matters governed by diplomatic rules; penalty provisions and tax increases; systems of notional taxation as for instance used in the agricultural sector; and tax exemptions.

As mentioned, in 2004, further changes to the ruling procedure were made so to enhance a flexible cooperation between taxpayers and the Ruling Commission. At the same time, the ruling procedure itself has been rendered more efficient. These changes have come into play as of 1 January 2005.

The provisions of double taxation treaties fall within the scope of the new ruling practice, and, therefore, the Belgian competent authority will be involved in the preparatory phase of making the ruling decision so to ensure consistency of the decisions of the Ruling Commission in this respect.

Summaries of the rulings are published on an anonymous basis in the form of individual or collective summaries. The rulings are published at the government's website, unless a foreign taxpayer is involved and the treaty partner has rules preventing publication. In such cases, approval to publication of the ruling will be asked.

Under the revised ruling practice, the use of pre-filing meetings is encouraged. A request for an advance ruling can be filed by (registered) mail, fax or email. The Ruling Commission must confirm receipt of a request within five working days. Subsequently, a meeting is organised allowing the Ruling Commission to raise questions and the applicant to support its request. Recent experiences have demonstrated the effectiveness of the Commission and its willingness to accommodate, within the borders of the national and international legal framework, the search by the taxpayer for upfront certainty. Although there is no legally binding term to issue a ruling, it is the Ruling Commission's intention to issue its decision within a three-month period. In most cases, this three-month period is adhered to.

### *Bilateral / Multilateral*

Under the new ruling practice, it is noted that taxpayers may be invited to open multilateral discussions with other competent authorities. These issues will be dealt with on a case by case basis, according to the relevant competent authority provision as stipulated in the tax treaty.

Recent experience learns that also the Belgian tax authorities are promoting bilateral or multilateral agreements and that they take a cooperative position for realising such agreements.

#### **1714 Competent authorities**

On November 27, 2006, the United States and Belgium signed a new income tax treaty and protocol to replace the 1970 income tax treaty. This new treaty and protocol entered into force on December 28, 2007. The new treaty introduces an innovative binding arbitration procedure in the context of the Mutual Agreement Procedure (MAP). Indeed, when the competent authorities are unable to reach an agreement, the case shall be resolved through arbitration within six months from referral. In this type of arbitration, each of the tax authorities proposes only one figure for settlement, and the arbitrator must select one of both figures ("baseball arbitration").

#### **1715 Anticipated developments in law and practice**

Practice has shown a significant increase in transfer pricing audits in Belgium. It is expected for this trend to be sustained.

Within that framework, the importance of having available upfront transfer pricing documentation will only rise.

In terms of new laws, no developments are anticipated in the coming months.

#### **1716 Liaison with customs authorities**

While the possibility exists of an exchange of information between the income tax and customs authorities, experience suggests that this rarely happens in practice.

#### **1717 Joint investigations**

A facility exists for the Belgian tax authorities to exchange information with the tax authorities of another country. According to Belgian law, such an exchange must be organised through the Central Tax Administration. A number of bilateral treaties have been concluded to facilitate this process.

The 1999 administrative Guidelines also consider the possibility to conducting joint investigations with foreign tax authorities.

Belgium is currently involved in several of these multilateral audits.

#### **1718 Thin capitalisation**

The arm's length principle applies to financing arrangements between affiliated parties. Article 55 of the ITC provides that interest paid is a tax deductible business expense provided that the rate of interest does not exceed normal rates, taking into account the specific risks of the operation, i.e. among others the financial status of the debtor and the duration of the loan.

For many years there was no general 'maximum permissible' ratio of debt to equity, although it should be noted that related party loans from shareholders or directors of a Belgian borrowing company are subject to specific restriction.

A Royal Decree, issued in January 1997, provides that, where a company's debt to equity ratio exceeds 7:1, interest will no longer be tax deductible when paid to persons who are subject to a considerably more favourable tax regime than in Belgium. This applies to interest payments made after 1 January 1997, unless the payments are under a contract concluded before 18 October 1996. The EU Lankhorst-Hohorst case is not expected to impact the Belgian thin capitalisation rules.



# 18 Brazil

## 1801 Introduction

From the outset, Brazil's transfer pricing rules, which became effective as of 1 January 1997, have been very controversial. The intention of the rules has been to enable the Brazilian Government to prevent multinational companies from transferring taxable income abroad through the manipulation of prices on imports and exports of products, services, and rights charged between related parties. The rules also address inter-company financing transactions not registered with the Brazilian Central Bank, as well as all import and export transactions between Brazilian residents (individual or legal entity) and residents in either low tax jurisdictions (as defined in the Brazilian legislation) or jurisdictions with internal legislation that call for secrecy relating to corporate ownership, regardless of any relation.

Contrary to the OECD Guidelines, US transfer pricing regulations, as well as the transfer pricing rules introduced by some of Brazil's key Latin American trading partners such as Mexico and Argentina, Brazil's transfer pricing rules do not adopt the internationally accepted arm's length principle. Instead, Brazil's transfer pricing rules define maximum price ceilings for deductible expenses on inter-company import transactions and minimum gross income floors for inter-company export transactions.

At the same time, through the provision of safe harbours and exemptions, the new rules were designed to facilitate the monitoring of inter-company transactions by the Brazilian tax authorities while they develop more profound technical skills and experience in the domain. Since the Brazilian rules do not adopt the arm's length principle, multinational companies with Brazilian operations have had to evaluate their potential tax exposure and develop a special transfer pricing plan to defend and optimise their overall international tax exposure. From the outset, planning to avoid potential double taxation has been especially important.

In view of the substantial double taxation and documentation burdens recently, a coalition of several international chambers of commerce and multinational companies has been lobbying for a significant overhaul of the current regulatory framework. Mainly as a result of this initiative, in August, 2001, legislators presented to the Brazilian Congress a draft legal bill to change the current transfer pricing law. In its initial form, the new law would bring Brazil's transfer pricing rules more in line with international standards, including the adoption of the arm's length principle. Presently, several commissions of the Brazilian House of Representatives are discussing the bill; however, it is not possible at this time to predict the timing and outcome.

## 1802 Statutory rules

In order to prevent income tax evasion through price manipulation, the Brazilian Government introduced transfer pricing rules specifically aimed at two areas over which it felt that it had little control – import and export transactions conducted by multinationals with foreign related parties. The rules require that a Brazilian company substantiate its inter-company import and export prices on an annual basis by

comparing the actual transfer price with a benchmark price determined under any one of the Brazilian equivalents of the OECD's comparable uncontrolled price method (CUP method), resale price method (RPM) or cost plus method (CP method). Taxpayers are required to apply the same method, which they elect, for each product or type of transaction consistently throughout the respective fiscal year. However, taxpayers are not required to apply the same method for different products and services.

While incorporating these transaction-based methods, the drafters of the Brazilian transfer pricing rules excluded profit-based methods, such as the transactional net margin method (TNMM) or profit split methods (PSM). This is contrary to the OECD Guidelines and the US transfer pricing regulations, as well as the transfer pricing regulations introduced in Mexico and Argentina.

Other material differences from internationally adopted transfer pricing regimes include Brazilian transfer pricing legislation's exclusion of a best method or most appropriate method rule; accordingly, a taxpayer may choose the respective pricing method. In addition, the Brazilian transfer pricing rules explicitly exclude inter-company royalties and technical, scientific, administrative or similar assistance fees, which remain subject to previously established deductibility limits and other specific regulations.

#### *Rules regarding imports of goods, services or rights*

Regarding imports, the government's main objective is to prevent multinationals from shifting income abroad by overcharging their Brazilian affiliates for imported products, services and rights. To this end, deductible import prices relating to the acquisition of property, services and rights from foreign related parties should be determined under one of the following three Brazilian equivalents of the OECD's traditional transaction methods:

#### *Comparable independent price method (PIC)*

This Brazilian equivalent of the CUP method is defined as the weighted average price for the year of identical or similar property, services, or rights obtained either in Brazil or abroad in buy-sell transactions using similar payment terms. For this purpose, only buy-sell transactions conducted by unrelated parties may be used.

#### *Resale price less profit method (PRL)*

This Brazilian equivalent of the RPM has originally been defined as the weighted average price for the year of the resale of property, services or rights minus unconditional discounts, taxes and contributions on sales, commissions, and a gross profit margin of 20% calculated based on the resale price (less unconditional discounts). If value is added before resale, the margin profit is increased to 60%, calculated based on the percentage of the value imported over the final resale price. In applying the PRL, a Brazilian taxpayer may use his/her own prices (wholesale or retail), established with unrelated persons.

#### *Production cost plus profit method (CPL)*

This Brazilian equivalent of the CP method is defined as the weighted average cost incurred for the year to produce identical or similar property, services, or rights in the

country where they were originally produced, increased for taxes and duties imposed by that country on exportation plus a gross profit margin of 20%, calculated based on the obtained cost.

Production costs for application of the CPL are limited to costs of goods, services or rights sold. Operating expenses, such as research and development (R&D), selling and administrative expenses, may not be included in the production costs of goods sold to Brazil.

In the event that more than one method is used, the method that provides the highest value for imported products will be considered by the Brazilian tax authorities as the appropriate import price. This is intended to provide taxpayers with the flexibility to choose the method most suitable to them. The Brazilian rules require that each import transaction be tested by the benchmark price determined using one of the three methods, as applicable to the type of transaction (this also applies to export transactions).

If the import sales price of a specific inter-company transaction is equal to or less than the benchmark price determined by one of the methods, no adjustment is required. On the other hand, if the import sales price exceeds the determined benchmark price, the taxpayer is required to make an adjustment to the calculation basis of income tax and social contribution.

The aforementioned excess must be accounted for in the retained earnings account (debit) against the asset account or against the corresponding cost or expense if the good, service or right has already been charged to the income statement.

One of the most controversial issues often raised with regard to import transactions is the treatment of freight and insurance costs as well as Brazilian import duty costs for purposes of applying the Brazilian transfer pricing rules. The current transfer pricing law considers freight and insurance costs as well as Brazilian import duty costs borne by the Brazilian taxpayer as an integral part of import costs, i.e. the tested import price. Meanwhile, the first transfer pricing regulations of 1997 gave taxpayers the option to include or exclude such cost items.

As a result of this controversy, the treatment of freight and insurance costs as well as Brazilian import duty costs borne by the Brazilian taxpayer became a matter of interpretation. Interpreting the legislation as requiring the inclusion of import duties and freight and insurance charges assumed by the taxpayer as part of the actual transfer price leads to an increase in the actual transfer price. From an economic perspective, however, considering that the payment of import duties and freight and insurance costs does not result in a transfer of profits to a foreign entity, taxpayers should be allowed to use only the free on board (FOB) price paid for imports as the tested transfer price.

According to the latest regulatory norms published in November 2002, taxpayers may now compare a benchmark price calculated under the CPL or PIC methods with an actual transfer price that includes or excludes freight and insurance costs as well as Brazilian import duty costs borne by the Brazilian taxpayer. Meanwhile, for testing under the PRL, freight and insurance costs as well as Brazilian import duty costs borne by the Brazilian taxpayer now always have to be added to the benchmark PRL price. This benchmark price is then compared with an actual transfer price that in accordance with the transfer pricing law includes the same cost components. Since these cost items form part of, both, PRL benchmark price and tested transfer price, their economic impact is nullified.

### *Rules regarding exports of goods, services and rights*

In the case of export sales, the regulations provide a safe harbour whereby a taxpayer will be deemed to have an appropriate transfer price with respect to export sales when the average export sales price is at least 90% of the average domestic sales price of the same property, services, or intangible rights in the Brazilian market during the same period under similar payment terms. When a company does not conduct sales transactions in the Brazilian market, the determination of the average price is based on data obtained from other companies that sell identical or similar property, services, or intangible rights in the Brazilian market. When it is determined that the export sales price is less than 90% of the average sales price in the Brazilian market, the Brazilian company is required to substantiate its export transfer prices, based on the benchmark obtained using one of the following Brazilian equivalents of the OECD's traditional transaction methods:

#### *Export sales price method (PVE<sub>x</sub>)*

This Brazilian equivalent of the CUP method is defined as the weighted average of the export sales price charged by the company to other customers or other national exporters of identical or similar property, services, or rights during the same tax year using similar payment terms.

#### *Resale price methods*

The Brazilian versions of the RPM for export transactions are defined as the weighted average price of identical or similar property, services, or rights in the country of destination under similar payment terms reduced by the taxes included in the price imposed by that country and a profit margin of either:

- 15%, calculated by reference to the wholesale price in the country of destination (wholesale price in country of destination less profit method, or PVA); or
- 30%, calculated by reference to the retail price in the country of destination (retail price in country of destination less profit method, or PVV).

#### *Purchase or production cost plus taxes and profit method (CAP)*

This Brazilian equivalent of the CP method is defined as the weighted average cost of acquisition or production of exported property, services, or rights increased for taxes and duties imposed by Brazil plus a profit margin of 15%, calculated based on the sum of the costs, taxes and duties.

In the event that the export sales price of a specific inter-company transaction is equal to or more than the transfer price determined by one of these methods, no adjustment is required to be made. On the other hand, if the export sales price of a specific inter-company export transaction is less than the determined transfer price, the taxpayer is required to make an adjustment to the calculation bases of income tax and social contribution.

### *Rules regarding interest on debt paid to a foreign related person*

The statutory rules provide that interest on related party loans that are duly registered with the Brazilian Central Bank will not be subject to transfer pricing adjustments.

However, interest paid on a loan issued to a related person that is not registered with the Brazilian Central Bank will be deductible only to the extent that the interest rate equals the LIBOR dollar rate for six-month loans plus 3% per year (adjusted to the contract's period). The actual amount of the interest paid on the loan in excess of this limitation will not be deductible for income tax and social contribution purposes.

The rules do not provide a reallocation rule, which would treat the foreign lender as having received less interest income for withholding tax purposes. Due to the fact that the foreign lender actually received the full amount of the interest in cash, the foreign lender will still be required to pay withholding tax at the rate of 15% on the full amount paid, including the excess interest. The punitive nature of this rule indicates the degree of disapproval by the Brazilian tax authorities.

Similarly, loans extended by a Brazilian company to a foreign related party that are not registered with the Brazilian Central Bank must charge interest at least equal to the LIBOR dollar rate for six-month loans plus 3%. This rule applies to loans made by Brazilian companies to foreign related companies as a means of extracting blocked cash from Brazil.

#### *Rules regarding royalties and technical assistance*

The statutory rules expressly exclude royalties and technical, scientific, administrative or similar assistance remittances from the scope of the transfer pricing legislation. Accordingly, provisions of the Brazilian income tax law established before the Brazilian transfer pricing rules went into effect still regulate the remittances and deductibility of inter-company payments for royalties and technical assistance fees.

According to this preceding legislation, royalties for the use of patents, trademarks and know-how, as well as remuneration for technical, scientific, administrative or other assistance paid by a Brazilian entity to a foreign related party are only deductible up to a fixed percentage limit set by the Brazilian Ministry of Finance. The percentage limit depends on the type of underlying royalty, product or industry involved (the maximum is 5% of related revenues, 1% in the case of trademarks).

Additionally, royalties and technical assistance fees are only deductible if the underlying contracts signed between the related parties have been approved by the National Institute of Industrial Property (INPI) and registered with the Brazilian Central Bank after 31 December 1991. Royalty payments that do not comply with the above-mentioned regulations and restrictions are not deductible for income tax.

Thus, while royalty and technical assistance payments are not subject to transfer pricing rules, they are subject to rules that impose fixed parameters that are not in accordance with the arm's length principle, except for royalties for the use of a copyright (e.g. software licences), which are not subject to the rate limitations mentioned above and, in most cases, are paid at much higher rates. Such remittances are subject to Brazil's transfer pricing rules for import transactions.

As of 1 January 2002, all royalty and technical, scientific, administrative or similar assistance remittances to non-residents are subject to a withholding tax of 15% and a contribution to a federal R&D investment fund (the *Contribuição de Intervenção no Domínio Econômico*, or CIDE) of 10%.

The Brazilian transfer pricing regulations make no mention of royalty and technical assistance payments received by a Brazilian taxpayer from a foreign related party. Hence, such foreign-source revenues should be subject to Brazil's transfer pricing

rules for export transactions.

### *Definition of related persons*

Brazil's transfer pricing rules provide a much broader definition of related parties than do internationally accepted transfer pricing principles. As described in the following section, the regulations go so far as to characterise foreign persons as being related when such persons are located in low tax jurisdictions, whether or not there exists a relationship between them. The statutory list of related persons illustrates that the transfer pricing regulations clearly target foreign related parties since none of the listed relationships would result in a Brazilian company being considered as related to another Brazilian company. Thus, the transfer pricing rules do not apply to two Brazilian sister companies, leaving the possibility for multinationals to conduct inter-company transfers between their Brazilian subsidiaries on non-arm's length terms. Inter-company transactions in a purely domestic context are covered by the disguised dividend distribution rules described below, which are less rigorous.

Under the statutory rules, a foreign company and a Brazilian company may be considered to be related if the foreign company owns as little as 10% of the Brazilian company, or when at least 10% of the capital of each of them is owned by the same person.

Additionally, regardless of any underlying relationship, the Brazilian definition of related parties considers a foreign person to be related to a Brazilian company if, in the case of export transactions, the foreign person operates as an exclusive agent of the Brazilian company or, in the case of import transactions, the Brazilian company operates as an exclusive agent of the foreign person. This broad definition was specifically designed to control potential price manipulations between third parties in an exclusive commercial relationship. For these purposes, exclusivity is evidenced by a formal written contract, or in the absence of one, by the practice of commercial operations relating to a specific product, service or right that are carried out exclusively between the two companies or exclusively via the intermediation of one of them. An exclusive distributor or dealer is considered to be the individual or legal entity with exclusive rights in one region or throughout the whole country.

### *Companies located in low tax jurisdictions or jurisdiction that allows secrecy in regard to corporate ownership*

Under the regulations, the transfer pricing rules apply to transactions conducted with a foreign resident, even if unrelated, that is domiciled in a country that does not tax income or that taxes income at a rate of less than 20% or in a jurisdiction with internal legislation allowing secrecy in regard to corporate ownership. For these purposes, the tax legislation of the referred country applicable to individuals or legal entities will be considered, depending on the nature of the party with which the operation was carried out. This rule creates some practical compliance issues in that it requires Brazilian companies to inform the tax authorities regarding transactions conducted with companies in tax havens even though the parties are completely unrelated and the transactions were contracted at arm's length.

In an effort to facilitate compliance by taxpayers, the Brazilian tax authorities have issued an inclusive list of jurisdictions that they consider as tax havens or without

disclosure of corporate ownership. This list currently includes the following jurisdictions: American Samoa, Andorra, Anguilla, Antigua and Barbuda, Dutch Antilles, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, Campione D'Italia, Singapore, Cyprus, Costa Rica, Djibouti, Dominica, Gibraltar, Granada, Cayman Islands, Cook Islands, Island of Madeira (Portugal), Isle of Man, Channel Islands (Jersey, Guernsey, Alderney, Sark), Hong Kong, Marshall Islands, Samoa Islands, Turks and Caicos Islands, British Virgin Islands, US Virgin Islands, Labuan, Lebanon, Liberia, Liechtenstein, Luxembourg (regarding holding companies established according to Luxembourg's law of 31 July 1929), Macau, Maldives, Malta, Mauritius, Monaco, Monserrat, Nauru, Nieu, Oman, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and Grenadines, San Marino, Seychelles, Tonga, Vanuatu and United Arab Emirates.

### **1803 Other regulations**

#### *Contemporaneous documentation requirements*

Many taxpayers initially failed to appreciate the complexities created by the Brazilian transfer pricing rules and their practical application to particular circumstances. The general impression held by many companies was that the fixed-income margins established by the Brazilian rules made it easier to comply with the rules and eliminated the need for detailed economic studies and supporting documentation. In practice, however, the actual application of the rules has shown that they are more complicated than they appear to be. The amount of information necessary to comply with the rules was underestimated because the regulations did not provide any contemporaneous documentation requirements.

This changed in August 1999, when the Brazilian tax authorities issued new information requirements concerning transfer pricing as part of the manual for filing the annual income tax return (*Declaração de Informações Econômico-Fiscais da Pessoa Jurídica*, or DIPJ). These documentation requirements, which include five new information forms (*Fichas*) for transactions conducted with foreign related parties, have greatly increased the transfer pricing compliance burden. These forms oblige taxpayers filing their annual tax returns to provide detailed disclosure regarding their inter-company import and export transactions, the method applied to test the inter-company price for the 49 largest import and export transactions, and the amount of any adjustments to income resulting from the application of the method to a specific transaction during the fiscal year in question.

For most companies, the elements needed to comply with the information requirements imposed by the new information returns and a possible transfer pricing audit should be available through analytical information or the accounting system. However, many companies have yet to develop the systems that can provide the information needed to comply with these requirements as well as for purposes of determining the best transfer pricing methodology. Companies need to develop the necessary information-reporting systems and controls that can provide reliable accounting information regarding all transactions conducted with foreign parties to both facilitate compliance with the Brazilian transfer pricing rules and to properly defend on audit.

### *Divergence margin*

For inter-company import and export transactions, even if the actually practiced transfer price is above the determined transfer price (for import transactions) or below the determined transfer price (for export transactions), no adjustment will be required as long as the actual import transfer price does not exceed the determined transfer price by more than 5% (i.e. as long as the actual export transfer price is not inferior to the calculated transfer price by more than 5%).

### *Relief of proof rule for inter-company export transactions*

In addition to the statutory 90% safe harbour rule for inter-company export transactions, there is a secondary compliance rule (herein referred to as the 'relief of proof rule') whereby a taxpayer may be relieved of the obligation to substantiate the export sales price to foreign related persons using one of the statutory methods if it can demonstrate either of the following:

- (1) net income derived from inter-company export sales, taking into account the annual average for the calculation period and the two preceding years, excluding companies in low tax jurisdictions and transactions for which the taxpayer is permitted to use different fixed margins is at least 5% of the revenue from such sales; or
- (2) net revenues from exports do not exceed 5% of the taxpayer's total net revenues in the corresponding fiscal year.

If a taxpayer can satisfy the relief of proof rule, the taxpayer may prove that the export sales prices charged to related foreign persons are adequate for Brazilian tax purposes using only the export documents related to those transactions.

### *Exchange adjustment*

With the objective to minimise the effect of the appreciation of local currency vis a vis the US dollar and the Euro, the Brazilian authorities issued Ordinances and Normative Instructions at the end of 2005, 2006 and 2007 which amended the Brazilian transfer pricing legislation for export transactions only. As per these amendments, Brazilian exporting companies will be allowed to increase their export revenues for calendar year 2005, 2006 and 2007 (for transfer pricing calculation purposes only) using the ratio of 1.35, 1.29 and 1.28, respectively. This exceptional measure will only apply for fiscal years 2005, 2006 and 2007 and for the statutory 90% safe harbour, 5% net income relief of proof and CAP method.

### *Cost-contribution arrangements*

No statutory or other regulations on cost-contribution arrangements have been enacted at this point. Accordingly, deductibility of expenses deriving from cost-contribution arrangements is subject to Brazil's general rules on deductibility, which require deductible expenses to be (i) actually incurred, (ii) ordinary and necessary for the transactions or business activities of the Brazilian entity, and (iii) properly documented.

Based on our experience, Brazilian Tax Authorities will assume that related charges merely represent an allocation of costs made by the foreign company and consequently



will disallow deductibility for income tax and social contribution on net income, unless the Brazilian taxpayer can prove that it actually received an identifiable benefit from each of the charged services specified in any corresponding contracts. Sufficient support documentation is crucial to substantiate any claims that expenses are ordinary and necessary, especially in the case of international inter-company cost-contribution arrangements.

In past decisions, the Brazilian tax authorities and local courts have repeatedly ruled against the deductibility of expenses deriving from cost-contribution arrangements due to the lack of proof that services and related benefits had actually been received by the Brazilian entity. Also, in past decisions, the Brazilian tax authorities have ruled against the deductibility of R&D expenses incurred by a foreign related party and allocated as part of the production cost base in the calculation of the CPL for inter-company import transactions.

With the exception of cost-contribution arrangements involving technical and scientific assistance with a transfer of technology, which are treated in the same way as royalties (please see above), resulting inter-company charges will have to comply with Brazil's transfer pricing regulations, in order to be fully deductible. Due to the nature of the transaction, the CPL is usually the most practicable documentation method.

#### **1804 Legal cases**

Prior to 1 January 2000, the PRL method was defined as the average price for the year of the resale of the property, services, or rights less unconditional discounts, taxes and contributions on sales, commissions and a gross profit margin of 20% calculated based on the resale price. As per Normative Instruction 38, issued in 1997, the PRL method was unavailable to the importation of any product, service, or right acquired to be used by the Brazilian importer in the local production of another product or service.

Based on the above-mentioned, the Brazilian tax authorities issued rulings as to the application of the PRL to the importation of active ingredients utilised to produce medicines for final consumption. The rulings held that the resale price method could not be used even where the Brazilian company had imported active ingredients in order to be transformed into final format for sale to consumers, since the product sold is different from the product that was imported. Hence, these rulings had precluded the use of the PRL method by those industries such as the pharmaceutical industry, which relied on their Brazilian subsidiaries to function as mere contract manufacturers or assemblers of products that are developed and produced abroad and merely put into final format (e.g. through assembly or packaging) by the Brazilian company.

Due to the severe difficulty of complying with this strict interpretation, the Brazilian government amended the PRL method in October 1999 for inter-company import transactions performed as from 1 January 2000, which involve an industrialisation process in Brazil before resale. Under the amendment, the PRL for inputs has been defined as the average resale price of the final product for the year less unconditional discounts, taxes and contributions on sales, commissions, the value added in Brazil and a profit margin of 60%. The 60% amended PRL method offered, as of 1 January 2000, an alternative to these industries. Nevertheless, the Brazilian tax authorities kept assessing entities (mainly pharmaceutical) for tax years 1997 to 1999, which

had used the PRL method (minus a profit margin of 20%) for import transactions of product, service, or right acquired to be used by the Brazilian importer in the local production of another product or service.

Two of these assessed entities contested the assessment (issued for tax years 1998 and 1999), at the Brazilian Taxpayers' Council. The main arguments raised by the two entities were that the Normative Instruction 38 (which is in general terms an interpretation bulletin of the law) could not prohibit the application of the PRL method as the Law 9430 did not include such exclusion. Additionally, it was argued that neither of the two other methods (PIC and CPL) were applicable, that is, no comparables were available and the foreign parent companies were disinclined to disclose their production cost of the imported pharmaceutical ingredients.

The Taxpayers' Council upheld the entities' arguments and overturned the assessments issued by the Brazilian authorities. Such decisions represent a foremost precedent as the Brazilian authorities, based on the same grounds, have assessed other Brazilian entities.

### **1805 Burden of proof**

The taxpayer is obliged to satisfy the burden of proof that it has complied with the transfer pricing regulations as of the date the annual corporate income tax return is filed. However, the fact that the Brazilian rules allow taxpayers to choose from several methods for each type of transaction does provide those taxpayers that properly prepare themselves with an advantage over the tax authorities. Proper and timely preparation enables taxpayers to collect the necessary information and choose the most appropriate method in advance. The rules also state that the tax authorities can disregard information when considered unsuitable or inconsistent. Assuming that the methodology is applied and documented correctly, taxpayers can satisfy the burden of proof and push the burden back to the tax authorities. This also applies when a taxpayer can satisfy the relief of proof rule for inter-company export transactions.

### **1806 Tax audit procedures**

Audits are the Brazilian tax authorities' main enforcement tool with regard to transfer pricing. Transfer pricing may be reviewed as part of a comprehensive tax audit or a specific transfer pricing audit. The Brazilian tax authorities have begun auditing companies with respect to transfer pricing.

### **1807 The audit procedure**

The audit procedure occurs annually, except in some cases such as suspicion of fraud. As part of the audit process, a Brazilian taxpayer is required by the regulations to provide the transfer pricing calculation used to test inter-company transactions conducted with foreign related parties as well as the supporting documents. Since the taxpayer is obliged to satisfy the burden of proof that it has complied with the transfer pricing regulations as of the date the tax return is filed, it is important that taxpayers have prepared the support and calculations at that time. If the taxpayer fails to provide complete information regarding the methodologies and the supporting documentation, the regulations grant the tax inspector the authority to make a transfer pricing adjustment based on available financial information by applying one of the

applicable methods.

As part of the audit process, the tax inspectors typically request that the methods used by the taxpayer be reconciled with the accounting books and records. The tax inspector also requests significant accounting information that is used to independently confirm the calculations performed by the company. The information requested by the tax inspector may be quite burdensome and may require the company to provide confidential data regarding the production cost per product, the prices charged in the domestic market, and the prices charged to foreign related and independent parties.

As previously mentioned, companies need to develop the necessary information-reporting systems and controls that can provide reliable accounting information regarding all transactions conducted with foreign related parties in advance to properly defend on audit.

### **1808 Assessments and penalties**

In making an assessment, the tax inspector is not required to use the most favourable method available. Thus, the inspector will most likely use the method that is most appropriate under the circumstances and assess income tax and social contribution at the maximum combined rate of 34%. The objective of an assessment would not necessarily result in the true arm's length result but would rather be based on an objective price determined by the regulations.

In the case of exports, the tax inspector would most likely use the CAP, because he or she could rely on the Brazilian cost accounting information of the taxpayer. In the case of imports, the tax inspector may have independent data collected from customs authorities, using import prices set by other importers for comparable products, based on the customs valuation rules.

If the Brazilian tax authorities were to conclude that there is a deficiency and make an income adjustment, penalties may be imposed at the rate of 75% of the assessed tax deficiency. The rate may be reduced by 50% of the penalty imposed in the event that the taxpayer agrees to pay the assessed tax deficiency within 30 days without contesting the assessment. On the other hand, if the assessed tax deficiency is not paid within 30 days, the penalty rate is increased to 112.5% of the tax liability. In addition, interest would be imposed on the amount of the tax deficiency from the date the tax would have been due if it had been properly recognised. In this instance, the interest rate used is the federal rate established by the Brazilian Central Bank known as the SELIC, which currently exceeds 1% per month.

### **1809 Resources available to the tax authorities**

The Brazilian tax authorities have created a group of agents specialised in transfer pricing audits. In addition, all tax agencies have a special area dedicated to the investigation and development of audits that conduct studies and form databases that can be used to compare prices and profit margins across industries and to identify questionable companies for audit. The electronic contemporaneous documentation filing requirements (DIPJ) for transfer pricing purposes facilitate the creation of such comprehensive databases. Since taxpayers are required to report in the DIPJ the average annual transfer prices for the 49 largest inter-company import and export transactions, the Brazilian tax authorities will be able to test these prices

using the prices of similar products that were traded by other companies. In addition, as mentioned before, the tax inspector may also use data collected from the customs authorities' electronic Integrated System for International Trade (Sistema Integrado de Comércio Exterior, or SISCOMEX).

### **1810 Liaison with customs authorities**

In principle, it should not be possible to have different import values for customs and transfer pricing purposes. However, in determining import sales prices, the transfer pricing rules and customs valuation rules are not the same. It is quite common to find that the customs and transfer pricing rules result in different import prices. In practice, many multinational companies find themselves having to use an import sales price for customs purposes that is higher than the price determined by the transfer pricing rules. As a result, the multinational company finds itself paying higher customs duties and, at the same time, making a downward adjustment to the price for transfer pricing purposes. In an effort to reduce such cases where customs valuations are found unacceptable for tax purposes and vice versa, cooperation between Brazilian tax and customs authorities in evaluating transfer prices is increasing.

### **1811 Limitation of double taxation and competent authority proceedings**

Should the Brazilian tax authorities adjust transfer prices, it is possible that the same income would be taxed twice, once in Brazil and once in the foreign country. Multinational companies transacting with their Brazilian affiliates through countries that have not signed a double tax agreement (DTA) with Brazil, such as the US and the UK, cannot pursue competent authority relief as a means of preventing double taxation arising from an income adjustment. Multinational companies transacting with their Brazilian affiliates through treaty countries may appeal for relief under the competent authority provisions of Brazil's tax treaties, although such recourse has never been tested by taxpayers to prevent double taxation. Since the Brazilian transfer pricing rules were enacted after the signing of the various tax treaties, until now, reasons for evoking competent authority relief on transfer pricing grounds did not exist.

However, the Brazilian transfer pricing regulations do state that the transfer prices established may be evidenced by a pronouncement by the tax authorities from a country with which Brazil has an agreement to avoid double taxation or to exchange information. Presumably this means that an advance pricing agreement (APA) obtained by a multinational company from the tax authorities of a treaty country could be used to justify a transfer price that does not satisfy the Brazilian transfer pricing rules.

### **1812 Advance pricing agreements (APAs)**

While Brazil's transfer pricing rules do not expressly refer to the institution of APAs, the statutory rules do leave some leeway with regard to the negotiation of an advance ruling from the tax authorities that a taxpayer's transfer prices are appropriate, even though they do not meet the fixed profit margins contained in the statute. Such different profit margins may be applied in special cases when the taxpayer can prove through an economic study that a different transfer price is justified. This may help

taxpayers to avoid the double taxation of income through the inconsistent application of the transfer pricing rules by Brazil and the country in which the foreign related person is located.

The regulations specifically state that taxpayers may file ruling requests to alter the fixed profit margins for either industry sectors or individual taxpayers. Careful planning and substantial documentation will be necessary to justify lower margins to the Brazilian tax authorities. To date, however, no ruling requests have been filed with the Brazilian tax authorities.

In addition, as mentioned in the previous section, the Brazilian transfer pricing regulations do state that the transfer prices established may be evidenced by a pronouncement by the tax authorities from a country with which Brazil has an agreement to avoid double taxation or to exchange information. Presumably this means that an APA obtained by a multinational company from a treaty country could be used to justify a transfer price that does not satisfy the Brazilian transfer pricing rules.

### **1813 OECD issues**

As with many other countries, Brazil is still at an initial stage in developing its transfer pricing policies. Brazil's transfer pricing regime has been criticised abroad for its failure to abide by international transfer pricing principles. For the most part, the Brazilian transfer pricing rules focus not on the identification of the true arm's length price or profit but on objective methods for determining what the 'appropriate' transfer price should be for Brazilian tax purposes. The regulations themselves do not mention the arm's length principle, and the rules do not expressly require that related parties conduct their operations in the same manner as independent parties.

Brazil is not an OECD member country. However, in the preamble to the tax bill that introduced the transfer pricing rules, the Brazilian Government stated that the new rules are in conformity with the rules adopted by OECD member countries. As mentioned above, in a more recent ruling, the Brazilian tax authorities reaffirmed that they consider Brazil's transfer pricing regulations to be in line with the arm's length principle as established in Article 9 of the OECD Model Tax Convention. Although these pronouncements appear to be an endorsement of the arm's length principle as the norm for evaluating the results achieved by multinational enterprises in their international inter-company transactions, the regulations do not provide the same level of explicit guidance and flexibility provided by the OECD Guidelines.

The fixed percentage margin rules, which have the appearance of safe harbours, are designed to facilitate administration and compliance and not necessarily to foster a fair and flexible system seeking maximum compatibility with the arm's length principle. The Brazilian rules prescribe methodologies for computing arm's length prices that are different from the methodologies approved by the US Regulations and the OECD Guidelines and apply to transactions between certain unrelated parties. In other areas, such as technology transfers and cost-contribution arrangements, Brazil has failed altogether to establish transfer pricing rules.

The question is whether non-Brazilian OECD compliant methods may be applied by taxpayers in valid situations when the three Brazilian transaction-based methods cannot be applied for practical reasons (for example, lack of applicability in general, lack of reliable information, etc). In the case of transactions conducted with related

parties in treaty countries, there is a strong basis to conclude that the treaties, which are based on the OECD model treaty and supersede Brazilian domestic laws, should allow a Brazilian company to apply profit-based methods accepted by the OECD.

In the case of transactions conducted with related parties located in non-treaty jurisdictions, such as the US, there is also room for interpreting the regulations as allowing the use of other methods. According to the regulations, transfer prices may be evidenced by transfer pricing studies performed by a company or an institution that is recognised for its technical expertise, which is conducted specifying the sector, the period, companies researched and margins encountered, as well as identify for each company the data collected and assembled. Such studies may be admitted as support for the transfer price if they observe internationally accepted methods of evaluation.

In practice, however, the Brazilian tax authorities have demonstrated that they clearly do not agree with this interpretation, especially when it comes to methodologies not provided in the Brazilian transfer pricing regulations. In transfer pricing audits, the Brazilian tax authorities have repeatedly rejected economic studies prepared in line with the arm's length principle under observance of the OECD Guidelines as acceptable documentation. It can be assumed that the Brazilian tax authorities do not want to set a precedent that would allow multinational companies to bypass the rigid Brazilian documentation methods in favour of more flexible OECD approaches. Defending the use of OECD methodologies may eventually be resolved only in the courts, involving a lengthy and costly legal process.

#### **1814 Disguised dividend distributions**

Brazil's income tax law lists seven types of related party transactions (domestic and international) that are deemed to give rise to disguised distributions of dividends. In summary, such disguised distributions of dividends encompass all those transactions between a Brazilian legal entity and its individual or corporate administrator(s) and/or controlling partner(s) or shareholder(s) that are negotiated at terms more favourable than fair market value. In the concrete case of related party financing transactions these rules have a certain analogy to thin capitalisation rules or practices. Amounts characterised as disguised dividends are added to the taxable income of the legal entity deemed to have performed such a disguised distribution. This rule does not apply when the taxpayer can substantiate that the terms of the related party transactions were at fair market value. However, as mentioned before, compliance with these disguised dividend distribution rules is less rigorously enforced than compliance with the transfer pricing rules, which focus exclusively on international inter-company transactions.

#### **1815 Proposal to change Brazilian transfer pricing law**

Partially as a result of an initiative led by several international chambers of commerce and multinational companies, in August 2001 legislators presented to the Brazilian Congress a draft legal bill to change the current transfer pricing law. In its initial form, the new law would bring Brazil's transfer pricing rules more in line with international standards. The main innovations would be the explicit adoption of the arm's length principle, the transformation of the current documentation methodologies into true safe harbours, the acceptance of functional analyses, the recognition of the TNMM,

the admittance of the basket approach, the applicability of the transfer pricing rules for those royalty and technical assistance remittances that exceed 5% on an annual accumulated basis, as well as the harmonisation of transfer pricing rules with Brazil's customs valuation regulations.

Other important modifications would include the adoption of comparability concepts for potential differences in geographic markets, functions, and risks, the removal of the exclusivity concept as a determinant for definition of related party, the requirement for an exclusive 'black list' of low tax jurisdictions to be presented by the Brazilian tax authorities by the end of each fiscal year, the introduction of certain relieves of documentation for draw back transactions, and the clear exclusion of freight and insurance costs as well as import duties from costs for transfer pricing purposes. Finally, the proposed transfer pricing law would also further formalise advance pricing agreements and ruling requests for alterations in fixed-margin requirements.

In its initial form, the reformed transfer pricing law would be a giant step in aligning Brazil's transfer regulations with internationally adopted principles. Presently, several commissions of the Brazilian House of Representatives are discussing the bill without any prediction of timing and outcome of an eventual vote by the two chambers of Brazil's Congress.

# 19 Bulgaria

## 1901 Introduction

The Bulgarian tax legislation requires that taxpayers determine their taxable profits and income applying the arm's length principle to prices at which they exchange goods, services, and intangibles with related parties (i.e. transfer prices). Interest on loans provided by related parties should be consistent with the market conditions effective at the time when the loan agreement is concluded.

The transfer pricing rules apply for transactions between resident persons, as well as for transactions between resident persons and non-residents.

## 1902 Statutory rules

The Bulgarian transfer pricing rules are provided in the Corporate Income Tax Act (CITA), Tax and Social Security Procedures Code, as well as in The Ordinance <sup>1</sup> H-9 for implementation of the transfer pricing methods, issued by the Minister of Finance on 29 August 2006.

The CITA sets the arm's length principle and explicitly determines cases where the prices are deemed not to comply with this principle (e.g. in cases of receiving or granting loans against an interest, which differs from the market interest rate effective at the time the loan agreement is concluded).

The Tax and Social Security Procedures Code include a definition of related parties and stipulates the method to be used when determining prices on transactions between related parties.

### *Definition of related parties*

For tax purposes related parties are:

- spouses, relatives of the direct descent without restrictions and relatives of the collateral descent up to the third degree included, and in-law lineage — up to and including the second degree;
- employer and employee;
- persons, one of whom participates in the management of the other or of its subsidiary;
- partners;
- persons in whose management or supervisory bodies one and the same legal or natural person participates, including when the natural person represents other person;
- a company and a person, who owns more than 5% of the voting shares of the company;
- persons, whose activity is controlled directly or indirectly by a third party or by its subsidiary;



- persons, who control together directly or indirectly a third party or its subsidiary;
- persons, one of whom is an agent of the other;
- persons, one of whom has made a donation to the other;
- persons who participate directly or indirectly in the management, control or capital of another person or persons, and therefore conditions different from the usual may be negotiated between them; and
- persons, one of whom controls the other.

In addition, according to specific provisions in the Tax and Social Security Procedures Code if a party to a transaction is a non-resident person, the revenue authorities may deem that the parties are related if:

- the non-resident entity is incorporated in a country, which is not an EU Member and in which the profit or the corporate tax due on the income, which the non-resident has realised or would realise from the transactions, is below 40% of the tax due in Bulgaria, except if there is evidence that the non-resident person is subject to preferential tax treatment, or that the non-resident has sold the goods or services on the domestic market; and
- the country, in which the non-resident is incorporated denies or is not able to provide information regarding the effected transactions or the relations, when there is an applicable Double Tax Treaty with this country.

#### *Methods for determining market prices*

For the purposes of transfer pricing rules market prices are determined by:

- the comparable uncontrolled method (CUP);
- the resale price method (RPM);
- the cost plus method (CPM);
- the transactional net margin method (TNMM); and
- the profit split method (PSM).

The Ordinance <sup>1</sup> H-9 for implementation of the transfer pricing methods stipulates the methods to be used when determining prices on related party transactions, the application of each method, as well as the approach of the tax authorities in case the taxpayer has transfer pricing documentation in place.

#### *Documentation requirements*

According to the Bulgarian legislation the taxable person is obliged to hold evidence that its relations with related parties are in line with the arm's length principle. Currently there are no specific requirements for transfer pricing documentation to be filed with the revenue authorities.

### **1903 Other regulations**

No specific guidelines and regulations concerning transfer pricing have been published by the tax authorities.

### **1904 Legal cases**

There have been only few court cases treating transfer pricing issues yet and all of them have been executed prior to the implementation of the Ordinance <sup>1</sup> H-9 for implementation of the transfer pricing methods. Most of them set the general principle for determination of the prices on related party transactions by referring to the transfer pricing methods stipulated in the tax legislation.

### **1905 Burden of proof**

Taxpayers should prove that the transfer prices are market based. If the taxpayer does not provide evidence that the transfer prices are market based, the revenue authorities may estimate the market prices. In such a case the burden of proof shifts to the revenue/tax authorities and they should back up their findings with sufficient evidence.

### **1906 Tax audit procedures**

Transfer pricing may be examined during a regular tax audit, as there are no separate procedures for transfer pricing investigations.

During a tax audit the revenue authorities may request additional information in order to make an assessment related to transfer pricing. The term for provision of information by the taxpayer will be determined in the tax authority's request (however, the term cannot be less than seven days).

### **1907 Revised assessments and the appeals procedure**

If the transfer prices are not market based, the revenue authorities may adjust the taxable result of the entity, and assess additional tax liabilities. Any tax assessments may be appealed at an administrative level. If the appeal fails, the assessments may be challenged in the court.

The statute of limitations (i.e. the period within which the state authorities are entitled to collect the tax liabilities and other related mandatory payments) is five years as from the end of the year in which the tax liabilities became payable. The above periods could be extended in certain cases (e.g. in case of a tax audit). However, the maximum period of the statute of limitation is 10 years.

### **1908 Additional tax and penalties**

Apart from an adverse tax assessment in respect of additional tax liabilities, the taxpayer may be also assessed with certain penalties.

If the taxpayer does not determine his tax obligations correctly and files a tax return, declaring lower tax liabilities than as per strictly applying the transfer pricing provisions, a penalty between EUR250 and EUR1500 may be imposed.

The difference between the agreed transfer prices and the market price may be considered as a hidden profit distribution, which will be associated with a penalty equal to 20% of the respective difference.

If the taxpayer does not provide evidence that the prices agreed with related parties are market based, a penalty between EUR25 and EUR250 may be levied.

**1909 Resources available to the tax authorities**

The Bulgarian revenue authorities do not have special teams dealing with transfer pricing issues. The relevant investigations are performed as a part of the general tax audit procedures.

**1910 Use and availability of comparable information**

The taxpayers may use all relevant sources of comparable information, in order to back up the arm's length compliance of the transfer prices with the relevant market conditions.

If the tax authorities challenge the transfer prices they may use various sources, such as statistical information, stock market data, and other specialised price information. The tax authorities should quote duly the source of the information used.

In Bulgaria there are no databases containing information on unrelated party transactions.

The financial statements of the local companies are publicly available but are not collected in one database that can be used for the purposes of transfer pricing studies.

**1911 Risk transactions or industries**

No transactions or industries can be considered exposed to transfer pricing investigations at a higher risk.

**1912 Limitation of double taxation and competent authority proceedings**

The double tax treaties concluded by Bulgaria provide for the possibility for the taxpayer to initiate a mutual agreement procedure for the purposes of eliminating double taxation.

Regulations with respect to the mutual agreement procedure and the exchange of information with EU Member States have been introduced in the Bulgarian Tax and Social Security Procedures Code as of 1 January 2007.

There is no public available information on the competent authority proceedings undergone in Bulgaria.

**1913 Advance pricing agreements (APAs)**

There is no possibility of obtaining Advance Pricing Agreements (APAs), pursuant to the local legislation. However, it is possible to obtain an opinion from the revenue authorities on a case-by-case basis. Such opinions are not binding, but they may provide protection from assessment of interest for late payment and penalties.

**1914 Anticipated developments in law and practice**

Although certain transfer pricing rules have been present in the Bulgarian tax legislation for a long time, there are no developed transfer pricing practices. However, in view of the recent amendments in the legislation, we expect this area to enter into the focus of the revenue authorities.

**1915 Liaison with customs authorities**

Pursuant to the customs legislation, the base on which the customs duties are calculated may be amended when the parties in the transaction are related. There are rules for determining the arm's length price for customs duties purposes using available data on comparable transactions.

**1916 OECD issues**

Bulgaria is not a member of the OECD. However, the general principles of the OECD Guidelines are implemented in the Bulgarian transfer pricing rules and followed by the Bulgarian tax authorities.

**1917 Joint investigations**

We are currently not aware of any simultaneous audits performed by the Bulgarian tax authorities and those of other countries.

**1918 Thin capitalisation**

According to the Bulgarian thin capitalisation rules, the interest expenses incurred by a resident company may not be fully deductible if the average debt/equity ratio of the company exceeds 3:1 in the respective year. However, even if the debt/equity test is not met, the thin capitalisation restrictions may not apply if the company has sufficient profits before interest to cover its interest expenses.

Interest under bank loans/financial leases are not restricted by the thin capitalisation rules, unless the transaction is between related parties or the respective loan/lease is guaranteed by a related party.

The Bulgarian thin capitalisation rules also do not apply to interest disallowed on other grounds (e.g. for transfer pricing purposes) and interest and other loan related expenses capitalised in the value of an asset in accordance with the applicable accounting standards.

Even if some interest expenses are disallowed under the thin capitalisation rules, they may be reversed during the following five consecutive years, if there are sufficient profits.

**1919 Management services**

The Bulgarian transfer pricing rules do not contain specific tax regulations regarding management services.

# 20 Canada

## 2001 Introduction

Canadian transfer pricing legislation and administrative guidelines are generally consistent with the OECD Guidelines. Statutory rules require that transactions between related parties be carried out under arm's length terms and conditions. Penalties may be imposed where contemporaneous documentation requirements are not met. There has been little tax litigation on transfer pricing in Canada, but the number of cases is expected to increase as the transfer pricing related audit activity of the Canada Revenue Agency (CRA) continues to intensify under ongoing mandates of the federal government.

## 2002 Statutory rules

### *Statutory rules specific to transfer pricing*

The Canadian statutory rules on transfer pricing contained in Section 247 of Canada's Income Tax Act (ITA) are effective for taxation periods beginning after 1997. These rules embody the arm's length principle.

'Transfer price' is broadly defined to cover the consideration paid in all related party transactions. 'Qualifying cost contribution arrangements' are also specifically covered in the Canadian rules (see Section 2021).

Transactions between related parties will be adjusted where the terms and conditions differ from those that would have been made between parties dealing at arm's length. If arm's length parties would not have entered into the transaction, the nature of the transaction can be adjusted (or recharacterised) in circumstances where it is reasonable to consider that the primary purpose of the transaction is to obtain a tax benefit. A reduction, avoidance or deferral of tax (or increase in a refund of tax) will be viewed to be a 'tax benefit'.

The legislation contains no specific guidelines or safe harbours to measure arm's length; rather, it leaves scope for the application of judgment. The best protection against a tax authority adjustment, and penalties, is the maintenance of contemporaneous documentation. The nature of the documentation required to avoid penalties is described in the legislation.

The legislation is supported by administrative guidelines in the CRA's Information Circular 87-2R (IC 87-2R) and the CRA's Transfer Pricing Memoranda (TPM-02 through TPM-10). The circular is cross-referenced to the OECD Guidelines.

To summarise the highlights of the Canadian legislation and administrative guidance:

- The CRA recognises the following five arm's length pricing methods in the circular: comparable uncontrolled price (CUP), cost plus, resale price, profit split and transactional net margin method (TNMM). The CRA will examine the application of the method selected by a taxpayer to ensure that the selected method produces the most reliable measure of an arm's length result (IC 87-2R paragraphs 47 to 63).

- Related party transactions may be adjusted if the CRA determines that they are not on arm's length terms (s. 247(2)).
- Transfer pricing adjustments that result in a net increase in income or a net decrease in a loss may be subject to a non-deductible 10% penalty (s. 247(3)) for taxation years beginning after 1998 (see Section 2009).
- Set-offs may reduce the amount of the adjustment subject to penalty where supporting documentation for the transaction that relates to the favourable adjustment is available (s. 247(3)) and is approved by the Minister (s. 247(10)).
- Penalties may not apply to a transaction where reasonable efforts were made to determine and use arm's length transfer prices. Contemporaneous documentation standards are legislated for that purpose (s. 247(4)).
- IC 87-2R also provides some administrative guidelines on cost-contribution arrangements, intangible property and intra-group services.

### *Other general provisions*

Section 69(1) of the ITA contains the general rule for inadequate consideration, which directs that a taxpayer who has acquired anything from or disposed of anything to a person (whether resident or non-resident) with whom the taxpayer does not deal at arm's length will be deemed to have done so at 'fair market value'. This section applies only to transfers of property (or interest in property), whether tangible or intangible.

Section 67 of the ITA contains a general provision restricting the deductibility of expenses to amounts that are reasonable in the circumstances, and s. 18(1)(a) restricts the deduction of expenses to those incurred for the purpose of gaining or producing income from a business or property.

Where property or services have been obtained by a resident taxpayer from a related non-resident at an overvalued amount or transferred from a resident taxpayer to a non-resident at an undervalued amount, a benefit will have been conferred on the non-resident. The amount will be recharacterised as a dividend and will be subject to withholding tax. These provisions apply to transactions with any related party, not just the parent or a shareholder. This result is accomplished through the combination of provisions in s. 15(1), s. 214(3)(a), and s. 212(2) of the ITA.

The Canadian legislation also includes a general anti-avoidance rule (GAAR) in s. 245 of the ITA that can apply to any transaction considered to be an avoidance transaction. In transfer pricing situations, if the specific provisions of s. 247(2) cannot be applied by the CRA, then it is possible that the GAAR could be applied by the CRA.

### *Legislation relating to inter-company debt*

Detailed legislation with respect to inter-company debt and interest charges also exists, as follows:

#### **Section 15(2) – loan treated as a dividend**

This provision applies where a loan or any other indebtedness that is owing to a corporation resident in Canada by a non-resident shareholder or a non-resident person not acting at arm's length with a non-resident shareholder has not been repaid within one year (i.e. 365 days) from the end of the corporation's tax year in

which the indebtedness arose. Where this provision applies, the amount is deemed to have been paid as a dividend and is subject to non-resident withholding tax of 25%. The withholding tax may be reduced depending upon the provisions of a relevant tax treaty. Anti-avoidance rules prevent a long-term loan from being disguised by a series of short-term loans and repayments. There are a number of exceptions to these rules, such as loans to a foreign corporation that is a foreign affiliate (defined as a foreign corporation in which the Canadian corporation has an equity interest of at least 1% and together with related parties has an equity interest of at least 10%).

The ITA provides a mechanism for the non-resident to apply for a refund of withholding tax paid, within a certain period of time, upon the repayment of the loan or indebtedness when the repayment is not part of a series of loans and repayments.

### **Section 17 – deemed interest income**

Where a loan or other indebtedness owing from a non-resident to a corporation resident in Canada is outstanding for one year (i.e. 365 days) or longer without a reasonable rate of interest being charged, the corporation is deemed to earn income from the loan or other indebtedness computed at a prescribed rate of interest and this amount, net of any interest actually received, is included in the corporation's income for tax purposes. Section 17 does not apply, however, if s. 15(2) as described above applies to the loan or indebtedness. Loans to controlled foreign affiliates are excluded from the deemed interest rule provided that the funds loaned are used by the controlled foreign affiliate to earn income from an active business. Accordingly, loans made downstream to these affiliates can be non-interest-bearing. However, the deductibility of any interest expense incurred in Canada relating to making such a loan must be considered under the general interest deductibility guidelines.

Avoidance of these rules through the use of a trust or partnership is not possible where a corporation resident in Canada is a beneficiary or partner of the trust or partnership. A further anti-avoidance provision imputes interest to the Canadian resident corporation on an amount owing between two non-residents when it is reasonable to conclude that such indebtedness arose because of a loan or transfer of property by the corporation to a person or partnership.

### **Section 80.4(2) – deemed benefit treated as a dividend**

Where a related non-resident has received a loan from or become indebted to a corporation resident in Canada at a rate of interest less than the prescribed rate or at a rate otherwise considered favourable to the non-resident, then the non-resident will be deemed to have received a shareholder benefit under s. 15(1). The amount of the benefit is calculated by comparing the interest rate charged with the prescribed rate of interest. This benefit is deemed to be a dividend and is subject to non-resident withholding tax of 25%. The withholding tax may be reduced by the provisions of a relevant tax treaty. This section does not apply, however, where s. 15(2) as described above applies or where the non-resident is a foreign affiliate of the Canadian taxpayer.

### **Section 18(4) – thin capitalisation**

The thin capitalisation rules can result in the permanent denial of an interest expense deduction to a corporation resident in Canada (see Section 2019).

### **Section 78(1) – unpaid expenses included in income**

This provision applies where a corporation resident in Canada has previously deducted

an amount that is owing to a related non-resident and has not paid or settled the liability within two tax years following the year in which the liability was incurred. In these circumstances, the unpaid amount is included in the income of the corporation in the third tax year following the year in which the liability was incurred. Alternatively, an election may be filed to have the liability deemed as paid and loaned back to the corporation on the first day of the third tax year, although this may result in a withholding tax liability on the amount deemed as paid. If such an election is filed late (i.e. more than six months after the third year), 25% of the unpaid amount will still be included in income in the third year.

### *Reporting requirements relating to transfer pricing*

#### **Section 231.6 – foreign-based information or documentation**

The CRA may formally serve notice requiring a person resident or carrying on business in Canada to provide foreign-based information or documentation where this is relevant to the administration or enforcement of the ITA. Supporting documents for inter-company charges and transfer pricing are prime examples of the types of information likely to be formally required. If the information or documentation is not produced following the delivery of the notice, then that information may not be used as a defence against a later reassessment. Such notices requiring the taxpayer to provide certain information must set out the time frame for production, a reasonable period of not less than 90 days. Taxpayers can bring forth an application to have the requirement varied by a judge. Failure to provide the information or documentation may lead to possible fines or possible imprisonment as discussed in s. 238(1). In a 2003 decision, the Tax Court of Canada prohibited Glaxo SmithKline Inc. from submitting foreign-based documents as evidence in its upcoming transfer pricing trial, because the documents had not been provided to the CRA earlier when it had served a notice pursuant to s. 231.6(2) (see Section 2004). In a 2005 decision, the Tax Court of Canada upheld the CRA's right to request such documentation from Saipem Luxembourg, S.A.

#### **Section 233.1 – annual information return: non arm's length transactions with non-resident persons**

Persons carrying on business in Canada are required to file an annual information return reporting transactions with related non-residents. The prescribed form, Form T106, *Information Return of Non-Arm's Length Transactions with Non-Residents*, (see also Section 2006), also asks for the North American Industrial Classification System (NAICS) codes for the transactions reported, whether any income or deductions are affected by requests for competent authority assistance or by assessment by foreign tax administrations, and whether an advance pricing arrangement in either country governs the transfer pricing methodology.

A separate T106 form is required for each related non-resident that has reportable transactions with the Canadian taxpayer. Each form asks if contemporaneous documentation has been prepared for transactions with that related non-resident.

For every type of transaction (tangible property, services, royalty arrangements, etc) the transfer pricing methodology used must be identified using a numerical code from the following list:

- (1) comparable uncontrolled price (CUP);



- (2) cost plus;
- (3) resale price;
- (4) profit split;
- (5) transactional net margin method (TNMM);
- (6) qualifying cost-contribution arrangement; or
- (7) other.

A *de minimis* exception removes the filing requirement where the total market value of reportable transactions with all related non-residents does not exceed CAD1 million.

#### *Foreign reporting requirements*

Canadian residents are required to report their holdings in foreign properties and certain transactions with foreign trusts and non-resident corporations. Significant penalties will be assessed for failure to comply with these rules.

#### **Section 233.2 – information returns relating to transfers or loans to a non-resident trust**

Generally, amounts transferred or loaned by a Canadian resident to a non-resident trust, or to a company controlled by such a trust, must be reported annually on Form T1141. The filing deadlines generally depend upon whether the Canadian resident is an individual, corporation, trust or partnership. The rules are complex and should be reviewed in detail for possible application.

#### **Section 233.6 – information return relating to distributions from and indebtedness to a non-resident trust**

Where a Canadian resident is a beneficiary of a non-resident trust and is either indebted to or receives a distribution from such trust, such transactions must be reported on Form T1142.

#### **Section 233.3 – information return relating to foreign property**

Where the cost of the Canadian resident taxpayer's total specified foreign property exceeds CAD100,000 at any time in the year, Form T1135 should be filed. The foreign property definition is comprehensive. Specific exclusions from the definition include personal assets (e.g. condominiums), property used exclusively in an active business, and assets in a pension fund trust.

#### **Section 233.4 – information return relating to foreign affiliates**

Where a person (including a corporation) or a partnership resident in Canada has an interest in a corporation or a trust that is a foreign affiliate or a controlled foreign affiliate, the person or partnership is required to file an information return (Form T1134A or T1134B) for each such corporation or trust. Financial statements of the corporation or trust must also be submitted. The filing deadline for these information returns is 15 months after the person's or partnership's taxation year-end.

#### *Treaty-based disclosure*

Any non-resident corporation that carries on business in Canada and is claiming a treaty-based exemption from Canadian tax must file a Canadian income tax return,

together with Schedules 91 and 97. This filing will identify those non-resident companies that are carrying on business in Canada without a permanent establishment or that are eligible for any other type of treaty exemption from Canadian income tax.

### **2003 Other regulations**

The CRA releases information explaining its interpretation of various taxation matters through a series of publications. This series includes:

- information circulars, which deal with administrative and procedural matters;
- interpretation bulletins, which outline the CRA's interpretation of specific law;
- advance tax rulings, which summarise certain advance tax rulings given by the CRA; and
- other documents.

These publications represent what is known as 'departmental practice': they do not have the authority of legislation. But the courts have found that these publications, while not determinative, can be persuasive where there is any doubt about the meaning of the legislation. News releases are another source of information, which communicate current changes in and confirm the current position of the CRA on income tax issues.

There are relatively few guidelines on transfer pricing published by the CRA. Those available are summarised below.

#### **Information Circular 87-2R: International Transfer Pricing**

IC 87-2R, dated 27 September 1999, provides guidance with respect to the application of the transfer pricing rules as amended in 1998 to conform to the 1995 OECD Guidelines.

To complement IC 87-2R, the CRA has published other documents on various transfer pricing matters. As at 21 March 2007, the following documents were available on the CRA's website:

- 27 March 2003, TPM 02 – Repatriation of Funds by Non-Residents – Part XIII Assessments: This document explains the CRA's policy on the repatriation of funds following a transfer pricing adjustment under s. 247(2) of the ITA.
- 20 October 2003, TPM 03 – Downward Transfer Pricing Adjustments under Subsection 247(2) [of the ITA]: This document provides guidance on dealing with downward transfer pricing adjustments that may result from an audit or from a taxpayer-requested adjustment.
- 27 October 2003, TPM 04 – Third Party Information: This document provides guidelines on the use of confidential third party information in the context of transfer pricing audits by CRA auditors.
- 13 October 2004, TPM 05 – Contemporaneous Documentation: This document provides directives to CRA auditors concerning requests for contemporaneous documentation pursuant to s. 247(4) of the ITA.
- 16 May 2005, TPM 06 – Bundled Transactions: This document explains that the CRA will accept bundled transactions in a limited number of circumstances.

- 2 August 2005, TPM 07 – Referrals to the Transfer Pricing Review Committee: This document replaces a 26 March 2003 document with the same title (TPM 01, which remains available in an archive on the CRA's website for reference purposes). Like its precursor, this document provides guidelines for referrals by CRA auditors to the International Tax Directorate and the Transfer Pricing Review Committee regarding the possible application of the transfer pricing penalty under s. 247(3) of the ITA or the possible recharacterisation of a transaction pursuant to s. 247(2)(b). The more recent version seeks to ensure a more open dialogue with taxpayers for consistent and fair application of the transfer pricing penalties.
- 5 December 2005, TPM 08 – The Dudney Decision – Effects on Fixed Base or Permanent Establishment Audits and Regulation 105 Treaty-Based Waiver Guidelines: This document provides guidelines and a general framework for permanent establishment determinations.
- 18 September 2006, TPM 09 – Reasonable Efforts under Section 247 of the Income Tax Act: This document provides guidance as to what constitutes reasonable efforts to determine and use arm's length transfer prices or arm's length allocations; it also provides examples of situations where taxpayers are more at risk for a transfer pricing penalty.
- 6 June 2007, TPM 10 – Advance Pricing Arrangement (APA) Rollback: This document conveys the policy regarding an APA request to cover prior tax years, sometimes referred to as an APA 'rollback'.

The CRA provided guidance on 'range issues' as they arise in testing a taxpayer's (or its affiliate's) profitability. This guidance on range issues that arise in the test procedure was published in an article presented at the Canadian Tax Foundation 2002 Tax Conference by Ronald I. Simkover, Chief Economist, International Tax Directorate, CRA.

In March 2003, the four member countries of the Pacific Association of Tax Administrators (PATA) – Australia, Canada, Japan and the US – published their final Transfer Pricing Documentation Package. This document presents the principles under which taxpayers can prepare a single documentation package that meets the transfer pricing provisions of each PATA member country. The use of PATA's documentation package is voluntary and if its principles are satisfied will protect the taxpayer from the transfer pricing documentation penalties that might otherwise apply in each of the four jurisdictions.

#### **2004 Legal cases**

Relatively few transfer pricing cases have been heard in the courts to date. Many issues are resolved at the audit and appeals levels. The following court cases relating to transfer pricing have been, or are scheduled to be, heard by the Canadian courts.

*Crestbrook Forest Industries Ltd v The Queen (92 DTC 6187), (91 DTC 5521)*

Revenue Canada Taxation (RCT, the predecessor to the CRA), through a third party, conducted a survey of wood pulp and newsprint exporters. The purpose of the survey

was to determine a reasonable range of arm's length sales discounts and commissions applicable to wood pulp and newsprint export prices. The survey was to provide the basis for bilateral discussions between RCT and the Internal Revenue Service (IRS), and possibly other foreign tax authorities, concerning the development of a set of 'safe haven' rules applicable to wood pulp and newsprint related party export price discounts and agency commissions. Various parties in the industry volunteered information to the surveyor, on the understanding that they would be provided with a copy of the results and the information provided would be kept confidential (not provided to their competition). RCT used some of the arm's length agreements obtained by the surveyor to reassess the tax liability of Crestbrook Forest Industries Ltd. Crestbrook then sought discovery (i.e. disclosure) of the survey information, which constituted secret comparables for RCT. RCT was prohibited from producing this without either the consent of the specific survey participants or a court order. When RCT requested permission to disclose the information from the specific participants, they intervened to oppose production of the information.

The Federal Court – Trial Division found for limited disclosure, i.e. for disclosure to be limited to two counsels and two expert advisers, who would give undertakings not to disclose the information to their clients. The Federal Court of Appeal favoured the protection of information given and obtained in confidence and in good faith on a voluntary basis for a specific and defined purpose. Given that the evidence was obtained by RCT for purposes that had nothing to do with Crestbrook Forest Industries' income tax liability, not only could it not be produced for discovery or at trial but RCT would not be permitted to rely on it for the purposes of raising a revised assessment.

The issue of importance from a transfer pricing perspective is the method by which RCT sought to obtain third party comparables for purposes of its assessments. The key question here was then whether it could use information volunteered for another purpose; the decision clearly indicates that it cannot.

The question must then be asked – When is information obtained on a voluntary versus an involuntary basis? Information received pursuant to a request for information to be used in the 'administration and enforcement of [the ITA]' may be viewed to be involuntary. If the information is not provided, the Minister may serve an official written notice requiring that the information be provided. The ITA provides for this with a number of judicial authorisations and opportunity to apply to the judge for a review of the authorisation etc. These provisions are contained in s. 231.2 of the ITA. It is unclear whether information viewed as involuntary would be permissible for use in the audit of an unrelated taxpayer (i.e. a competitor), pursuant to this decision.

*Canadian Forest Products Ltd, et al. v The Minister of National Revenue (96 DTC 6506)*

In 1994 the Minister sought to obtain information from a number of taxpayers active in the forestry industry to be used in assessing the reasonableness of the pricing of various activities conducted by five specific Canadian companies, each selling forestry products to or through a non-resident related party, that were subject to audit at that time. The Minister has the power to require information for the administration and enforcement of the Act under s. 231.2(1) of the ITA. However, where the requirement relates to unnamed persons, the Minister must obtain prior approval from a judge as set out in s. 231.2(2) and (3) of the ITA. The requirement for prior judicial authorisation

puts the onus on RCT to show that the interest of RCT in obtaining the information, which could be prejudicial, outweighs those of the individual taxpayers. The court held that RCT could not bypass the judicial authorisation requirement when seeking information relating to the tax returns of unidentified taxpayers (i.e. third parties who may well be direct competitors).

This case appears to disclose RCT's next step in trying to access a CUP in the forestry industry. It should provide some comfort to taxpayers that RCT's attempts to access third party information for use as comparables on audit of the transfer prices of unnamed competitors should first be subjected to judicial scrutiny.

*Crestbrook Forest Industries Ltd v The Queen (93 DTC 5186) (92 DTC 6412)*

It would appear that this case is on the same audit issue as the one cited above. However, at issue here is clarification of what foreign-based information may be required to be produced. In this instance, the Canadian company was not 'related' to two non-resident corporate shareholders; however, 'responses to the discovery undertakings ... [led] to the inference' that the two corporate shareholders 'exercised active control over Crestbrook' (citation at 93 DTC 5193). Accordingly, the Canadian company's lack of success in obtaining answers where its officers and employees had gaps in their knowledge, and where it had exercised its best efforts to obtain that missing knowledge, was not accepted.

The Federal Court of Appeal ordered Crestbrook to obtain answers to all 22 questions asked upon discovery within 90 days, or its Statement of Claim would be struck. Note that under current legislation, which is effective September 1988, s. 231.6 (see Section 2002) means that RCT may require a person resident in Canada (or a non-resident person carrying on business in Canada) to provide foreign-based information or documents. If the person fails to comply with such a requirement to provide this information, and where it has not been set aside by a judge, then the court can prohibit the introduction by that person of any foreign-based information or document previously requested and not provided. In this case, the court rejected the suggestion that an order under s. 231.6 would provide an acceptable solution. The court viewed the remedy under these provisions to be inadequate in the circumstances.

*Agricultural and Industrial Corporation and Brimstone Export Ltd v The Minister of National Revenue (91 DTC 1286)*

Historically, RCT focused on management fees with the purpose of collecting non-resident withholding tax thereon. However, the advent of more recent tax treaties and their exclusion from withholding tax of management fees means the focus on management fees has shifted towards an assessment of the reasonableness of the charge and, accordingly, the deductibility thereof. In this 1991 Tax Court decision, RCT successfully challenged the management fees charged to a Canadian subsidiary of a US parent company.

The court case emphasises several points that should be considered in establishing management fees that will be deductible in Canada:

- (1) Pursuant to s. 212(4)(b) of the ITA, a 'specific expense incurred' by a non-resident person for the performance of a service that was for the benefit of the Canadian taxpayer is not viewed to be a management fee subject to non-resident withholding tax under Canadian legislation. The court considered the meaning

of 'specific expense incurred'. At 91 DTC 1290, Judge Beaubier concluded 'Therefore, to be a 'specific expense incurred', it must be an explicit and identifiable expense that has been paid, or in respect to which an obligation to pay has been assumed' by the Canadian taxpayer.

- (2) Furthermore, to be deductible, s. 67 of the ITA requires that the amount of the expense be 'reasonable in the circumstances'. In assessing the reasonableness, the court considered several items of evidence or lack thereof. One may conclude that the following evidence should be available:
  - (a) evidence of bargaining between the parties in respect of the amount in order to refute any inference that the taxpayer 'passively acquiesced' to the charge;
  - (b) working papers supporting the expenses charged;
  - (c) detailed explanations of how the charges were calculated, including support for the apportionment of employee work performed or other expenses such as rent allocated or hours devoted by the service provider for the Canadian company's benefit;
  - (d) written agreement for the management charge; and
  - (e) expenses, which should relate to the period of the charge, not a prior period.

*Spur Oil Ltd v The Queen (81 DTC 5168)*

Spur purchased oil for its refining business from a related US company for a set price. In 1970, Spur began to source its oil from a related Bermuda company at a higher price, the increase allegedly being in respect of shipping costs. RCT denied the additional charge on the basis that the transaction was artificial and unduly reduced Spur's income. The Trial Court originally concluded that the revised arrangement did result in an artificial reduction in income on the basis that there was a binding contract at the original lower price for a five-year term. The Federal Court of Appeal reversed the Trial Court decision, concluding that the original arrangement was not a binding contract. The ultimate price paid to the Bermuda company was approximately equal to the fair market value of the oil at the relevant time, and therefore it could not be said that the payment to the related Bermuda company resulted in an undue reduction in income. This decision shows an early use of the CUP method.

*Irving Oil Ltd v The Queen (91 DTC 5106), (88 DTC 6138)*

This case is similar to the Spur case, in that Irving arranged its affairs so that some profit was made by a Bermuda company through an intermediary sales arrangement. The Federal Court of Appeal upheld the trial judgment that the price at which sales to Canada took place was similar to that which would have been paid to acquire the product from any other source, and the transactions were not a sham or artificial.

The court followed the Spur decision in concluding that an amount could not artificially reduce income when the transaction price did not exceed what was reasonable in the circumstances. This case again shows that the courts have looked to comparable transaction prices in reviewing transactions with non-residents.

*Indalex Ltd v The Queen (88 DTC 6053)*

This case again involves the use of a Bermuda company. The group companies were

part of an international group purchasing substantial quantities of aluminium and aluminium billet. The taxpayer ordered aluminium from the Bermuda company; however, the Bermuda company simply forwarded the information to a related company, which supplied the product directly to the taxpayer. The Bermuda company retained volume discounts available from pooling the purchases of several group companies and charged the Canadian company the undiscounted invoice price as an arm's length price.

The trial judge concluded that the price charged to the plaintiff was not arm's length. The court determined that s. 69(2) of the ITA applied and a determination had to be made on the price which was 'reasonable in the circumstances'. On appeal, the Federal Court of Appeal agreed with the trial judge and, in reviewing the operations, concluded that the Bermuda company bought nothing for its own account, contributed nothing in the way of financial or administrative advantage and did not provide any value deserving compensation. Therefore, the discount was not attributable to the Bermuda company's activities and was reallocated to Canada.

The court recognised that the Bermuda company could not justify the income it earned by the functions it performed or the capital it employed.

#### *SPG International Limited v The Queen (98 DTC 1706)*

This case concerned the deductibility of marketing and related expenses incurred by SPG on behalf of its American subsidiary, International Tool Boxes Corporation (ITB). RCT refused the deductibility of the expenses and treated them as advances to the subsidiary and therefore outlays of capital. The Tax Court determined that the expenses were legitimate expenses of SPG, as these expenses were incurred to generate income through ITB's sales to the US market. It was reasonable that the taxpayer absorbed these expenses itself, rather than making its subsidiary pay them during its initial promotional period, while the subsidiary attempted to penetrate the US market. The court found that there was no reason why the taxpayer could not deduct such expenses, drawing a parallel to the practice of sharing expenses for advertising, marketing or promoting its products with its distributors.

#### *Cudd Pressure Control Inc. v The Queen (98 DTC 6630), (95 DTC 559)*

Although not strictly a transfer pricing case, this case highlights the important distinction between a branch and a subsidiary, one that companies should consider before choosing a vehicle for doing business in Canada.

In this case, the Canadian branch of a US-based company was denied a deduction for notional rent for the use of certain specialised equipment owned by the head office. Cudd was a US-based corporation providing technical services to the oil industry. During 1985, the company was engaged by Mobil Oil to provide 'snubbing services' on a drilling rig located off the east coast of Canada. The services involved the use of 'snubbing units', sophisticated high-pressure equipment used to control or repair oil wells. Cudd owned the only large snubbing unit in the world and won the contract on that basis. There was no dispute that Cudd was carrying on business through a permanent establishment (the branch) in Canada. In computing the branch profits, Cudd included the amounts billed to Mobil Oil and deducted direct expenses plus a notional rent of approximately CAD2.5 million for the use of the snubbing units. The rent was intended to reflect the fair market charge for the use of the equipment by the Canadian branch.

The Tax Court and the majority of the Federal Court of Appeal denied the deduction of the notional rent on the basis that no rent had in fact been paid to anyone and there was no obligation to pay it. The court acknowledged that the relevant treaty articles allowed the Canadian branch to deduct 'all expenses wherever incurred reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable' in the determination of its net industrial and commercial profits. However, as the notional rent was neither an 'expense' nor 'incurred' by the head office as required under Canadian tax law, and the treaty could not be construed to permit a non-resident to deduct amounts that were unavailable to Canadian residents in computing their business income, it was not deductible. Instead, the court considered that, under the circumstances, a more reasonable hypothesis than renting the unit would be that the branch would purchase the unit from its head office and therefore allowed capital cost allowance in lieu of the notional rent.

In a separate opinion, Mr Justice McDonald of the Federal Court of Appeal commented that there could be situations where the deduction of notional expenses would be allowed under the treaty even though such expenses are disallowed under the Canadian tax law. In McDonald's view, a permanent establishment must calculate its profits under the fiction that it is an independent enterprise and it may deduct expenses, which may be fictional, that are allocable to a permanent establishment (PE).

We take comfort from the fact that one judge specifically accepted the concept of notional expenses, although his views represent the minority and therefore the precedential value of his comments may be limited. Moreover, his interpretation of the facts allowed a substantial portion of the profit to be taxed in Canada despite the minimal functions performed there.

Companies setting up business in Canada through a branch must keep in mind that the net profit that is taxable in Canada may exceed the amount that a subsidiary would earn for the same functions.

### *Safety Boss Limited v The Queen (2000 DTC 1767)*

In 1991, Safety Boss paid a bonus to its president and 99% shareholder, Mr Miller, a non-resident. In 1992, a fee was paid to a non-resident company for Mr Miller's services. RCT applied s. 69(2) to disallow a portion of the bonus on the basis that the amount was in excess of an amount that would have been reasonable had the parties been dealing at arm's length. At issue was the reasonableness of the payment for the services rendered by Mr Miller to Safety Boss. Safety Boss was in the business of extinguishing oil well fires and was hired at the end of the Gulf War to work in Kuwait. RCT took the position that reasonable compensation would be based on the amount paid to one of the managers, who was not a shareholder. The court found that any goodwill associated with Safety Boss was personal goodwill attributable to Mr Miller as it was through his initiative, contacts, reputation and skill that the company was successful. Mr Miller was the driving force behind the company and, without his services, neither the company nor its contract with Kuwait would have existed. As the company owned no goodwill apart from the personal goodwill of Mr Miller, there was no reason that significant earnings should be retained in it. The bonus was merely payment for the value of services that Mr Miller could have obtained directly had he chosen to structure the transactions that way.



*Glaxo SmithKline Inc. v The Queen (2003 DTC 918)*

Glaxo SmithKline Inc. (Glaxo) operates in the pharmaceutical industry. The transfer pricing issue in this case deals with the pricing of pharmaceutical products purchased from foreign related companies where generic comparables exist. Although this decision does not concern the transfer pricing issue central to the case, it is important to understand how the rules pertaining to foreign-based information will be applied.

This decision deals with the interpretation and application of s. 231.6(8) of the ITA, which prohibits the introduction of foreign-based information in civil proceedings if the taxpayer has previously failed to 'comply substantially' with a notice served by the CRA requiring such information under s. 231.6(2) of the ITA. The prohibition resulted from Glaxo's failure to produce within the prescribed time limits foreign documents considered by the CRA to be covered by the notice.

Glaxo argued that the language used in the notice served to Glaxo by the CRA pursuant to s. 231.6 should be read restrictively because earlier discussions that Glaxo had had with the CRA's auditors prevented the CRA from widening the scope of its previous written requests for information. Glaxo further argued that s. 231.6(8) cannot be construed and applied in such a way that Glaxo would be deprived of its right to a fair hearing under the Canadian Bill of Rights. The trial judge disagreed with both arguments.

In disagreeing with Glaxo's first argument, the trial judge stated that the law has been crafted in such a way as to provide that notices served under s. 231.6(2) must be in writing so as to explicitly detail the subject matter that the notice is to cover. Although subsequent discussions with the auditor or requests for written clarification from the auditor may have helped clarify the notice, the notice can only be varied or set aside upon application to a judge by the taxpayer. The notice cannot be limited in its reading because of prior conversations between the CRA and the taxpayer, nor because of assumptions made by the taxpayer in interpreting the notice. Glaxo neither sought clarification from the CRA auditor of the language nor brought an application to have the requirement varied by a judge as contemplated by s. 231.6(4).

While the trial judge criticised the language used in the notice, he could find no reason to conclude that the inadequate language was sufficient cause for Glaxo failing to 'comply substantially' with the requirement, although he did observe that 'ambiguities in the requirement are to be interpreted restrictively'.

In disagreeing with Glaxo's second argument, the trial judge again referred to the remedies available under s. 231.6(4). If the taxpayer does not avail itself of these remedies (as in this case), then it is difficult for the taxpayer to argue later that its rights to a fair hearing have been infringed. However, once the time established in the notice to deliver the information has lapsed, on a plain reading of the ITA, there is no discretion available to the judge in making an order under s. 231.6(8) – the taxpayer has either failed to 'comply substantially' with a notice or it has not.

However, the trial judge did agree with Glaxo in that, in certain circumstances, this provision could be 'unnecessarily obtrusive' if the trial judge could not apply some discretion in order to prevent an injustice at a later stage (even though Glaxo made no assertions in this regard in this case). Therefore, the trial judge found that Glaxo is prohibited from introducing any foreign-based information or document covered by the notice for any subsequent court proceedings otherwise than as rebuttal evidence or in cross-examination, and only with leave of the trial judge.

The lesson to be learned here is that if taxpayers are unclear about what is being asked of them in a notice issued under s. 231.6(2), they should seek appropriate advice. Making assumptions or failing to clarify the requirements of a notice served under s. 231.6(2) are not considered prudent courses of action, particularly when the ramifications of failing to 'comply substantially' with such a request cannot later be undone by the courts.

*Ford Motor Company of Canada v OMERS et al. (2004 OJ 191)*

In 2004, an Ontario Superior Court of Justice decision focused on the fair value of Ford Motor Co. of Canada, Ltd. (Ford Canada) shares and concluded that an adjustment to the transfer pricing policy was required to determine the fair value of the shares.

This case was brought under the Canada Business Corporations Act and the Business Corporations Act (Ontario) regarding the valuation of minority shareholding under an oppression remedy. This was not a transfer pricing case, and Justice Cumming emphasises throughout the decision the distinction between minority shareholder actions and the transfer pricing requirements of tax legislation. Nevertheless, transfer pricing analyses supporting each side's position were submitted as evidence and thus several transfer pricing lessons can be extrapolated from the case.

A minority shareholder in Ford Canada contended that the amount per share offered by Ford Motor Company (Ford US) in 1995 was significantly below the fair value of the shares. The minority shareholder asserted that the transfer pricing policy between Ford Canada and Ford US was unfair and oppressive because Ford Canada was a 'price taker' and its Canadian Vehicle Division (CVD) paid too high a price to Ford US for vehicles, parts and intangible assets, given the adverse economic and business conditions encountered by Ford Canada. Ford Canada's CVD incurred losses for 19 consecutive years beginning in 1977; the high transfer prices paid therefore increased Ford Canada's losses or reduced its profits.

Ford Canada argued that as the owner of the intellectual property for the Canadian market, it should earn the residual profit or suffer the residual loss. Moreover, despite the losses of its CVD, Ford Canada as a whole had been profitable during the recessionary years of 1979–1982 and 1990–1995. The minority shareholder argued that no arm's length party would have continued to operate over such an extended period under such adverse economic and business conditions without renegotiating the prices of its purchases; that Ford Canada's earnings were understated; and that the value of the Ford Canada shares was therefore also understated.

Taking the view that the structure of the transfer pricing policy was a relevant factor in determining the fair value of the shares under the oppression remedy, Justice Cumming evaluated reports and testimony by several transfer pricing experts and valuers before concluding that arm's length parties would not have entered into a similar arrangement and therefore the transfer pricing policy between Ford Canada and Ford US was not realistic. He noted that 'it is too simplistic to look at nominal ownership of intellectual property' and 'no rational, independent entrepreneur in Ford Canada's position would agree to continue operations destined only to generate foreseeable, inevitable losses year-in, year-out, due to foreseeable continuing adverse economic conditions coupled with a known, static transfer pricing system'. Justice Cumming also pointed out that 'the fact that the existing transfer pricing is acceptable

from the standpoint of the tax authorities (or more precisely, has not been challenged) does not mean in itself that there cannot be a finding of oppression.'

Because the transfer pricing policy was not realistic, a transfer pricing adjustment was required to calculate the fair value of the minority shares in 1995. Justice Cumming determined that, based on the analysis prepared by certain transfer pricing expert witnesses, the minority shareholders were entitled to an additional amount per share. The additional amount recognised the future earning potential of Ford Canada using a revised cash-flow projection that included a transfer pricing adjustment to the present value of Ford Canada's operations.

While not a transfer pricing case, this case serves to remind taxpayers undertaking cross-border transactions with related parties that they should regularly review and update their transfer pricing policies. Similar to the evaluation process undertaken by Justice Cumming, taxpayers should separately analyse each function and ask themselves if the transfer pricing policy is reasonable, that is, would a rational, independent party continue to operate under a similar arrangement or seek to renegotiate? This review may be particularly relevant when one party consistently incurs losses.

Ford Canada appealed the case (2006 OJ 27), but the appeal on the issue of the transfer pricing system being unfair was dismissed.

#### *Current cases under review*

In addition to Glaxo, noted above, SmithKline Beecham Animal Health Inc. (SmithKline) was an earlier transfer pricing case involving the pricing of pharmaceutical products purchased from foreign related companies where generic comparables exist. SmithKline filed formal documents in 1995. In November 2003, the court was advised that a settlement had been reached between SmithKline and RCT. The terms of the settlement have not been disclosed. Similarly, Hoffmann-La Roche Limited filed formal documents with the Tax Court of Canada in 2000. This case is pending.

All three companies operate in the pharmaceutical industry, and their cases involve similar facts, showing the CRA's intention to apply the generic CUP approach across the industry where relevant. (Glaxo Wellcome Inc. and SmithKline Beecham Inc. began operating under the name GlaxoSmithKline Inc. as of 1 January 2001. The Glaxo decision on the generic comparable issue is expected soon.)

In an upcoming Tax Court of Canada case, Tregaskiss Limited (Tregaskiss) is asserting that its Barbados distribution company has been effectively recharacterised by the CRA as a call centre. The CRA reallocated the Barbados company's profits to Tregaskiss on the basis that the Barbados company was actually a routine service provider. The Barbados company had a legal and operational presence in Barbados, including an office and employees. One employee, the president and managing director, was also a major Tregaskiss shareholder with more than 20 years of industry experience. However, the CRA determined that, based on its assessment of the functions being performed and the risks being assumed, the profit realised by the Barbados company should be comparable to that earned by call centres rather than full-fledged distributors. The CRA thus increased the price of goods sold to the Barbados company by Tregaskiss, which manufactured the goods, to reallocate a substantial portion of the profits back to Canada. In making this adjustment, the CRA also noted the lack of consideration paid by the Barbados company for

international distributorship rights when the Barbados company was established, and the fact that those rights covered territories served by existing wholesale distributors.

The recharacterisation of a transaction can have a very significant effect on the tax position of the parties. While ongoing transactions may appear to have arm's length terms and prices within the legal relationship between the parties involved, the CRA has the discretion, under certain circumstances, to revise the nature of the relationship to reflect what the CRA considers it to be. Any situations involving the transfer of assets, rights, functions or operations that could have a material long-term effect on income streams within a multinational group of related corporations must be reviewed to ensure that fair market values have been established and paid.

Even when fair market value is established and paid, the CRA has been known to attempt to recharacterise a sale of rights as a licence of the rights for an ongoing royalty if that results in a higher allocation of profits to Canada, arguing that no arm's length party would enter into such a sale. The CRA's success with the recharacterisation provision has yet to be proven in the courts.

#### *Frequency of transfer pricing cases*

Court cases on transfer pricing in Canada are not frequent. It is expected that the number of cases will increase as the CRA continues to focus on transfer pricing in general.

### **2005 Burden of proof**

Under the Canadian taxation system, the taxpayer makes a self assessment of tax, which is then assessed by the CRA (either with or without an audit). In the event of an audit by the tax authorities, the burden of proof to satisfy the tax authorities that transfer prices are arm's length lies with the taxpayer.

This requirement took on a new dimension in the 1997 transfer pricing legislation. The taxpayer is required to show that it has made reasonable efforts to determine and use arm's length transfer prices in order to exclude any related adjustments from penalty. The maintenance of complete and accurate contemporaneous documentation, as provided in the legislation, will constitute reasonable efforts for these purposes (see Section 2006).

### **2006 Tax audit procedures**

#### *Selection of companies for audit*

Transfer pricing is monitored initially through the routine tax audit process. Typically, transfer pricing issues are referred to senior auditors who specialise in the international area.

Form T106 (see also Section 2002) requires disclosure of information on transactions with related non-resident persons. It is understood that information gathered from these forms is used in selecting candidates for transfer pricing audits.

#### *Provision of information and duty of the taxpayer to co-operate with the tax authorities*

If a transfer pricing question arises during an audit, prompt response to any requests

for information and evidence that all necessary resources are being dedicated to gathering that information are important. The taxpayer should try to resolve the issues with the field auditor based on available information. Extensive delays in providing the information should be avoided, because the field auditor may interpret such delays as an indication that transfer pricing policies and documents are informal or non-existent.

Because the onus of proof is on the taxpayer to provide sufficient support for the arm's length nature of its transfer pricing, it is in the taxpayer's best interest to provide as much supporting evidence as possible. As discussed above, s. 231.6 of the ITA requires foreign information or documents that are available or located outside Canada to be provided to the CRA if these are relevant to the administration or enforcement of the ITA. Failure to comply may result in the foreign-based information or documents being inadmissible in defending a later reassessment in court.

### *Contemporaneous documentation*

The CRA has, for a number of years, had a relatively aggressive programme of transfer pricing enforcement. Any transfer pricing adjustment may be subjected to a 10% penalty, with some *de minimis* exceptions (see Section 2009), unless the taxpayer has made reasonable efforts to determine and use arm's length prices. This requires contemporaneous documentation to be on hand at the time the tax returns for the year are due (i.e. six months after the end of the taxation year for corporations).

As a minimum, the taxpayer should have a complete and accurate description of the following:

- (1) the property or services to which the transaction relates;
- (2) the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;
- (3) an organisation chart – the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;
- (4) a functional analysis – the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;
- (5) the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and
- (6) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

### **2007 The transfer pricing audit procedure**

Transfer pricing audits can be initiated in two ways: as part of a regular corporate audit (where transfer pricing may be included in the audit at the discretion of the audit case manager), or when a local international tax auditor screens a file solely for a transfer pricing audit primarily using form T106 (see also Section 2002), which taxpayers must file annually.

Whenever a transfer pricing audit is about to take place, CRA auditors are required to provide a taxpayer with a written request for the taxpayer's contemporaneous documentation at the initial contact stage of the audit. The request states that the transfer pricing documentation is to be provided within three months from the date of service of the request. Canada's transfer pricing legislation offers no opportunity to negotiate an extension of the three-month deadline: the time frame is specified in the ITA and is not discretionary. If the deadline is not met, the taxpayer will be deemed not to have made reasonable efforts to determine and use arm's length transfer prices and may be subject to penalty if an adjustment is ultimately assessed that exceeds the legislated penalty threshold.

After the CRA has been provided with the contemporaneous documentation, the auditor will normally visit the taxpayer's premises to confirm the information contained in the documentation. In some circumstances, the auditor may refer the case to the CRA's head office to obtain technical assistance from economists.

### *Statute of limitations*

The legislative statute of limitations for most taxpayers is four years. However, transactions with related non-resident persons can be subject to audit up to seven years after the tax year is initially assessed. In the rare situations where an audit may take longer, the CRA can request that the taxpayer sign a waiver to extend beyond the seven years. However, such a waiver must be signed within the four-year period. The CRA has stated that it is committed to timely review and audit.

The appropriate tax treaty should be consulted, because it may contain a provision whereby an audit may have to be completed within a different time frame in order for the taxpayer to preserve its right to request competent authority assistance in the event of double taxation.

### **2008 Reassessments and the appeals procedure**

Many transfer pricing issues can be resolved with the field auditor or the auditor's supervisor based on information provided and discussions held during the audit. If an issue cannot be resolved, the CRA will issue a Notice of Reassessment for tax owing based on its audit findings. At this stage, a taxpayer may have two options. The first is to pursue the issue through the CRA's Appeals Division and possibly the Canadian tax courts. The second (which is available only if the transfer pricing reassessment involves a related entity in a country that has a tax treaty with Canada) is to request relief through competent authority.

In either case, the taxpayer should file a Notice of Objection. A taxpayer has 90 days from the date of mailing of the Notice of Reassessment to file such a Notice of Objection. Doing so can start the appeal process if that is the desired option, or the Objection can be held in abeyance while the taxpayer pursues relief through the competent authority process. If the taxpayer pursues the appeal process and is not satisfied with the appeal result, the taxpayer may then seek a resolution in the Canadian tax courts. If the taxpayer chooses to pursue relief through the competent authority process, the Objection will protect the taxpayer's rights of appeal in the event that the competent authority process does not resolve the issue.

A taxpayer can request competent authority assistance after the taxpayer has proceeded through the appeal process and/or obtained a decision from a Canadian

tax court. However, the Canadian competent authority will be bound by any settlement with the CRA's Appeals Division or by a Canadian court decision in its dealings with the foreign competent authority, and will only be seeking relief, without the ability to negotiate a different result.

A 'large corporation' (as defined under Canada's Income Tax Act), may be required to remit 50% of the reassessed tax (and 100% of the related withholding taxes) while appealing the Notice of Reassessment.

### **2009 Additional tax and penalties**

For tax years commencing after 1998, the transfer pricing penalty provisions apply. Transfer pricing adjustments can result from the following two circumstances:

- a net increase in income or a net decrease in loss; and
- a reduction in the taxpayer's tax cost of non-depreciable and depreciable capital property and eligible capital property.

These transfer pricing adjustments are liable for a 10% penalty, subject to certain exceptions:

- Penalties will not be applied where the net transfer pricing adjustment does not exceed the lesser of 10% of the taxpayer's gross revenue and CAD5 million.
- No penalties will be applied where the taxpayer has made reasonable efforts to determine that its prices are arm's length and to document such on or before the date its tax return is due for the taxation year (see Section 2006). Taxpayers must be able to provide this documentation to the Minister of National Revenue within three months of a request therefor.

The legislation allows favourable adjustments to reduce unfavourable adjustments when determining the amount subject to penalty. To obtain a set-off, however, taxpayers must have documentation supporting the transaction to which the favourable adjustment relates and receive the Minister's approval of the favourable adjustment. Thus, taxpayers without contemporaneous documentation cannot benefit from set-offs.

During 2006, the CRA issued a transfer pricing memorandum (TPM-09) which provides additional guidance on what constitutes reasonable efforts to determine and use arm's length transfer prices. According to TPM-09, a reasonable effort is defined as 'the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances.' Furthermore, the CRA considers a taxpayer to have made reasonable efforts when the taxpayer has 'taken all reasonable steps to ensure that [its] transfer prices or allocations conform with the arm's length principle.'

Canada's penalties are based on the amount of the transfer pricing adjustment and can apply when the taxpayer is in a loss position such that no increased taxes are payable as a result of the adjustment. During 2004, the CRA's Transfer Pricing Review Committee (TPRC) reviewed and recommended the application of its first transfer pricing penalty under s. 247(3) of the ITA. Since then, the CRA has increased its application of transfer pricing penalties. As of February 2008, out of the 121 penalty referrals made to the TPRC, penalties were recommended to be applied in 71

cases, i.e. for 59% of the referrals made.

Interest is charged on the underpayment of income tax liabilities and withholding tax. These interest charges are based on the taxes owing, the period of time outstanding and the rates of interest prescribed by the CRA. This interest is not deductible for income tax purposes.

### **2010 Resources available to the tax authorities**

Each of the CRA's tax services offices has international tax auditors who either conduct the transfer pricing audit themselves or act in an advisory role to regular corporate auditors. Supporting the international auditors when necessary are teams of economists, lawyers or more senior international auditors located at the CRA's head office. At any time, if necessary, the CRA engages outside consultants to provide expertise in specific areas. Although this is normally done at the appeal level when preparing for litigation, outside experts can be engaged during the audit process.

As the CRA views transfer pricing audits as 'high risk', it is placing more international auditors and economists in the field.

### **2011 Use and availability of comparable information**

When reviewing a taxpayer's profitability using a cost plus method, resale method or TNMM analysis, there are several databases that contain financial information on comparable public companies that can be used to evaluate the appropriateness of profit levels. Canadian databases contain limited information as there are relatively few public Canadian companies whose activities are narrow enough to provide good comparables for routine activities. As a result of the lack of Canadian information, US information is often used to evaluate profitability levels in Canada. US information, in general, is more readily available and complete. Public databases are also available that contain royalty and investment management agreements.

The CRA can also use 'secret comparables'. This is non-public information that the CRA has normally acquired through the 'administration and enforcement' of the ITA. Examples include financial information filed by taxpayers with their tax returns and information acquired during an audit of another taxpayer. Since the CRA may encounter resistance if it attempts to introduce secret comparables in a court proceeding, their use on a routine audit is rare. In 2003 (see Section 2003), the CRA reaffirmed its right to collect confidential third party information and use that information as an audit tool for screening purposes, for secondary support and as a last resort to form the basis of an assessment.

### **2012 Risk transactions or industries**

At this point, it is apparent that the pharmaceutical industry has been targeted for transfer pricing reviews and audits. The CRA is attempting to apply the CUP approach to many Canadian subsidiaries of multinational pharmaceutical groups.

The CRA is also increasing its attention to the automotive industry.

Based on informal discussions with the CRA, it is understood that the CRA is evaluating the formation of industry specific tax services offices. With industry specific tax services offices, the auditor is expected to perform audits under the direction of managers who have a better understanding of the industry. Over time, they are expected to become more sophisticated with respect to a specific industry. Examples of such



industries are automotive and oil and gas.

Inter-company debt, interest charges, guarantee fees, inbound royalties, intellectual property migrations, contract manufacturing arrangements and intra-group services are transactions that are typically examined by the CRA. The CRA has also focused on permanent establishments.

The recently reorganised International and Large Business Directorate regime is promoting a risk-based audit approach. Their focus is on high risk transactions, which include transfer pricing and other international transactions. For instance,, the CRA has increased its targeting of transactions involving the use of tax havens and other low-tax jurisdictions for transfer pricing reviews and audits. Additionally, in the 2005 federal budget, the CRA was infused with additional funding to expand its Aggressive International Tax Planning initiative, a division of the International and Large Business Directorate, which is aimed at identifying and responding to international transactions that may be designed to avoid paying income tax in Canada. The additional funding, which was split equally between international tax audits and tax avoidance audits, resulted in the hiring of 140 international and avoidance auditors by CRA offices across Canada.

### **2013 Limitation of double taxation and competent authority proceedings**

Canada's income tax treaties contain two articles which are relevant to transfer pricing. The Associated Enterprises article provides a definition of related parties for the purpose of the treaty and possibly a time line within which a reassessment can be raised. In the absence of a time line, then the time provided under domestic legislation prevails. The Mutual Agreement Procedure (MAP) article provides the competent authorities the ability to attempt to resolve taxation not in accordance with the treaty (e.g. double taxation).

A taxpayer does not need to wait for a notice of reassessment to be issued before filing a request for competent authority assistance. However, the competent authority will not act upon such a request until a reassessment has been issued.

The competent authority process where a Canadian taxpayer has been reassessed can be summarised as follows. The non-resident related party must file a request for competent authority assistance (complete submission) in the country of residence within the time line contained in the treaty. A similar request is normally filed simultaneously in the country where the reassessment was initiated. Upon receipt of a request from the non-resident, the competent authority informs the competent authority of the country that initiated the reassessment that it has received such a request, and asks for a position paper outlining the details pertaining to the reassessment. The competent authority of the initiating country reviews the case and provides the position paper, after which negotiations between the competent authorities take place through face-to-face meetings or correspondence to resolve the double taxation. Once the competent authorities reach agreement, they each send a letter to the taxpayers in their respective countries informing them of the proposed settlement to avoid the double taxation. Once the taxpayers have accepted the proposed settlement, each competent authority has the necessary adjustments processed in its respective country.

The timing for filing a competent authority request varies from treaty to treaty. It is therefore extremely important to consult the MAP article of the relevant treaty. Generally the competent authority submission must be filed within two years from the date of the Notice of Reassessment.

Canada currently has two treaties where the Associated Enterprises article requires the other competent authority to be notified of a potential request for competent authority assistance within six years from the end of the taxation year under audit. With this notification provision, the MAP articles in those treaties do not contain a time line within which the competent authority submission must be filed.

If a request for competent authority assistance with a submission or notification is not filed on time, a taxpayer may be denied relief by the competent authority of the non-resident related party.

The CRA's Competent Authority Services Division is responsible for the competent authority function as it pertains to the MAP and Exchange of Information articles contained in the treaties. Case officers in this Division meet quarterly with its United States counterparts and occasionally with governments of other foreign jurisdictions to discuss specific cases

On 1 January 2005, the CRA issued a revised Information Circular 71-17R5 (IC 7117R5), Guidance on competent authority under Canada's tax conventions. Significant changes included:

- Taxpayers cannot use both the appeals process and the competent authority process at the same time. However, taxpayers who do not concur with an appeals decision can request competent authority assistance and the Canadian competent authority will no longer be restricted by the decision of the Appeals Division during its negotiation process.
- The CRA will now consider on a case-by-case basis waiving or cancelling a portion of the interest accrued during the period that the taxpayer had no influence on the MAP.
- Large corporations (as defined in the ITA) that file protective Notices of Objection and proceed with the competent authority process may defer payment of the additional corporation tax and interest that arise as a result of a reassessment.

With the signing of the Protocol amending the Canada-US treaty on 21 September 2007, diplomatic notes were also exchanged by the two governments which paved the way for binding arbitration in MAP cases. Arbitration will become effective with the coming into force of the Protocol after ratification. The process is referred to as 'baseball' arbitration, where an arbitration board comprised of three members will select one of the proposed resolutions provided by the competent authorities as its determination.

The CRA's MAP programme report for 2007 contained the following highlights:

- The average time to complete a competent authority case was 26 months.
- A total of 273 new cases were accepted during the year, and 266 were completed.
- Of new cases accepted, 69 were categorised as 'negotiable' (i.e. involving another tax administration); and 65 negotiable cases were completed.

- Of the completed cases, full relief was granted in 92% of the cases.

### **2014 Advance pricing arrangements (APAs)**

Canada was one of the first countries that implemented an APA programme in the early 1990s. The APA service is intended to assist Canadian taxpayers in determining transfer prices acceptable to the CRA for the purposes of the ITA and, where negotiated with tax authorities of other jurisdictions, the relevant treaties with those countries. An APA is intended to consider proposed pricing arrangements or methodologies that have prospective application. The APA is designed to seek agreement on an appropriate transfer pricing methodology for a specified cross-border transaction between related parties, as opposed to seeking agreement on specific prices. The service is offered in addition to competent authority assistance on the appropriateness of historic transactions that have been challenged by one or both of the jurisdictions involved.

APAs can be unilateral, bilateral or multilateral. At the conclusion of the procedure there is a 'binding agreement' between the taxpayer and the CRA and, in the case of bilateral or multilateral APAs, between the CRA and the other tax authorities involved.

Information Circular 94-4R (IC 94-4R), dated 16 March 2001, outlines the procedures and guidelines for obtaining APAs in Canada.

During 2007, the CRA announced the following changes to the APA programme as they pertain to the rollback of transfer pricing methodologies agreed upon through the APA process. The changes established the following regarding rollbacks.

- A rollback will be considered if a request for contemporaneous documentation has not been issued by the CRA.
- The facts and circumstances are the same.
- The foreign tax administration and the CRA both agreed to accept the APA rollback request.
- The filing of a waiver for each year in question in accordance with the ITA.
- Once an APA is in force, transactions occurring in tax years covered by the APA and the rollback period will **not** be subject to a transfer pricing penalty.
- The CRA will not issue a request for contemporaneous documentation for transactions in a year that a taxpayer has requested to be covered by an APA rollback at a pre-filing meeting.
- An APA rollback will not be permitted when a taxpayer requests a unilateral APA.

The first year of implementation for a unilateral APA will be the first taxation year for which a tax return has not been filed.

These changes will be reflected in the next revision to IC 94-4R.

On 18 March 2005, the CRA released Information Circular 94-4R (Special Release) on the topic of advance pricing arrangements for small businesses. The key highlights contained in this release are:

- The programme will have a fixed non-refundable administration fee of CAD5,000.

- Taxpayers must have gross revenues of less than CAD50 million or a proposed transaction to be covered by the APA of less than CAD10 million.
- The programme will cover only transactions of tangible property and routine services.
- Site visits will not be performed.
- The minimum information required from a taxpayer is a functional analysis. The CRA will perform the economic analysis if requested to do so.
- The programme will pertain only to a unilateral APA without a rollback.
- Taxpayers' annual reporting under the programme will be limited to stating, in writing, whether the critical assumptions have or have not been breached.

The 2007 annual report on the APA programme published by the CRA reports the following:

- 15 new cases were accepted and nine were completed. Of the completed cases, three were unilateral and six were bilateral.
- The three unilateral cases took an average of 721 days to complete and the bilateral cases took an average of 943 days.
- Since the inception of the programme, 156 cases have been accepted, 108 completed (85 bilateral, 21 unilateral and two multilateral), and three have been unresolved.
- For completed cases, the TNMM is the most common methodology (38 cases), followed by the profit split (29 cases), comparable uncontrolled price (18), cost plus (13) and resale price methods (10).
- When the TNMM was used, the operating margin has been the most used profit level indicator (21), followed by total cost plus (12), the Berry ratio (4) and return on assets (1).

### **2015 Anticipated developments in law and practice**

In 2003, the CRA began publishing documents on its website on various transfer pricing matters (see Section 2003). This mode of communicating CRA views and evolving practices is expected to continue.

### **2016 Liaison with customs authorities**

Customs programmes are administered by the Canada Border Services Agency (CBSA). The role of the CBSA is to manage Canada's borders by administering and enforcing domestic laws that govern trade and travel – including customs and excise taxes.

Canada implemented the World Trade Organisation's 'Valuation Code' under which the primary basis of the value for customs purposes is the *price actually paid or payable* in a sale for export. As a matter of policy, the CBSA does not generally challenge the arm's length nature of a price in a sale between related parties. It will generally accept that the transfer price was not influenced by the relationship if the transfer price was determined in accordance with the OECD Guidelines. The CBSA does, however, closely scrutinise other payments flowing from the buyer to the related

seller (e.g. 'management fees') to determine whether these should be part of the *price paid or payable* for the goods.

In the course of a 'valuation verification' (i.e. an audit of the values declared on customs entries), an importer that purchases goods from a related party can expect to be asked to provide a copy of the documentation (such as a transfer pricing study) which demonstrates that the transfer price was determined in accordance with the OECD Guidelines.

There is no routine exchange of information between the two agencies. However, the two agencies have been encouraged to have greater co-operation as anticipated by the OECD Guidelines. The two agencies have tended to stress the difference between a value calculated for income tax purposes and a value calculated for customs purposes, given the different legislative bases.

It should also be noted that income tax decisions that are adverse to the taxpayer may not result in the recovery of duty or tax that may have been payable on the import of goods. Taxpayers are not required to report post-importation reductions in the price to the CBSA, and no duty refund can be claimed based on the reduced customs value. However, post-importation increases in the transfer price must be reported to the CBSA, and additional duty (if any) must be paid. Failure to do so may result in penalties being assessed against the importer.

### **2017 OECD issues**

Canada is a member of the OECD. The Canadian transfer pricing legislation was redrafted in 1997 in conformity with the OECD Guidelines.

### **2018 Joint investigations**

Most tax treaties contain exchange-of-information provisions that normally include a provision for joint investigations. Canada and the US have an agreement in place for joint investigations. These investigations are initiated to minimise the time and effort by both groups of auditors on complex audits.

### **2019 Thin capitalisation**

Canada has had fairly specific legislation with respect to thin capitalisation and restricting the amount of deductible interest since 1972. Therefore, this concept is well entrenched and is usually enforced through the general audit procedures of CRA assessors and auditors.

Where a corporation resident in Canada has average 'outstanding debts to specified non-residents' that exceed two times the corporation's 'equity' (as defined for the purposes of the thin capitalisation rules), a portion of the related interest expense is not deductible in computing the corporation's income for tax purposes. It should be noted that the disallowed portion of the interest expense is permanently disallowed.

'Outstanding debts to specified non-residents' is a defined term and generally refers to interest-bearing debts or other obligations owed either to non-resident shareholders who own (together with related persons) 25% or more of the voting shares of the corporation or to persons related to such shareholders. The average of such debts is determined using the greatest amount of such debt outstanding at any time during each calendar month that ends in the year.

'Equity' is defined to include (i) the retained earnings of the corporation as at the

beginning of the year, except to the extent that those earnings include retained earnings of any other corporation; (ii) the average of all amounts each of which is the corporation's contributed surplus (determined, in the CRA's view, in accordance with Canadian generally accepted accounting principles) at the beginning of each calendar month that ends in the year, to the extent that it was contributed by a specified non-resident shareholder of the corporation; and (iii) the average of all amounts each of which is the corporation's paid-up capital at the beginning of each calendar month that ends in the year, excluding the paid-up capital in respect of shares of any class of the capital stock of the corporation owned by a person other than a specified non-resident shareholder of the corporation.

International groups that have a Canadian holding company for their Canadian operating company or companies should be cautious when a related non-resident makes a loan directly to the Canadian operating company. The Canadian operating company may not have any direct non-resident shareholders and, accordingly, a portion or the entire amount of the interest could potentially become non-deductible under the thin capitalisation rules. Where possible, loans from related non-residents should be made to the Canadian holding company that has the direct non-resident ownership, keeping in mind the lack of consolidated tax filing in Canada and the 'back-to-back' anti-avoidance provisions included in the thin capitalisation rules.

It should also be noted that because of the difference in timing with respect to including debt and equity in the statutory averaging formula, interest may become non-deductible even where equity and debt are contributed concurrently, since the thin capitalisation calculation does not recognise increases in equity amounts until the beginning of the next calendar month.

### **2020 Intra-group services (management fees)**

As discussed in more detail in the 'Legal cases' section above (see Section 2004), the Brimstone case emphasised several points that should be considered in charging intra-group service fees if those fees are to be tax deductible in Canada, i.e. there should be a 'specific expense incurred', and the expense should be 'reasonable in the circumstances'. There should also be documentary evidence to support the amount of charge made, such as a written agreement to provide the services and working papers evidencing the expense charged.

Intra-group service charges are governed by s. 247 of the ITA; there is no specific transfer pricing legislation for intra-group service fees. The CRA's position on intra-group service fees for transfer pricing purposes is included in IC 87-2R. The withholding tax legislation in s. 212 of the ITA provides insight into what constitutes intra-group services.

The province of Ontario assesses an additional 5% income tax on management fees paid or payable to a related non-resident person. The tax is levied by requiring that a portion of the expense be added back in calculating income for tax purposes. The add-back is currently 5/14.0, being 5% over the current effective tax rate. In effect, this constitutes a 5% withholding tax at the provincial level. The Ontario Ministry of Revenue is very active in auditing compliance with this add-back. In order to be exempt from the add-back, the taxpayer must demonstrate that the management fee constitutes a reimbursement of costs incurred on its behalf. The Ontario test is more stringent than the federal test. For Ontario purposes, the taxpayer must support

specific expenses, whereas for federal purposes it is necessary only to demonstrate the reasonableness of the charge.

**2021 Qualifying cost-contribution arrangements**

Qualifying cost-contribution arrangements provide a vehicle to share the costs and risks of producing, developing or acquiring any property, or acquiring or performing any services. The costs and risks should be shared in proportion to the benefits that each participant is reasonably expected to derive from the property or services as a result of the arrangement. Where a participant's contribution is not consistent with its share of expected benefits, a balancing payment may be appropriate.

# 21 Chile

## 2101 Introduction

Article 22 of Law 19,506, published in the Official Gazette on 30 July 1997, introduced four new paragraphs to Article 38 of the Income Tax Law. These new paragraphs contain the basic Chilean transfer pricing rules, which became effective from calendar year 1997. A minor amendment to these rules was introduced by Law 19,840, published in the Official Gazette on 23 November 2002.

In addition, the Chilean tax authority (Servicio de Impuestos Internos – SII) issued Circulars No. 3 and 57, both in 1998. These Circulars contain the guidelines for the application of the rules by the tax inspectors.

## 2102 Statutory rules

### *General*

In general, Chilean transfer pricing rules are consistent with the OECD Guidelines. There is a specific interpretation of the application of the CUP method, which is described below.

### *Scope of the rules*

The rules apply to all types of transactions, including among others the following transactions:

- sale of goods;
- provision of services;
- transfer of technology;
- use of patents and trademarks; and
- financing transactions (interest, commissions and other payments).

### *Concept of a related party*

The rules establish a broad concept of 'related parties', which includes the following:

- the branch or agency and its parent company, or another agency or related company of the parent company;
- a company incorporated abroad that participates, directly or indirectly, in the management, control or capital of a company established in Chile or vice versa;
- a person that participates, directly or indirectly, in the management, control or capital of both a Chilean enterprise and a foreign enterprise;
- when there is an agreement for exclusivity, joint performance, preferential treatment, or economic, financial dependence or deposits of trust;



- when the transaction is performed with an enterprise established in a tax haven or low tax jurisdiction under the OECD; and
- in some other cases where Circular 3 considers the transaction not entered into between independent parties.

### *Methods*

The tax authority is allowed to use the following methods:

- A reasonable profitability given the nature of the transaction;
- The resale price, meaning the resale price to third parties of goods acquired from a related company, less the profit margin earned in similar transactions among independent companies;
- The cost plus a reasonable profit margin; and
- The international market value for which data from the national Customs Service and the Central Bank of Chile can be used.

The CUP method could be applied by the local taxpayer as a methodology for testing the arm's length principle; however, the Chilean SII would not be entitled to use it as a tool to determine an eventual transfer pricing adjustment on the same cross-border transaction.

There is no best-method rule.

### **2103 Other regulations**

Neither the law nor the tax authority requires preparation of a transfer pricing study or compliance with reporting requirements. There is no transfer pricing documentation requirement.

However, when conducting a transfer pricing examination, the tax authority welcomes transfer pricing studies voluntarily prepared by the taxpayer to support their pricing.

The Chilean tax authorities are requesting selected Chilean taxpayers to report their transactions with non-resident taxpayers. The transactions must be reported on oath on a form provided by the Chilean tax authorities. The information to be disclosed includes the following: (a) identification of the Chilean taxpayer; (b) identification of and information about the non-resident taxpayer, including name, tax identification number, country of residence and type of relationship with the Chilean taxpayer (if any); (c) type of transaction; (d) method utilised to price the transaction; (e) amounts received or paid as a consideration for these transactions; and (f) profit or loss margin from these transactions.

### **2104 Cases**

At present, there is no administrative guidance or judicial precedence.

### **2105 Burden of proof**

There are no specific rules on the burden of proof relating to transfer pricing. However, under the general rules in the Tax Code it is generally considered that the burden of proof lies with the SII.

**2106 Tax audit procedures**

The tax authority has a specialised group that performs transfer pricing examinations. This group is part of the International Tax Inspection Department (Departamento de Fiscalización Internacional).

There is evidence of transfer pricing examinations into mining companies and pharmaceuticals groups.

**2107 Advance pricing agreements (APAs)**

At present, there are no provisions enabling taxpayers to agree APAs with the tax authority. However, the tax authority has expressed its intention to implement APAs in the future.

**2108 Anticipated developments in law and practice**

It is expected that transfer pricing examination activity will increase in the near future. It is also expected that the tax inspectors will become more skilled in this area, due to increasing training and experience.

In a recent interview with the Head of the Chilean SII, he mentioned that the SII will attack tax evasion in Chile via the auditing of Transfer Pricing issues in key industries.

Finally, it is expected that documentation and reporting requirements will be introduced in the near future.

**2109 Liaison with customs authority and Central Bank of Chile**

The tax authority is allowed to request information from the customs authority and Central Bank of Chile for transfer pricing examinations.

**2110 Tax treaty activities**

It is interesting to note that Chile has been very active in the area of treaties, expanding its tax treaty network and concluding free trade agreements with the European Union and the US.

**2111 OECD issues**

Chile is not a member of the OECD. However, the tax authority has generally adopted the arm's length principle, and tax inspectors use the OECD Guidelines as a general guidance.

# 22 China

## 2201 Introduction

Prior to 1990, the Chinese tax authorities had already started conducting tax audits of a transfer pricing nature on foreign investment enterprises (FIEs). During the 1990's and in the early 2000's, transfer pricing audits became more active focusing mainly on pricing of tangible goods associated with FIEs' manufacturing activities. In recent years however, such audits have been broadened with transfer pricing for intangibles, services as well as tangibles goods being scrutinised.

The new Corporate Income Tax (CIT) Law and its Implementation Regulations (the CIT Implementation Regulations) were promulgated in 2007 and became effective on 1 January 2008. The new CIT regime merges the Enterprise Income Tax Provisional Regulations (which previously applied to PRC domestic enterprises) and the Foreign Enterprise Income Tax Law (which previously applied to FIEs and foreign enterprises). It also introduces a number of new transfer pricing and anti-avoidance concepts and further strengthens transfer pricing enforcement in China.

## 2202 Statutory rules

### *The CIT Law and Its Implementation Regulations*

Legislation relevant to transfer pricing is mainly found in Chapter 6 Special Tax Adjustments of the CIT Law. The chapter contains eight articles. It provides the arm's length standard as the guiding principle for related party transactions, and empowers the tax authorities to adjust a taxpayer's taxable income if the taxpayer fails to comply with the arm's length standard in dealing with related parties. The CIT Law and its Implementation Regulations provide a high level legal framework for transfer pricing methods, the cost sharing agreement (CSA), the advance pricing arrangement (APA), annual disclosure of related party transactions and contemporaneous documentation, methods for deeming taxable income, the controlled foreign corporation (CFC) rule, the thin-capitalisation rule, the general anti-avoidance rule (GAAR) and special interest levy.

### *The Tax Collection and Administration Law and its detailed implementation rules*

The Tax Collection and Administration Law, promulgated in 2001, and its Implementation Rules, issued in 2002, constitute the underlying tax procedure law and regulations with respect to tax filing, APA, tax investigation, tax appeals and litigation, and punishments for non-compliance (such as penalty and surcharge).

## 2203 Other regulations

Detailed implementation rules and circulars for tax laws and regulations are formulated by the State Administration of Taxation (SAT), a ministry-level department directly under the State Council. The main transfer pricing rules and circulars issued by the SAT prior to the CIT Law include, among others:

- Tax Circular Guoshuifa [1998] 59 / [2004] 143 (Circulars 59 and 143), the transfer pricing foundation rules covering identification and disclosure of

related party and related party transactions, transfer pricing investigation and target selection, transfer pricing adjustment methods, appeal procedures, etc;

- Tax Circular Guoshuifa [2002] 128, tax treatment for services rendered by China holding companies to its subsidiaries;
- Tax Circular Guoshuifa [2004] 118 (Circular 118), APA implementation rules; and
- Tax Circular Guoshuifa [2005] 115, the mutual agreement procedure (MAP) rules.

Since the new CIT Law has superseded the Foreign Enterprise Income Tax (FEIT) Law, which is the legal basis for the tax circulars listed above, the SAT is drafting a comprehensive tax circular to update and consolidate previous circulars. In March 2008, the SAT circulated a discussion draft entitled the Provisional Administrative Rules on Special Tax Adjustments (the Draft Rules), which contains 13 chapters covering all aspects of Special Tax Adjustments under the CIT regime, including:

- General principles;
- Annual disclosure of related party transactions;
- Administration of contemporaneous documentation;
- Transfer pricing methods;
- Transfer pricing investigation and adjustment;
- APA;
- CSA;
- Administration of CFC;
- Administration of thin-capitalisation;
- GAAR;
- Corresponding adjustments and international consultation;
- Legal obligations; and
- Supplementary provisions.

The Draft Rules are expected to be issued in the second half of 2008 but take effect retrospectively from 1 January 2008. While many of the Draft Rules are consistent with the existing circulars and current practices, there are notable changes and significant additions to the existing rules, some of which are discussed below. However, as the Draft Rules are still under review and revision by the SAT, their contents may change substantially when they are finally issued. Therefore, discussions below on the Draft Rules are for information purposes only and should be checked against the final rules when they are issued.

## **2204 Legal cases**

There has been only one unpublished case relating to transfer pricing brought before China People's Court on local level. The local court has found in favour to the SAT. Since there is limited experience in court cases and the SAT has great discretionary

power, taxpayers should generally seek mutually satisfactory resolutions before the issuance of audit decisions.

### **2205 Burden of proof**

In China, the burden of proof that a related party transaction was dealt at arm's length rests with the taxpayer. According to Paragraph 2 of Article 43 of the CIT Law, where tax authorities conduct a transfer pricing investigation on a taxpayer, the taxpayer, its related party and other relevant enterprises are obligated to provide relevant information upon request.<sup>8</sup> If the taxpayer under investigation fails to provide information in relation to its related party transactions or provides false or incomplete information which does not truly reflect its related party transaction situations, the tax authorities are authorised to deem an adjustment on the related party transactions that are inconsistent with the arm's length principle.

According to the CIT Implementation Regulations, information required by tax authorities during a transfer pricing investigation may include:

- The taxpayer's contemporaneous transfer pricing documentation;
- Relevant overseas information regarding the resale (or transfer) prices or ultimate sales (or transfer) prices of tangible goods, intangible goods and services involved in the related party transactions; and
- Other relevant information of the related party transactions.

### **2206 Information reporting**

#### *Annual disclosure of related party transactions*

Under the old FEIT regime, FIEs and foreign enterprises (FEs) were required to complete Form 13-A or Form 13-B to disclose their related party transactions during their annual income tax filing. Under the CIT regime, the taxpayer is subject to broader disclosure requirements. Paragraph 1 of Article 43 of the CIT Law provides that the taxpayer shall attach an annual related party transactions report with respect to its transactions with related parties as part of its annual CIT return. Article 43 forms the legal basis for contemporaneous documentation and annual disclosure requirements on related party transactions, as specified in the Draft Rules.

The Draft Rules contain ten schedules relating to special tax adjustments, which must be filed by the taxpayer along with its annual CIT return. These schedules include:

- Relationship with the Related Parties;
- Summary of Related Party Transactions;
- Purchases and Sales;
- Services;
- Financing;

---

<sup>8</sup> "Other relevant enterprises" as stated in Article 43 of the CIT Law refers to enterprises which are comparable to the Enterprise under investigation in terms of the substance and form of the production and business operations.

- Transfer of Assets;
- Thin-capitalisation;
- Payment to Overseas Related Parties;
- Outbound Investment; and
- Controlled Foreign Corporation.

Under the Draft Rules, the taxpayer is not required to submit contemporaneous documentation as part of its annual CIT return. However, it must confirm whether such contemporaneous documentation exists at the time it files the CIT return.

#### *Contemporaneous documentation requirements*

China has no contemporaneous documentation requirements currently. However, under the Draft Rules, which may become effective retrospectively from 1 January 2008, the taxpayer must prepare contemporaneous documentation by 1 June after the end of each taxable year, i.e., the CIT return due date, and the contents of contemporaneous documentation should include the following:

- (1) Organisational structure (e.g. global organisational structure, description of the enterprise and its related parties);
- (2) Details of business operations (e.g. the enterprise's business overview, composition of the principal business operations, business strategy and expected earnings, market position and the relevant market competitive environment, internal organisational structure, copies of annual financial statements, audit reports of related parties and consolidated financial statements of the group, explanation on financing arrangements, business form of related party transactions);
- (3) Details of related party transactions (e.g. background information, transaction flow, intangible properties, copies of inter-company agreements, economic and legal factor analysis, segmental financial data of related and unrelated party transactions);
- (4) Comparability analysis (e.g. description of comparable transactions, selection of comparables and adjustments); and
- (5) Selection and application of transfer pricing method.

The Draft Rules provide that a taxpayer is exempted from the contemporaneous documentation requirement in a given year if it meets one of the following conditions:

- its annual related party transactions amount is less than RMB20 million (the SAT is reviewing this "de-minimis" exemption threshold); or
- it is within the covered period of an APA; or
- it only conducts related party transactions with domestic related parties (excluding related parties in Hong Kong, Macau, and Taiwan).

The Draft Rules also stipulate that the taxpayer must submit contemporaneous documentation within 15 days upon request, unless it is exempted from the contemporaneous documentation requirements.

**2207 Audit targets**

The Draft Rules list 8 key criteria for selecting audit targets, which are generally consistent with the current circulars, including:

- enterprises with significantly large quantities and varieties of related party transactions;
- enterprises with consecutive losses or low profitability or fluctuating patterns of profits and losses;
- enterprises with profit levels lower than those of other enterprises in the same industry;
- enterprises with profit levels lower than those of other enterprises within the same group;
- enterprises with profit levels which obviously do not correspond to the functions performed and risks borne;
- enterprises which have business dealings with related parties established in a tax haven;
- enterprises which have not complied in reporting related party transactions or preparing Contemporaneous Documentation; and
- enterprises which are in obvious violation of the arm's length principle.

The Draft Rules provide that, in principle, no transfer pricing adjustment will be made on related party transactions between domestic related parties with the same effective tax burden.

**2208 Audit information requests**

Under the CIT Law and its Implementation Regulations, not only the enterprise under audit, but also its related parties and other relevant enterprises are obligated to provide information as requested by the tax authorities. The other relevant enterprises refer to enterprises that are considered by the tax authorities to be similar to the enterprise under audit, that is, its potential comparable companies. As previously indicated, contemporaneous documentation must be submitted to the tax authorities within 15 days upon request. Where timely submission of the required documents is not possible due to special circumstances, the enterprise being questioned shall file a written application for extension to the tax authority. An extension of no more than 30 days may be granted by the tax authority at its discretion.

If the taxpayer under audit fails to provide information within the prescribed time as required by the tax authority, or refuses to provide information as requested, it may be subject to:

- an administrative penalty of up to RMB10,000 in accordance with the Tax Collection and Administration Law;
- transfer pricing adjustments as determined by the tax authority by means of deeming the taxpayer's taxable income, and
- an additional 5% interest levy on the amount of the tax underpayments resulted from the transfer pricing adjustments (see Section 2210).

## 2209 The audit procedure and adjustments

In China, the SAT as the national tax authority in Beijing serves primarily as a policy-maker. Transfer pricing is the responsibility of one of the many local tax authorities, which consist of tax bureaus at the provincial, municipal and county levels.<sup>9</sup> Various factors help determine which authority will conduct the transfer pricing audit. However, all transfer pricing audits need to be ultimately approved by the SAT.

Tax audits in China may be conducted either at the taxpayer's offices or at the tax authorities' offices. According to Circulars 59 and 143 (see Section 1903), the tax authorities should notify the FIE of the time and location of the audit up to three to seven days in advance.

When it is determined that transactions are not conducted at an arm's length basis, the tax authorities are empowered to adjust the FIE's income, based on various methods prescribed in Circulars 59 and 143.

Under the Draft Rules, which are consistent with Circulars 59 and 143, the transfer pricing audit procedure typically comprises the following main steps:

- Desk audits and selection of transfer pricing audit targets by the tax authority;
- Notification to the taxpayer of a transfer pricing audit;
- Information collection and on-site audit by the tax authority;
- Negotiation with the enterprise by the tax authority;
- Initial assessment notice issued by the tax authority;
- Further negotiation between the taxpayer and the tax authority, if necessary.
- Final determination by the tax authority (e.g. issuance of "Transfer Pricing Adjustment Notice" if there is any transfer pricing adjustment or "Transfer Pricing Investigation Conclusion Notice" if the related party transactions of the audited enterprise are considered consistent with the arm's length principle);
- Appeal to the upper-level tax authority and litigation by the taxpayer (if any); and
- Post-audit follow-up management by the tax authority.

Article 111 of the CIT Implementation Regulations specifies that the following transfer pricing methods may be used to evaluate or adjust a taxpayer's transfer pricing:

- Comparable Uncontrolled Price Method;
- Resale Price Method;
- Cost Plus Method;
- Transactional Net Margin Method;
- Profit Split Method, and
- Other Methods in compliance with the arm's length principle

---

<sup>9</sup> As of 2004, there were 34 provincial-level, 333 municipal-level, and 2862 county-level governments in China. There are different and separate tax regimes in Hong Kong and the Macau Special Administrative Regions (SAR).



The CIT Implementation Regulations do not provide a particular preference or hierarchy of transfer pricing methods, as opposed to the OECD Guidelines or the Best Method Rule as provided in the U.S. Transfer Pricing Regulations. According to the CIT Law, the tax authority is empowered to select appropriate adjustment methods at its discretion during a transfer pricing investigation. Under the Draft Rules, the taxpayer is required to justify its selection of the transfer pricing method in its contemporaneous documentation, so in essence the taxpayer has to select the most appropriate or the best method even though the tax authority does not seem subject to the same requirement.

The Chinese local tax authorities are encouraged by the SAT to use the databases of the National Bureau of Statistics, which are not publicly available, the OSIRIS database of Bureau van Dijk and other databases in transfer pricing audits, as directed in a tax circular prior to the new CIT Law. The Draft Rules also endorse that the comparability analysis by the tax authorities in a transfer pricing audit shall be primarily based on publicly available information. However, the tax authorities are not obligated to use only public information in transfer pricing audits, nor is it uncommon for the tax authorities to use non public information. The CIT Law and its Implementation Regulations also empower the tax authorities to collect the necessary information (e.g. contemporaneous documentation) from other comparable enterprises in the industry to conduct transfer pricing audit, and such information obviously cannot be obtained from the public domain.

Article 123 of the CIT Implementation Regulations provides that adjustments may be made on a retroactive basis for up to 10 years as a result of a transfer pricing audit. The same statute of limitations also applies to general anti-avoidance investigations.

## **2210 Assessments and appeals procedure**

Transfer pricing audits are usually settled through negotiation. While the conduct of the taxpayer should not significantly affect the outcome, a friendly working relationship with the tax authorities is always to the taxpayer's advantage, as Chinese tax legislation gives broad discretion power to tax authorities.

When an enterprise under audit receives an initial assessment from the tax authority and disagrees with the assessment, it may provide written explanations and supporting documents on the reasonableness of its transfer prices. Further discussions and negotiations may continue until the tax authority reaches a conclusion and issues a written notice of its audit decision in the form of "Transfer Pricing Adjustment Notice" or "Transfer Pricing Investigation Conclusion Notice". Once the written notice is issued, the decision is considered final and further negotiation usually is not possible.

If the taxpayer disputes the adjustment, the matter is resolved through the appeal procedures. The Tax Collection and Administration Law provides both administrative and judicial appeal procedures for resolving tax disputes. The taxpayer may appeal to the tax authority at the next higher level within 60 days for an administrative appeal and a decision on the appeal must be made within 60 days. If the taxpayer is not satisfied with this decision, it may start legal proceedings in the People's Court within 15 days of receiving the decision. Before proceeding with the appeal process, the taxpayer is required to pay the assessed tax, fine and surcharge (if any). In practice,

tax or transfer pricing litigation is rare in China since the SAT has extensive discretionary power, so taxpayers should generally seek mutually satisfactory resolutions before the issuance of audit decisions.

For related party transactions between China and a treaty country, mutual consultation between the SAT and the competent authority of the treaty country is available for the taxpayer to resolve double taxation issues resulted from transfer pricing adjustments.

## **2211 Additional tax and penalties**

Under the CIT Law, special tax adjustments including transfer pricing adjustments are subject to a special interest levy. The special interest levy mechanism is different from surcharge and fines, which constitute the current penalty measures of tax collection and administration. This is explained further below.

### *Surcharge*

Article 32 of the Tax Collection and Administration Law provides that if a taxpayer fails to pay the tax due, the tax authority shall impose a daily surcharge of 0.05% on the amount of the tax unpaid commencing on the day of default.

### *Fines*

Articles 60 to 73 of the Tax Collection and Administration Law provide that violations of the Law are subject to fines, and serious violations such as tax evasion, tax fraud and tax violence are subject to criminal prosecution. .

### *Special interest levy*

Article 122 of the CIT Implementation Regulations defines the rate for the special interest levy as based on the RMB loan base rate applicable to the relevant period of tax delinquency as published by the People's Bank of China (PBOC) in the tax year to which the tax payment is related, plus 5 percentage points. The following formula illustrates the calculation of the interest rate:

*Interest rate = PBOC RMB loan base rate of the year of assessment in which the tax adjustment relates + 5%*

According to the Draft Rules, the 5% additional interest levy may be waived if the taxpayer has prepared and timely submitted contemporaneous documentation upon request.

In the context of a transfer pricing adjustment, the taxpayer will be subject to a special interest levy where a transfer pricing adjustment is imposed. A daily surcharge of 0.05% will be levied if the taxpayer fails to pay or remit the tax and interest levy before the deadline set by the tax authorities on the Transfer Pricing Adjustment Notice. The taxpayer is subject to fines if it has any violations as specified in Articles 60-71 of the Tax Collection and Administration Law, and such violations may include, among others, the taxpayer's failure to prepare or maintain documents as required by tax laws and regulations, or its failure to provide information as requested by the tax authority during an audit.

### 2212 Resources available to the tax authorities

- The SAT has a group of transfer pricing officials to monitor, develop and interpret transfer pricing regulations in China. These officials have frequent exchanges with tax authorities in other countries and with OECD. Generally, this group does not deal directly with taxpayers but acts in a supporting role to local tax officials conducting field audits. Circulars 59 and 143 require local tax authorities to set up specialist transfer pricing audit groups, and, since the issuance of the ruling, the Chinese tax authorities have continuously to build up the local transfer pricing audit teams.
- The increasing sophistication of the transfer pricing officials is reflected in the transfer pricing regulations released by the SAT.

### 2213 Advance pricing arrangements (APAs)

Before the CIT Law was promulgated, China already had rules and regulations relating to APAs, namely:

- Article 48 of Circulars 59 and 143;
- Article 53 of Detailed Implementation Rules of Tax Collection and Administration Law; and
- Circular 118 entitled Implementation Rules on Advance Pricing Arrangements for Transactions between Related Parties.

While most of the APAs concluded so far have been unilateral, including APAs involving multi-jurisdictions within China, five bilateral APAs have been concluded, including two with Japan, one with the US and two with Korea.

The CIT Law further consolidates the legislative foundation of APA practice in China. Article 42 of the CIT Law indicates uniform implementation guidelines and strong support from the tax authorities for the APA process. The Draft Rules further state that an APA should be recognised by the relevant state and local tax bureaus<sup>10</sup> as long as the taxpayer complies with all of the terms and requirements of the APA, which can be regarded as a positive sign from the SAT to increase certainty of APAs.

More and more taxpayers are pursuing APAs as an effective way to manage their tax risks in China. As the SAT become more receptive to this process, more APAs are expected to be concluded as taxpayers continue adopt APA as part of its tax planning alternative.

### 2214 Anticipated developments in law and practice

It is expected that the Draft Rules will be issued in the second half of 2008. Additionally, new annual report forms regarding related party transactions, thin-capitalisation and CFC will be formulated. Further tax circulars will also be issued in the near future to clarify various matters relating to administration of special tax adjustments, such as the calculation of effective tax rate and definition of tax haven.

---

<sup>10</sup> China has a dual tax bureau system at the local level consisting of a state tax bureau and a local tax bureau, each of which is responsible for collecting certain categories of taxes.

### **2215 OECD issues**

While China is not a formal member of the OECD, it has modelled its transfer pricing legislation on the OECD Guidelines. Therefore, in general, China's transfer pricing regulations reflect the same arm's length principle and support the same type of transfer pricing methodologies that are being adopted in the OECD countries. However, a transfer pricing policy or practice that is acceptable in an OECD country will not necessarily be followed in China (e.g. voluntary transfer pricing adjustment by taxpayer, collaboration between the customs and tax authorities in determining the transfer price/import value of related party tangible goods transactions).

### **2216 Joint investigations**

China would not usually join another country to undertake a joint investigation of a multinational group for transfer pricing purposes. However, the Chinese tax treaties generally contain the Exchange of Information article which provides the cooperation between the competent authorities in the form of exchanges of information necessary for carrying out the provisions of the treaty (including transfer pricing investigation). In practice, the methods of exchanging information include exchange on request, spontaneous exchanges and automatic exchanges.

There are intra-country transfer pricing investigation cases where authorities in different locations collaborate their efforts in conducting simultaneous audits on Chinese subsidiaries of a group corporation.

### **2217 Cost sharing**

CSAs for development of intangible assets and provision of services are allowed under Article 41 of the CIT Law. However, detailed rules on the CSA are yet to be issued.

Under the Draft Rules, service-related CSAs are generally limited to procurement and marketing services and must be submitted for the SAT's approval. In addition, an enterprise should report the CSA to the tax authorities for filing purposes within 15 days upon the conclusion of the CSA and contemporaneous documentation for the CSA must be submitted to the tax authorities within five months after the end of a tax year.

### **2218 Anti-avoidance**

For the first time, the new CIT Law introduces GAAR which formally authorises Chinese tax authorities to make an adjustment where the taxpayer enters into an arrangement 'without reasonable commercial purpose'. This is a strong signal of the tax authorities' growing scrutiny of business structures.

Under the Draft Rules, the general anti-avoidance investigations focus on the following transactions / structures:

- abuse of tax preferential treatments;
- abuse of tax treaties;
- abuse of corporate structure;
- frequent transactions with entities in tax havens; and
- other arrangements without reasonable commercial purposes.

Under the Draft Rules, all general anti-avoidance investigations and adjustments shall be subject to the SAT's final review and approval.

### **2219 Thin capitalisation**

Also for the first time, the CIT Law introduces a thin capitalisation rule providing that the ratio of debt investments to equity investments from related parties should not exceed the 'prescribed criteria', or the excess interest expenses shall not be tax deductible. The prescribed criteria are yet to be determined and issued by the SAT.

### **2220 Special features**

#### *Multiple audits*

In general, China does not allow consolidation of CIT returns for multinational companies; therefore a multinational with subsidiaries located in various parts of China may be subject to multiple transfer pricing audits.

#### *Management fees*

Under Article 49 of the CIT Implementation Regulations, management fees paid to related parties are not deductible for CIT purposes. On the other hand, service fees are deductible. According to Article 8 of the CIT Law, an enterprise can deduct reasonable expenses (including service fees paid to its related parties) that are actually incurred and are related to the generation of income. As there is no clear guidance on how to distinguish between service fees and management fees, tax authorities in different locations may have different views and practices in this regard.

#### *Business tax and other taxes*

In establishing transfer pricing policies for China, it is important for foreign investors to realise that income tax is not the only tax issue. Besides the Chinese CIT, other taxes such as business tax, VAT, consumption tax and customs duties can be quite significant. Thus, transfer pricing planning in China must also consider its impact on other taxes.

# 23 Colombia

## 2301 Introduction

Transfer pricing regulations (TP Rules) were first introduced in Colombia by Act 788 in 2002. The scope of TP Rules was specified and clarified by Act 863 in 2003. Subsequently with the enactment of the Regulatory Decree 4349 in 2004, the enforcement of the formal and substantial transfer pricing obligations was enacted.

Colombian regulations regarding TP Rules apply from FY 2004<sup>11</sup> and are consistent with the spirit of the OECD (Organisation for Economic Co-Operation and Development) Guidelines. TP Rules include specific issues such as financial transactions, application of the inter-quartile range, and adjustment to the median when the taxpayer's margins or prices fall out of the range and considerations of the industry and/or life business cycles.

Colombian tax authorities (Dirección de Impuestos y Aduanas Nacionales – DIAN) are entitled to assess taxpayers' transactions subject to the rules as from year 2005.

## 2302 Statutory rules

TP rules apply to income taxpayers engaging in cross-border transactions with foreign related parties.

These rules only impact the income and complementary tax computation regarding ordinary and extraordinary income and expenses (costs and deductions) and for the determination of assets and liabilities between related parties. Therefore, TP Rules will not affect the determination of other taxes under such transactions, such as industry and trade tax, value added tax, stamp tax, customs tariffs, etc.

Subject to the TP Rules are all types of transactions, including, among others, the transfer or use of tangible and intangible property, provision of services and financial transactions (such as loans and investments).

Regarding the application of any of the transfer pricing methods, the TP Rules clarify that income, costs, gross profit, net sales, expenses, operating profits, assets and liabilities will be determined based upon the Colombian GAAPs.

### *Related economic party or related party*

The concepts of related economic party or related party, upon which the TP Rules are based, should be considered synonyms and are basically defined by references to other rules that include situations ranging from statutory to economic dependency and control of companies by individuals. In this matter, TP Rules refer to the following regulations:

- Commercial Code, under the meaning of which subordinated or controlled entity (Sections 260 and 261), including branches and agencies (Sections 263 and 264), is addressed;

---

<sup>11</sup> In Colombia, Fiscal Year equals Calendar Year.

- Section 28 of Act 222 of 1995, which defines the concept of a group company and the notion of unity of management and purposes;
- Tax Code, which applies the subordination levels provided by Sections 450 and 452;
- Finally, unless otherwise proven, transactions among residents or persons domiciled in Colombia and residents or persons domiciled in tax havens will be assumed to be transactions among related parties.

### *Transfer pricing methods*

Following the spirit of the OECD Guidelines, TP Rules specify the methods for the transfer pricing analysis, as well as the comparability factors that should be taken into account when assessing controlled transactions to those performed by independent third parties in comparable transactions. In Colombia, Section 260-2 of Tax Code specifies the following six transfer pricing methods:

- Comparable uncontrolled price method (CUP);
- Resale price method (RPM);
- Cost plus method (CPM);
- Profit split method (PSM);
- Residual profit split method (RPSM);
- Transactional net margin method (TNMM).

### *Best method rule*

TP Rules do not establish a ranking for selecting the above methods nor do they provide guidance as to the specific cases in which they will have to be used. In practice, taxpayers will need to select the most appropriate method applicable to the transaction(s) under review and provide adequate support of the rejection of the other methods.

To determine that the method used is most appropriate, it should be the one that better reflects the economic reality of the transaction, be compatible with the company's enterprise and commercial structure, rely on the best quantity and quality of information, contemplate the better degree of comparability and require the least level of adjustments.

### *Tested party*

For the application of transfer pricing methods that require the selection of a tested party, the Colombian TP Rules do not determine which party should be subject to analysis. Therefore, it is permissible to choose as tested party either the local or the foreign related party when conducting the transfer pricing analysis.

### *Formal obligations*

Income taxpayers obliged to fulfil TP Rules requirements are those who perform transactions with related parties located abroad who exceed the established caps of gross equity equal or higher than 100,000 Taxable Units (TU) or gross income higher

than 61,000 TU<sup>12</sup>, and those taxpayers that perform transactions with companies located or domiciled in tax havens.

For the enforcement of the transfer pricing obligations, taxpayers should report on the informative return all transactions entered into with foreign related parties regardless the amount. However, for supporting documentation purposes, only those operations exceeding 10,000 TU should be subject to the transfer pricing analysis.

Below is a short description of the requirements included in the Regulatory Decree regarding the individual and consolidated informative return as well as the supporting documentation.

#### *Individual informative return*

Pursuant to the Regulatory Decree, the transfer pricing return must contain, among other information, the following:

- Form fully completed;
- Taxpayer's fiscal identification;
- Income tax ID and country of domicile of the related parties involved in the controlled transactions;
- Transfer pricing method used to determine the prices or profit margins;
- Inter-quartile range obtained in the application of the transfer pricing methodology;
- Assessment of sanctions, when necessary;
- Electronic signature of the taxpayer or its legal representative, its agents or the special agents.

#### *Consolidated informative return*

In cases of control or holdings, when the controller or headquarter or any of its subordinated entities must file the individual informative return, the controller or head office will have to file a consolidated informative return listing all transactions, including those involving affiliates that are not required to file the individual informative return. Additional considerations:

- In cases of joint control the DIAN must be informed, by a letter, which of the controllers will file the consolidated return;
- When the controller or head office has a branch and one or more subsidiaries in Colombia, the branch is the one required to file the consolidated return;
- When there is no branch, the subordinate with the higher net equity would be responsible for complying with this formal obligation;
- The content of the consolidated return is similar to the individual one. However, all of the operations performed by the related parties must be consolidated by type of transaction.

---

<sup>12</sup> For FY 2007 one TU is equivalent to COP20,974 (approximately USD11.65) and for FY 2008 it is equivalent to COP22,054 (approximately USD12.25). Exchange rate of COP1,800 per USD.



*Filing of the informative returns*

The forms of the informative returns are generally due in the last week of June or the first week of July and they should be filed through the Electronic Media and Payment System. The forms to be used are N° 120 for the individual informative return and N°130 for the consolidated informative return. The informative returns for FY 2007 are due by the following dates:

| Return       | Last Digit of Tax ID | Filing       |
|--------------|----------------------|--------------|
| Individual   | 9 or 0               | 1 July 2008  |
|              | 7 or 8               | 2 July 2008  |
|              | 5 or 6               | 3 July 2008  |
|              | 3 or 4               | 4 July 2008  |
|              | 1 or 2               | 7 July 2008  |
| Consolidated | 6, 7, 8, 9 or 0      | 10 July 2008 |
|              | 1, 2, 3, 4 or 5      | 11 July 2008 |

*Supporting documentation*

The supporting documentation should be prepared and made available to the tax authorities upon request no later than 30 June following the related fiscal year. Tax authorities should grant at least 15 calendar days as from the date of notification of the request. The supporting documentation must contain among other the following information:

*General information*

- Description of the taxpayer's organisational and functional structure;
- General description of the business;
- Equity composition with name, income tax ID and ownership percentage of partners or shareholders;
- General description of the industry or sector where the company belongs to, indicating the taxpayer's position in it;
- Name, income tax ID, domicile, description of the business purpose and activity of the related parties including ownership details and subsidiaries. The fact that gives rise to the relationship must be informed.

*Specific information*

- Detailed description of each type of transaction;
- For contracts or agreements, parties, purpose, terms and prices must be specified;
- For transactions with residents or domiciled in tax havens, a copy of the documentation that certifies that the operation was done must be included;

- Functional analysis by type of operation, including a short description of the activities, classification of used assets and inherent risks of the operations, among others;
- General information about commercial strategies;
- Information of the industry and description of substitute goods or services;
- Politic or normative changes that could affect the result of the transaction;
- Method used by the taxpayer in the transfer pricing analysis, selected in accordance with the best method rule;
- Profit level indicator used in the analysis;
- Identification and determination of comparable parties used, information sources, inquiry dates and indication of the rejection criteria of non-accepted comparable companies;
- Technical adjustments' description and, when needed, generic description of the principal differences between Colombian accounting practice and the practice in those countries where the comparable parties are located;
- Detailed conclusions of the level of compliance with transfer pricing regulations.

#### *Annex information*

- Financial statement (general purpose);
- Balance Sheet, Profit and Losses Statement, Production Costs Statement and Sales Costs Statements segmented by type of transaction;
- Copy of the contracts or agreements;
- In economic or special business situations, pertinent supporting information, such as marketing studies, projections and reports must be attached.

### **2303 Other regulations**

#### *Related rules*

The following Tax Code provisions will not apply whenever taxpayers' transactions are analysed according to TP Rules:

- Determination of the gross profit in case of transfer of assets (Section 90);
- Other non-deductible payments (Section 124-1);
- Non-deductibility of losses in case of transfer of assets to economic related parties (Section 151);
- Non-deductibility of losses derived from the transfer of a company's assets to its shareholders (Section 152);
- Cases in which occasional losses are not accepted (Section 312, paragraphs two and three).

The majority of the above-mentioned rules aim to control transactions between related parties, although in a very general manner. As a result, it would not be appropriate to

apply these rules in a case in which arm's length values for controlled transactions would be analysed through TP Rules.

Finally, the Tax Code states that the transactions to which TP Rules apply will not be subject to the limitations on the costs and deductions established on the Tax Code, for related parties (Section 260-7 of the Tax Code).

### *Tax havens*

Act 863, 2003 specifically established the criteria to determine if a country or jurisdiction qualifies as a tax haven. A country or jurisdiction will be considered as a tax haven if it fulfils the first requirement and any one of the other three listed below:

- Nonexistence of taxation or low nominal rates as compared to those applied in similar transactions in Colombia;
- Lack of an effective information exchange, or the existence of regulations or administrative practices that could limit the exchange of information;
- Lack of transparency at a legal level, regulatory or administrative functioning;
- Absence of requirements for the development of a real economic activity that is important or substantial to the country or territory or the simplicity by which a jurisdiction accepts the establishment of private entities without a substantive local presence.

The Colombian Government has the authority to issue through a Decree the list of countries and jurisdictions considered as tax havens, however an up to date Decree has not been issued.

On the other hand, for foreign policy reasons, the Colombian Government has the authority to exclude a country or jurisdiction even if it fulfils the above mentioned characteristics.

### **2304 Legal cases**

Since the transfer pricing regulations were introduced in 2004, no legal cases have yet been brought before courts.

### **2305 Burden of proof**

The TP Rules shift the burden of proof to the taxpayers, allowing them to develop their transfer pricing policies, and to document all their cross-border related party transactions subject to the rules.

### **2306 Tax audit procedures**

During 2006, the Colombian tax authorities issued a general communication requesting the FY 2004 supporting documentation. During 2007, tax authorities requested the supporting documentation of FY 2005 and FY 2006. Nevertheless, there has been no further action from tax authorities related to these requirements.

Additionally, in 2006, tax authorities purchased the OSIRIS database, which gave them the possibility to review different aspects of the international sets of comparables. However, there has been no further action on the tax authorities' side.

### 2307 The audit procedure

Despite the fact that there has been no transfer pricing-specific audit, it is expected that tax authorities will use regular or standard procedures, such as on-site examination or written requests. During the examination, the tax authorities may request additional information and must be allowed to have access to the company's accounting records.

### 2308 Additional tax and penalties

Penalties for TP Rules are established in Section 260-10 of the Tax Code.

#### Summary of Penalties

|                             | Supporting Documentation  |                                    | Informative Return             |  |                              |
|-----------------------------|---|------------------------------------|--------------------------------|--|------------------------------|
| <b>Case</b>                 | Inconsistent / After deadline / not there requested / Mistaken / Does not permit Verification | Not filed                          | Late filing                    | Amendment  | Not filed                    |
| <b>Rate</b>                 | 1%  | 1%                                 | 1% per month or month fraction | 1%   | 20%                          |
| <b>Base</b>                 | Total value of transactions with related parties  |                                    |                                |  |                              |
| <b>Cap</b>                  | 28,000 TU   | 39,000 TU                          | 39,000 TU                      | 39,000 TU  | 39,000 TU                    |
| <b>Effect</b>               |   | Rejection of the cost or deduction |                                |  | Could not be used as a proof |
| <b>Other considerations</b> | After tax notice penalty will be doubled.   |                                    |                                | Inconsistent information could be amended between the next following 2 years after the deadline established for the return and before the notification of the requirement. |                              |

It is important to bear in mind what is established in the following paragraph of Section 260-10 which states:

In accordance with TP Rules, there will be sanction able inaccuracy with the inclusion in the income tax return, informative returns, supporting documentation or in reports filed to tax authorities, of false, mistaken, incomplete or disfigured data or factors, and/or the determination of income, costs, deductions, assets and liabilities in operations with related parties, with prices or margins that do not match those used by independent parties in comparable transactions, which derive in a lesser tax or payable value, or in a greater balance in favour of the taxpayer. The applicable sanction would be the one established in Section 647 of the Tax Code.

### 2309 Use and availability of comparable information

Comparable information is required in order to determine arm's length prices and should be included in the taxpayers' transfer pricing documentation. Colombian companies are required to make their annual accounts publicly available by filing them to the Colombian Superintendency of Societies (Superintendencia de Sociedades). This financial information can be accessed through the Internet and is considered

reliable data. PwC Colombia has made an important investment accruing and formatting this information so it can be used for supporting documentation purposes as of FY 2007.

Additionally, as mentioned previously, tax authorities have access to the OSIRIS database, and so far, there has been no attempt to reject the taxpayers' selection or use of international comparables.

### **2310 Limitation of double taxation and competent authority procedure**

Where there is a tax treaty or agreement entered into by Colombia with a foreign jurisdiction, in the case that such foreign jurisdiction adjusts the profits (as a result of a transfer pricing audit) of the foreign related party, the taxpayer in Colombia is allowed to request a reciprocal adjustment, upon approval of the tax authorities on its income tax return.

### **2311 Advance pricing agreements (APAs)**

As of 1 January 2006 taxpayers can request an APA. These regulations refer to the duration, time limits so that the APA may be authorised by the tax authorities, time limits so that taxpayers could request an APA, modification of an APA and cancellation of the agreement among others.

### **2312 Anticipated developments in law and practice**

#### *Law*

Changes in the transfer pricing rules or enactment of new rules are not expected in the near future.

#### *Practice*

Tax authorities have become more aggressive, and have improved their transfer pricing knowledge. It is expected that transfer pricing audits will come in the near future, being some of the main areas that are likely to be examined as follows: inter-company debt, technical services fees, commission payments, royalty payments, transfers of intangible property and management fees.

### **2313 Liaison with customs authorities**

There are no records or evidence of any direct communication between customs and tax authorities regarding Transfer Pricing.

### **2314 OECD issues**

Although Colombia is not a member of the OECD, the tax authorities have generally adopted the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the OECD in 1995 and supplemented in 1996 (with periodic update), as a specialised technical reference and not as a supplementary source of bylaw interpretation.

### **2315 Joint investigations**

There have been no requests to other tax authorities for specific information concerning transfer pricing.

# 24 Croatia

## 2401 Introduction

Transfer pricing provisions in Croatia were introduced through the new *Corporate Income Tax Act* ('*CIT Act*') on 1 January 2005.

Prices between a Croatian entity and its foreign related party must be charged at arm's length (the arm's length principle).

According to the *CIT Act*, in order to determine the arm's length price, the following methods can be used:

- the comparable uncontrolled price method;
- the resale price method;
- the cost plus method;
- the profit split method; and
- the net-profit method which is equivalent to the transactional net margin method under the OECD Guidelines.

According to Article 41 Paragraph 2 of the *General Tax Act* related entities are legally independent companies which, in their mutual relations, fall into one of the categories below:

- Two or more companies, of which one holds a majority share or majority decision-making interest in the others;
- Two or more companies, of which at least one is dependent and one is controlling, Companies that are part of the same "concern" (Group);
- Companies with common shareholders; and
- Companies linked by special contracts in accordance with the *Companies Act* or have arrangements such that profits and losses can be transferred between them.

## 2402 Statutory rules

Transfer pricing rules are prescribed by Article 13 of the *CIT Act* and by Article 40 of the *Corporate Income Tax Ordinance*.

Currently, detailed transfer pricing regulations are in a draft form. There is no indication of when they will be published, but it is unlikely to happen before 2009.

## 2403 Other regulations

There are no other regulations, but the OECD Guidelines can be used as a general guide.

## 2404 Legal cases

As this is a relatively new provision, there are no legal cases in Croatia related to transfer pricing.

### 2405 Burden of proof

The burden of proof lies with the local taxpayer.

According to the transfer pricing provisions of the *CIT Act* and the related Ordinance, the business relations between related entities will only be recognised if a taxpayer has and provides (at the request of the Tax Authority) information as follows:

- Identification of the method selected and the reasons for the selection of such method;
- A description of information reviewed, methods and analyses, which are conducted in determining the arm's length price and the explanation for the reasons for selecting the specific method;
- Documentation regarding the assumptions made in the course of determining the arm's length price;
- Documentation regarding all calculations made in the course of the application of the selected method in relation to the taxpayer and any comparables used in the analysis;
- Information regarding adjustments for material changes in relevant facts and circumstances when documentation is an update that relies on a prior year analysis; and
- Any other documentation which supports the transfer pricing analysis.

### 2406 Tax audit procedures

In Croatia, in order to be fully recognised for tax purposes, all costs incurred between two companies must meet the following conditions:

- They should be proven as necessary and provided for the benefit of the company;
- The description of the services on the invoice must correspond to the services actually provided;
- The invoice must be supported with documentation of services provided (e.g. in case of consulting or advisory activities, this may include various correspondence, emails, reports, projects, etc); and
- The value on the invoice should be an arm's length price.

Currently there is no special tax audit procedure prescribed specifically for transfer pricing that differs from the regular tax audit procedure.

### 2407 Revised assessments and the appeals procedure

The standard legal procedure is for the Tax Authority to issue a 'Resolution' at the conclusion of the tax audit (i.e. First Instance).

Prior to the issuance of the Resolution, the Tax Authority issues 'Tax Audit Minutes'. The taxpayer has an opportunity to object to the Tax Audit Minutes and make written comments/remarks regarding the statements made in the Minutes. Subsequently, the Tax Office issues the written Resolution

If, at the First Instance level, the Tax Office does not accept the taxpayer's remarks/

comments to the Resolution, then the taxpayer can appeal to the Central Tax Office against the Resolution (i.e. Second Instance). In the Second Instance, the Central Tax Office will issue a Second Instance Resolution. With this Second Instance Resolution, the Central Tax Office can resolve the conflict itself or prepare instructions for the First Instance as to how to resolve the conflict.

In the event that the Second Instance Resolution is unfavourable and not acceptable to the taxpayer, the taxpayer may then appeal the Second Instance Resolution to Court.

#### **2408 Additional tax and penalties**

According to Croatian legislation, additional tax and penalties in relation to transfer pricing are not proscribed. The “general” penalties prescribed by the law apply to these cases as well. However, if the prices between related entities are different from those between non-related resident and non-resident entities, any excess amounts will not be recognised for taxation purposes.

#### **2409 Resources available to the tax authorities**

No information is publicly available regarding any database which the Tax Authority uses for transfer pricing purposes. The Tax Authority is known to use relevant data (publicly available) from other companies which operate in the Croatian market.

#### **2410 Use and availability of comparable information**

See above.

#### **2411 Risk transactions or industries**

Inter-company management services usually draw the attention of the Tax Authority and may trigger an inspection.

The Tax Office is not organised on an industry-specific basis.

#### **2412 Limitation of double taxation and competent authority proceedings**

While mutual agreement provisions exist in Croatian tax treaties, as yet there is little practical experience in this area.

#### **2413 Advance pricing agreements (APAs)**

Croatia does not have an APA program in place.

#### **2414 Anticipated developments in law and practice**

Yes. Please see under ‘Statutory rules’ above.

#### **2415 Liaison with customs authorities**

Yes.

#### **2416 OECD issues**

No.



**2417 Joint investigations**

We are not aware of joint investigations so far.

**2418 Thin capitalisation**

Thin capitalisation provisions were introduced on 1 January 2005. These provisions provide that interest payments made in respect of loans from a shareholder of a company holding at least 25% of shares or voting power of the taxpayer will not be recognised for tax purposes if the amount of the loan exceeds four times the amount of the shareholder's share in the capital or their voting power.

A third party loan will be considered to be given by a shareholder if it is guaranteed by the shareholder.

**2419 Management services**

These services consist of various consulting and business services, which are attracting the attention of the Tax Authority. The Tax Authority is very aggressive in challenging the deductibility of this type of expense. Therefore in order to prove these services are tax deductible, the taxpayers must satisfy the terms stated under the tax audit procedures section (i.e. having sufficient support or evidence for the provision of the services).

# 25 The Czech Republic

## 2501 Introduction

The Czech tax authorities have begun to recognise the importance of transfer pricing, resulting in an increase in the number of tax audits that focus on related party transactions.

## 2502 Statutory rules

### *Acceptance of OECD Guidelines*

The Czech Republic has been a member of the OECD since 1 January 1996. OECD Guidelines on transfer pricing were translated into the Czech language and published by the Czech Ministry of Finance in 1997 and 1999. Although the OECD Guidelines are not legally binding, they are generally accepted by the Czech tax authorities.

### *Arm's length principle in Czech tax legislation*

Czech transfer pricing legislation covers transactions between companies as well as individuals, and applies equally to domestic and cross-border transactions. The legislation contains a general definition of the arm's length principle, which is basically in harmony with the OECD Guidelines.

The legislation states that a taxpayer's tax base will be adjusted for any related party transaction undertaken by the taxpayer in which the price differs from what would have been agreed upon between unrelated parties in a comparable transaction.

### *Definition of related parties*

Based on Czech tax legislation, parties are regarded to be related if one party participates directly or indirectly in the management, control or capital of the other, or where a third party participates directly or indirectly in the management, control or capital of both of them, or where the same persons or their close relatives participate in management or control of the other, excluding parties, where one person is the member of supervisory boards of both parties. Participation in management suffices to assume a relationship, even without equity ownership. Participation in control or capital means ownership of at least 25% of a company's registered capital or voting rights. Individuals are related if they are close relatives. Parties are also deemed to be related if they enter into a commercial relationship largely for the purpose of reduction of the tax base (or increase of a tax loss).

### *Methods for determination of the arm's length price*

In general, there are no provisions in the Czech tax legislation on how an arm's length price should be determined in related party transactions. However, as mentioned above, the OECD Guidelines are generally accepted by Czech tax authorities. It is therefore recommended to apply the methods described in the OECD Guidelines.

*Czech transfer pricing guidelines and documentation rules*

In accordance with the guideline of the Czech Ministry of Finance D-258 (regarding use of the international standards for taxation of transactions between related parties), followed by the guidelines of the Czech Ministry of Finance D-292 (regarding the transfer pricing advanced pricing agreement) and D-293 (regarding transfer pricing documentation), Czech companies should follow the principles of the OECD Transfer Pricing Guidelines (OECD Guidelines).

The Czech tax legislation does not prescribe any obligation to maintain any transfer pricing documentation (including preparation of a benchmarking or functional study). Nevertheless, as such documentation might be required by the Czech Tax Authorities during a potential tax audit, it is highly recommendable that such documentation be prepared in advance and that the transfer pricing methodology applied in transactions with related parties be properly documented.

Based on Decree D-293 on transfer pricing documentation issued by the Czech Ministry of Finance, documentation for transfer pricing should contain at least the following information:

- Information about the group
- Information about the company
- Information about the transaction
- Information about the price methodology
- Information about other relevant circumstances

*Advanced pricing agreement*

Based on the Czech Income Taxes Act, if a company is in doubt as to whether the prices applied in the respective transactions are considered to be set at arm's length, since 1 January 2006 it has been possible to submit a written request to the Czech Tax Authorities for an advanced pricing agreement, i.e., a binding transfer pricing ruling.

*Customs*

According to customs legislation, the base on which customs duty is calculated may be amended when the seller and buyer are related. There is a description of how an arm's length price will be determined for customs duty purposes through available data on comparable goods and services.

**2503 Reporting under the commercial code**

Starting in 2001, the Czech commercial code introduced new rules and regulations relating to groups of companies, including reporting requirements. Group companies may conclude a controlling agreement listing the companies that are subject to common management by the controlling company. In the absence of such an agreement, the new reporting requirements impose an obligation on companies having a common majority shareholder to report intra-group transactions.

The information on intra-group transactions is to be prepared as part of the annual report, and is to be filed with the relevant Commercial Court. This document must

outline all transactions carried out in the fiscal year between the subsidiary company and the majority shareholder, and also with any sister company. There are no guidelines in the legislation as to what level of detail is required to be included. The document is available to the public, including the Czech tax authorities and minority shareholders, which increases the risk of transfer pricing investigations. The report on intra-group transactions is also subject to statutory audit review.

### **2504 Penalties and interest on late payments**

If there is a successful challenge of a company's transfer prices by the tax authorities, then additional tax, penalties and interest on late payments may be due.

With effect from 1 January 2007 (for tax due after 1 January 2007) the interest on late payments and penalties are calculated as follows:

- a penalty in the amount of 20% applies if tax is increased or a tax deduction is decreased;
- a penalty in the amount of 5% applies if a tax loss decreases;
- no penalty applies if the tax base is reassessed in an additional tax return; and
- the basic daily interest rate on late payments was changed to Czech National Bank's repo-rate increased by 14%. This interest charge is applicable for the period of maximum of five years.

### **2505 Tax audit procedures**

#### *Obligations of the taxpayers*

Based on the Taxes and Fees Administration Act, which governs tax audit procedures, the taxpayer has two main obligations:

- (1) to declare the tax liability to the tax authorities in a tax return; and
- (2) to be able to substantiate the liability declared. In principle, the tax authorities can request that the taxpayer provide evidence to substantiate all the facts relevant to the tax return. This also applies to documentation on the taxpayer's approach to transfer pricing.

#### *Approach of the tax authorities*

In practice, rather than requesting general information, the authorities will specify their requirements. They must grant the taxpayer sufficient time to compile the required information (although practice shows that in a transfer pricing inquiry situation, this might be an issue given the complexity of transfer pricing and the documentation required).

In cases where the tax authorities have requested evidence to substantiate items included in the tax return, it is the tax authorities themselves that decide whether that evidence is adequate. Where it is considered inadequate, the tax authorities may reassess the taxpayer's liability on the basis of their own sources of information, such as third party valuations or information obtained from other taxpayers' returns or investigations.

However, in order to be able to make an assessment, the tax authorities should have a reasonable basis for the challenge of the declared tax liability. In transfer pricing disputes, they should primarily:

- (1) Provide sufficient evidence that the arm's length principle was not followed; and
- (2) Demonstrate that, as a consequence of non-compliance with the arm's length principle, the taxpayer has declared an incorrect low tax liability.

There are only very rarely any negotiations on the tax liability between the taxpayer and the tax authorities; for example, when the taxpayer cannot substantiate the declared liability and the tax authorities cannot obtain adequate evidence from their own sources to issue a reassessment.

### *Burden of proof*

The burden of proof effectively lies with the taxpayer since, in order to mount a challenge, the tax authorities must only demonstrate that there is some basis for that challenge. It is the taxpayer who must then provide the evidence to refute the challenge.

## **2506 Transfer pricing practice**

### *Transfer pricing inquiries*

The number of transfer pricing inquiries has increased in recent years, which indicates that the Czech tax authorities are becoming more confident in this area. Nevertheless, the practical knowledge of transfer pricing significantly varies across the country from tax office to tax office. The nature of the inquiries is such that they currently do not go into too much detail regarding the transfer price calculations. They are more focused on other aspects of the transactions, such as benefits received by the local companies, formal aspects (e.g. existence of a written agreement), etc. The tax authorities pay special attention to intra-group services.

### *Investment incentives*

Currently, the Czech government gives the opportunity for companies investing in the Czech Republic to participate in an investment incentives program. The investment incentives package contains various benefits including, e.g. a 10-year tax holiday.

Czech tax legislation contains a specific provision on the interplay between a tax holiday and transfer pricing. Based on this provision, if a company that was granted investment incentives does not comply with the arm's length principle, it may lose the granted tax holiday. This may result in suspension of the tax relief and assessment of severe penalties. Therefore, the Czech tax authorities are likely to closely focus on transfer pricing when examining companies that participate in investment incentives.

## **2507 Anticipated developments**

It is expected that the Ministry of Finance will continue with the establishment of special audit teams focused on transfer pricing. This initiative should also crystallise during the tax audits and therefore it is expected that companies will have to more often and in more detail justify the arm's length nature of their inter-company transactions.

*Thin capitalisation rules in Czech tax legislation*

Thin capitalisation provision is also included in the Czech tax legislation. The Amendment to Czech Income Taxes Act introduces new thin-capitalisation rules as of 1 January 2008.

The major changes are outlined below:

- the tax-deductibility tests will apply not only to interest but also to all so-called financial costs on loans (i.e. interest plus other related costs, such as bank fees, etc);
- the debt-to-equity ratio for related party loans to equity will change to 2:1. Unrelated party loans (e.g., bank loans) guaranteed by a related party will be considered related party loans for thin-capitalisation purposes;
- A new debt-to-equity ratio will be introduced for all loans (the total of unrelated- as well as related party loans); the ratio limit will be 6:1 in 2008 and 4:1 from 2009;
- Financial costs exceeding the average of the reference rate increased by 4% (i.e., 12M EURIBOR, PRIBOR, etc. + 4%) will be considered tax non-deductible;
- Financial costs paid on subordinated loans will be fully tax non-deductible; and
- Financial costs paid on profit participating loans will be fully tax non-deductible.

The new thin capitalisation rules will not apply to “old loans” (loans concluded before 1 January 2008) immediately. The old thin capitalisation rules will continue to apply to such loans in 2008 and 2009 (under the old thin capitalisation rules, the applicable debt equity ratio is 4:1, and 6:1 in the case of banks and insurance companies and the thin capitalisation provisions are applicable to all related party interest bearing debts). Starting from 2010, the new thin capitalisation rules will apply to all loans, including the “old loans”.

# 26 Denmark

## 2601 Introduction

The Danish transfer pricing rules, which are based on the 1995 OECD Transfer Pricing Guidelines, have evolved considerably since their implementation in 1998. The implementation of transfer pricing rules was partially infused by two notable court cases which had made it difficult for the Danish Tax Authorities (DTA) to achieve tax adjustments for transfer pricing reasons. The Danish transfer pricing rules can be found in Section 2 of the Danish Tax Assessment Act (DTAA).

Since 1998, the Danish Parliament has passed a comprehensive set of rules on documentation requirements and tax returns. In December 2002, the DTA issued a guideline on transfer pricing documentation requirements. Based on a study completed in 2003, it was determined that approximately half of the 233 companies surveyed had provided documentation that was “obviously not adequate.” Consequently, transfer pricing has been declared a tax audit theme.

In 2005, the Danish government suggested introducing various measures in order to increase the focus on tax assessment and control of transfer pricing issues. The various measures include extending and tightening transfer pricing documentation requirements in order to ensure that the Danish transfer pricing rules are not in conflict with EU Anti-Discrimination Law and are in alignment with the EU’s Code of Conduct, and encouraging businesses to prepare quality and adequate transfer pricing documentation.

In February 2006, in addition to formalising the new 2006 Danish Transfer Pricing Guidelines, the DTA also announced new statutory rules for documenting controlled transactions. The main aim of tightening the rules is to ensure that all the requirements in the statutory rules are observed when documenting controlled transactions, truly demonstrating the adoption of the arm’s length principle.

In 2006, the DTA announced adjustments of DKK4.5 billion.

## 2602 Statutory rules Arm’s length principle

Section 2 of the DTAA addresses not only cross-border transactions, but all transactions between related parties. Section 2 of the DTAA provides that the arm’s length principle applies to taxable Danish entities that:

- are controlled by an individual or legal entities; or
- control legal entities (i.e. directly or indirectly own more than 50% of the share capital or control more than 50% of the votes in another entity); or
- are related to a legal entity (i.e. are controlled by the same group of shareholders); or
- have a permanent establishment situated abroad; or
- are a foreign individual or a foreign legal entity with a permanent establishment in Denmark.

The arm’s length principle applies to transactions with all of the above-mentioned

persons, legal entities, and permanent establishments.

### *Disclosure*

The following entities are required to prepare and keep transfer pricing documentation:

- Danish legal entities that are controlled by foreign individuals or legal entities;
- Danish individuals and Danish legal entities that control foreign legal entities;
- Danish legal entities that are related to a foreign legal entity through ownership or voting rights;
- Danish individuals and Danish legal entities that have a permanent establishment outside Denmark; and
- foreign entities that have a permanent establishment in Denmark.

In this context the term ‘control’ means that an entity – directly or indirectly – owns more than 50% of the share capital or controls more than 50% of the votes in another entity. ‘Related parties’ are parties that are controlled by the same (group of) shareholder(s), and the term ‘controlled transactions’ means commercial or financial cross-border transactions between parties, where one party either controls or is controlled by the other party or between related parties.

A foreign legal entity included in a Danish joint taxation also falls under the Danish documentation requirements with respect to controlled transactions with other foreign entities or foreign individuals.

Entities that fall under the transfer pricing documentation rules must supply certain information on their tax return regarding the nature and the scope of controlled commercial and financial transactions with foreign related parties. In short, all entities falling within the scope of the transfer pricing documentation rules must complete the balance sheet section. In addition, entities that have controlled transactions in the profit and loss account exceeding DKK5 million must complete the profit and loss section.

Companies with cross-border related party transactions exceeding a total of DKK5 million must state for each individually defined group of transactions whether all transactions amount to:

- less than DKK10 million;
- between DKK10 million and DKK100 million; or
- more than DKK100 million.

Companies should state whether the controlled transaction exceeds 25% of total transactions within each individual group of transactions. In addition, certain transactions must be disclosed in a company’s income tax return, such as a sale of fixed assets and an inter-company financial transaction.

At the same time, the DTA have eased the documentation requirements for small and medium enterprises (SME), which are defined as having:

- less than an average of 250 full-time employees during the year; and
- total assets of less than DKK125 million or net sales of less than DKK250 million.



There is a box in the annual tax return information requirement form that can be checked by the enterprise eligible for SME status. However, this SME exemption does not apply to inter-company transactions with enterprises and permanent establishments in states outside of EU and the European Economic Area which have not concluded a tax treaty with Denmark.

#### *Danish transfer pricing documentation (DTPD)*

From 1 January 1999, documentation supporting transfer prices has been required. The documentation has to be sufficient for the tax authorities to evaluate transfer pricing policies and to assess whether prices are consistent with the arm's length principle.

In December 2002, the DTA issued a guideline on transfer pricing documentation requirements but the taxpayers are not obligated to strictly follow the documentation guideline provided that the principles contained in the OECD Guidelines on transfer pricing are applied. If the documentation upon evaluation is judged insufficient, the DTA may estimate transfer pricing adjustments.

In 2005, the Minister of Taxation proposed a new bill regarding the tightening of the transfer pricing documentation rules. The extended and tightened DTPD rules took effect from January 2005 and include the following four elements:

#### **(a) Expansion of rules on documentation requirements to domestic transactions**

Prior to the proposed bill, the rules on documentation applied only to cross-border transactions. DTPD requirements now also apply to intra-group transactions between domestic companies to satisfy non-discrimination principles of EU law (i.e. the arm's length principle is to be applied to both domestic and cross-border transactions).

#### **(b) Part exemption to small and medium sized enterprises (SME)**

Part exemption from the documentation requirements for small and medium sized businesses with less than 250 employees at group level and which either have assets of less than DKK125 million or turnover of less than DKK250 million.

#### **(c) Penalties for non-fulfilment**

Significant penalties apply for non-compliance with the DTPD rules. The Danish Tax Control Act (DTCA) Section 14 provides that the DTA may impose penalties on enterprises for filing incorrect information regarding their eligibility for SME status. The DTCA Section 17 provides that penalties may be imposed for not preparing transfer pricing documentation and applies to controlled transactions carried out in income years starting 2 April 2006 or later. In summary, to impose penalties, it must be a matter of intent or gross negligence.

The DTA must fix rules with respect to the content of the transfer pricing documentation and the rules must be approved by the Board of Assessment before the rules can be enforced. The fines that may be imposed must be evaluated according to the rules fixed by the taxation authorities, whether it is lacking of transfer pricing documentation or inadequate documentation.

From a practical perspective, penalties shall apply if the DTPD does not exist or if the documentation is inadequate. The two-tier penalties are proposed according to the following principles:

- 1) For the lack of documentation or inadequate documentation, a minimum penalty must be paid in the amount equal to twice the cost saved by not preparing the documentation or by preparing only inadequate documentation. However, if sufficient documentation is prepared subsequently and submitted, the penalty is then reduced by 50%. There is no guidance as to how the cost saving is to be measured but rumours indicate that the penalty amount will be between DKK100 thousand to DKK250 thousand. Also, interest of 1% per month applies to this amount.
- 2) In addition to the lack of documentation or inadequate documentation, if an adjustment is issued after a tax assessment (i.e. the arm's length principle has not been observed); the minimum penalty will be increased with an amount of 10% of the profit adjustment.

**(d) Tightening of documentation requirements**

The quality of the documentation must correspond to the principles and descriptions included in the documentation guidelines prepared by the DTA and the Danish transfer pricing regulations based on the OECD Guidelines.

**(e) Benchmarking as one of the requirement in DTPD**

There is no compulsory requirement to do comparable databases searches. However, in the case of a transfer pricing audit, the DTA can explicitly require that a comparable databases search using commercial databases be completed within 60 days upon request.

*Statutory rules for documentation of controlled transactions*

The DTA have issued explanatory notes regarding the extent of documentation required. The explanatory notes are binding on the DTA but not necessarily on the taxpayers. The 2002 guideline on transfer pricing documentation requirements issued by DTA sets forth an applicable and operational model for the preparation of transfer pricing documentation. The explanatory notes and the guideline on documentation take up the position that taxpayers are generally better at deciding on what information could be relevant as transfer pricing documentation. Hence, the recommendations in the guideline on documentation requirements are of an overall nature only, and useful as inspiration for the preparation of taxpayer specific transfer pricing documentation.

Effective February 2006, the new Danish statutory rules for documentation of controlled transactions are applicable to all controlled transactions. The DTPD, as a whole, forms the foundation for an estimation of the prices and terms and conditions fixed in an agreement that could be obtained between independent parties.

The new statutory rules imply specifically that taxpaying companies must observe all the requirements when documenting controlled transactions.

In accordance with the new statutory rules, a DTPD must include the following:

- a description of the company concerned;
- a description of the controlled transactions;

- a comparability analysis;
- a description of the implementation of the price-setting methods;
- a list of inter-company contracts; and
- a description of the database searches (if performed).

The DTA must make their analysis in accordance with the OECD Guidelines, and consequently take the situation as a whole into consideration when auditing.

The DTPD can be prepared in one of the following languages: Danish, English, Norwegian, or Swedish.

There is a special transfer pricing regulation concerning financial institutions and insurance companies.

#### *Statute of limitation concerning transfer pricing adjustments*

As a general rule, the DTA are not allowed to re-open a tax assessment detrimental to the taxpayer later than the end of April in the fourth year after the income year has expired.

According to the transfer pricing rules, this time limit may be extended by two years in respect of transfer pricing adjustments. The notification of an adjustment of the taxable income in transfer pricing cases, therefore, must be made prior to 1 May in the sixth year after the expiry of the income year.

### **2603 Legal cases**

To date, few cases concerning transfer pricing issues that have been taken to court and no cases under the new legislation have yet been litigated.

There have been two important decisions of the court in the field of transfer pricing, the so-called 'oil decisions', both of which were tried under the previous legislation. These two cases have had a significant influence on the development of transfer pricing rules in Denmark, and are described below. In the early 1970s, political attention focused on the non-payment of taxes by oil companies and the Ombudsman was asked to examine the extent to which the DTA applied Section 12 of the Company Tax Act to the oil industry. Following his report, the DTA audited and then raised additional assessments against the Danish subsidiaries of Exxon, Chevron, Texaco, and BP for the tax year 1977–78.

These companies appealed against the assessments and the appeal was heard by the National Income Tax Tribunal. The decision of the Tribunal was in favour of the oil companies and allowed only a small assessment against Texaco Denmark. The tax authorities then brought two further cases before the courts.

In the *Texaco* case, the appeal concerned an additional tax assessment for 1977–78 made by the authorities based on a comparison of the net profit of the company with the net profits of other Danish subsidiaries in the oil industry.

The court affirmed the principle that it was for the DTA to substantiate or prove a violation of the arm's length principle. The court found that Texaco Denmark could be required to disclose information regarding price and gross profit of the parent company when dealing with other group companies and with unrelated customers. This information was not available to Texaco Denmark, but only to the foreign management of Texaco. Since this was not disclosed, the court concluded that the burden of proof on the DTA should be reduced.

Nevertheless, the High Court ruled in favour of Texaco Denmark, allowing no increase in its taxable income. The court found that the company's reduced profitability could be accounted for by factors other than that of control by the foreign parent. Texaco had entered the Danish market by acquiring 71 companies, resulting in high implementation costs. Also, several differences in products (oil versus petrol) and customers (no retail sales) disqualified comparison with other Danish subsidiaries in the oil industry. Finally, prices were not found to differ materially from those identified on the Rotterdam Spot Market.

The case of *BP Denmark* also concerned an additional tax assessment for 1977–78. The High Court upheld a minor increase in BP Denmark's taxable income. Based on similar premise to *Texaco Denmark*, the court found that the prices paid by BP Denmark were approximately 9% higher than the Rotterdam Spot Market and concluded that this justified an increase in BP Denmark's income. The company appealed to the Supreme Court.

The Supreme Court repeated that the burden of proof rested on the DTA but that a taxpayer's failure or refusal to disclose evidence will reduce this burden. However, since BP Denmark's purchases were on long-term contracts this fact could explain the deviation from the Rotterdam Spot Market rates. Hence the authorities had failed to show that the deviation was due to the company being controlled and not to other factors. BP's failure to disclose information was considered to be of less importance and the Supreme Court ruled in favour of BP Denmark.

The most recent Danish ruling on transfer pricing was made by the National Income Tax Tribunal and concerns transfer prices for royalties. This case also addresses the years before the new Danish transfer pricing legislation came into force. The National Income Tax Tribunal ruled that it is crucial whether the royalty charges are reasonable compared to the value of what is received in return, and accepted tax deductibility for royalties paid by a Danish branch to a foreign group company based on a fixed percentage of the branches' sales to third parties. However the National Income Tax Tribunal did not accept royalties paid on sales related to products for which the branch owned the patents.

Although there are no major cases on transfer pricing in Denmark since the 'oil decisions' above, the development in transfer pricing audit cases will increase the number of cases brought before the Danish courts in the near future. These cases will without a doubt emphasise the significant importance of transfer pricing issues placed by the DTA in Denmark.

## **2604 Burden of proof**

The question of burden of proof has been one of the most important issues in relation to the development of transfer pricing in Denmark.

In the *Texaco* and *BP Denmark* court cases, the High Court and Supreme Court confirmed that the burden of proof lies with the tax authorities and that the taxpayer is required to disclose information relevant to the question of whether the arm's length principle has been violated. This information would include items such as prices and gross profit earned by the parent company when dealing with other group companies and with unrelated customers. Where this information is not disclosed, the court concludes that the burden of proof on the DTA is reduced.

In the explanatory notes to the new statutes on disclosure and documentation it

is, however, said explicitly that the DTA probably have interpreted the court decisions too pessimistically and the attitude towards the burden of proof question is going to change in the future so that the burden of proof situation in transfer pricing cases will not be any different from other tax cases.

The fact that the DTA may estimate transfer pricing adjustments if documentation is judged insufficient represents a significant shift in the balance of the burden of proof between the tax authorities and taxpayers. Furthermore, the conduct of the taxpayer during the investigation may influence the outcome since a refusal to provide documentation can reduce or even reverse the burden of proof of the DTA.

### **2605 Tax audits**

As transfer pricing have been a tax audit theme since 2004 and with the new tightened and expanded Danish transfer pricing regulations, the attitude of the DTA have changed (i.e. the DTA is practically always questioning transfer pricing policies of Danish companies).

The Danish Government has introduced various measures since 2007 in order to increase focus on tax assessment and control of transfer pricing issues. Among the measures are establishment of a unit dedicated to transfer pricing issues, centrally led by the tax authorities in Copenhagen and assisted by eight centres of excellence, which are responsible for tax assessment of the largest and most complex transfer pricing cases. In addition, more sophisticated IT systems have been introduced to enable selection of relevant companies for control. A 'model company' has not yet been formally defined, however, in general it is expected that a 'model company' is a company which fulfils all legislative requirements and delivers reliable, transparent, and informative financial information. Under such circumstances a 'model company' will only be subject to reduced control by the public authorities.

For 2009 the central focus areas in tax audits are expected to be a repetition of the 2008 areas, including for example the transfer of intangibles and deficits. Additionally, new focus areas are expected to include transactions with low cost countries, as well as a focus on transactions between certain developed transfer pricing jurisdictions. Moreover, the DTA have disclosed that tax audits focused on whole sectors of industries will be a centre of attention.

#### *Selection of companies for audit*

There are currently no standard rules as to how a company or group might be selected for transfer pricing audit. In the previous oil cases, the investigation was triggered by an apparent lack of taxes paid in Denmark. In the future, the most significant risk factor will be the preparation or lack of the documentation. In general, the DTA are allowed to request any information of relevance for the tax assessment and the authority to make an estimated adjustment of the taxable income if information is not provided. In addition, the conduct of the taxpayer during audit may influence the outcome since a refusal to provide documentation can reduce or even reverse the burden of proof of the DTA. Whilst it is possible to negotiate with the DTA before the adjustment is finalised, it is not very likely that the outcome of the audit will be a result of either negotiation or litigation, but rather an assessment raised by the DTA based on their audit findings.

### *Simultaneous examinations*

Denmark will co-operate with other countries in undertaking simultaneous examinations of multinational groups. Indeed, this has already been practiced with the Nordic countries and it is conceivable that it will occur with respect to other countries as well.

### **2606 Revised assessments and the appeals procedure**

It is possible to appeal after an assessment has been raised. There is one level of administrative appeal, after which it is possible to continue the appeal in the courts.

### **2607 Resources available to the tax authorities**

As already mentioned above a unit dedicated to transfer pricing issues has been established with the central tax authorities in Copenhagen. The unit is supported by eight centres of excellence, which are responsible for tax assessment of the largest and most complex transfer pricing cases.

In order to secure unified assessments of the transfer pricing cases throughout the entire country, the tax assessment authorities must obtain prior authorisation from the central transfer pricing unit to make adjustments to the transfer pricing.

This office is also the competent authority in relation to transfer pricing issues, and is expected to spend an equal amount of time on mutual agreement work and Danish transfer pricing cases.

### **2608 Comparability analysis**

Under the previous statutory transfer pricing documentation requirements, a comparability analysis was not explicitly required to be part of the transfer pricing documentation. Although a comparability analysis is not required, taxpayers were, nonetheless, required to explain the prices in their inter-company transactions and to provide the explanation and reasoning for proving that the prices were in accordance with the Arm's length principle.

As a result, the DTA has had some difficulty in accessing whether the prices set by the taxpayers were consistent with the arm's length principle. Therefore, one of the basic requirements that was emphasised through the tightening of the rules in 2006 is with regard to comparability analysis.

#### *The requirements of comparability analysis*

Following the tightening of the transfer pricing documentation requirements, the DTA is now allowed to request for a comparability analysis as part of taxpayer's transfer pricing documentation for one or more controlled transactions.

The comparability analysis is to provide, firstly, a basis for assessing whether the principles used by the taxpayer's group to determine prices in respect to their controlled transactions are in conformity with the arm's length principle and secondly, the reasoning for the benchmarks used and the method chosen.

#### *Criteria to consider for comparability analysis*

Consistent with the OECD Guidelines, the Danish Guidelines connect the concept of comparability analysis to the concept of functional analysis. All the conditions

concerning an inter-company transaction must be examined in order to determine if the transaction or if the company is comparable. The criteria set out in the Danish Guidelines to assess a comparability analysis are:

- characteristics of the products or services;
- a functional analysis;
- contractual terms;
- economic circumstances; and
- business strategies.

In practice, the retrieval of comparable data related directly to transactions between independent companies operating under similar conditions remain infrequent as this type of direct observation implies access to detailed information that generally is confidential. Furthermore, even if the information is available, it would still be necessary for the transactions to be comparable, which also is very seldom found in practice.

In order to conduct a sufficiently thorough comparability analysis that produces satisfactory and reliable results requires the databases used by the taxpayers to be publicly available and the data to be comparatively numerous and sufficient to build an argument justifying that the selected independent companies are comparable to the tested company. Practical experiences show that two transactions are never perfectly identical. It is therefore necessary for the taxpayers to examine the results thoroughly on whether the differences found are significant enough to affect the comparability of the selected independent companies.

#### *Type of database*

The Danish Guidelines have set out a list of examples of databases that could be utilised by taxpayers for their comparability analysis. In practice, the most commonly used database for comparability analysis in Denmark is the Bureau Van Dijk's Amadeus database, which is listed in the Danish Guidelines. It is presumed that comparability analysis using public domain sources of information would also qualify. This is provided that the comparability analysis prepared based on these public domain sources of information is clarified clearly and is prepared in a transparent manner to allow validation of the information source.

#### *Elements of the comparability analysis write-up*

In addition to the preparation of the comparability analysis, the comparability analysis must be described as part of the transfer pricing documentation. The descriptions must contain the following four elements:

- identification of the tested transaction(s) and the pricing methods;
- detailed written description of the comparability searches providing the arguments and reasons for the qualitative and quantitative search steps;
- explanation of the justification and range; and
- materials for the documentation from the database.

Although the Danish Guidelines provide an example of the presentation of the elements described above, it is stated that taxpayers may prepare the descriptions of their

comparability analysis differently as long as the elements above are taken into account and references are provided thoroughly.

#### *Quantitative and qualitative search steps*

According to the Danish Guidelines, the following search criteria are suggested, but not compulsory, to be included in a comparability search process:

- identify the activity of the tested company: branch code(s), keywords related to the industry, key accounting data;
- identify the economic circumstances: geographic boundary, size of the tested company's activity, number of years with activity;
- identify the key accounting data to justify the pricing and qualification of the Arm's length principle; and
- verify the data available through additional qualitative steps through: Internet, websites of companies and other possible methods.

It is pointed out that the selection of comparable companies must, nonetheless, be consistent. This section of the Danish Guidelines implied the need to avoid any 'cherry picking' of profitable companies among the independent companies available as comparables by both the taxpayers, when preparing a comparability analysis, and by the tax authorities during tax audits.

Like many European countries that use the OECD Guidelines as the model for the local transfer pricing guidelines, Denmark recognises the use of average data of past few years for the purpose of comparability analysis. Furthermore, the range of data available for multiple years might disclose facts that may have influenced the determination of the transfer prices.

It is a common practice in Denmark for the data from the database to be measured using median as the statistical tool to determine the representative result of a sample set. The interquartile range is also used to determine the range of acceptable transfer prices. An interquartile range is advantageous because, by excluding 'outlying' or extreme data point which may be unrepresentative, the range will frequently provides a good indication of representative values.

The DTA generally accept the transfer prices used by taxpayers if such prices are known to be within normally acceptable 'market range' and if such prices fall within a broader range of comparable prices. Such prices could either be the interquartile range of the comparable results or the complete range of results.

#### *Request for the preparation of documentation and penalties*

Following the tightening of Danish rules, taxpayers are now obliged to prepare comparability analysis if the DTA request it. The taxpayers must be given a 60 days period to prepare the comparability analysis upon request with the possibility to extend to a maximum of 90 days with authorisation from the DTA.

#### **2609 Risk transactions or industries**

It is not possible at this stage to identify any specific transactions or industries where transfer pricing adjustments are more likely than others. Income regulations on this subject are often not appealed and therefore not published. However, we see



that there has not been much focus on more complicated transfer pricing issues by the authorities since the oil cases (see Section 2603 above). More straightforward cases, such as management fees and interest on inter-company loans, are frequently taken up during tax audits. However, this situation is changing as the tax authorities have become more experienced in transfer pricing matters, and more resources have been dedicated to this area. Another new focus area is inter-company financing

### **2610 Limitation of double taxation and competent authority proceedings**

The DTA are, without any limitations in time, obliged to re-open a tax assessment on request by a taxpayer if there has been a transfer pricing adjustment abroad.

It should be noted, however, that the DTA are still entitled to form their own opinion on the transfer pricing issue in question. The authorities may disagree with an adjustment made by a foreign tax authority and consequently refuse to make a corresponding adjustment.

The risk of a secondary adjustment in connection to the corresponding adjustment exists in Denmark. The consequence of a secondary adjustment is a neutralisation of the corresponding adjustment. According to Section 2 of the DTAA, a taxpayer has a favourable position to avoid a secondary adjustment on transfer pricing adjustments compared to other tax adjustments.

The Danish competent authority on transfer pricing matters is the special central transfer pricing unit. Danish administrative principles, whilst not permitting the mutual agreement procedure to become a process of litigation, grant the taxpayer the right to comment on and discuss the position taken by the authorities. If a corresponding adjustment is refused by the authorities, it is possible to appeal to the courts.

The Convention on the elimination of double taxation in connection with the adjustments of profits of associated enterprises (Convention of 23 July 1990, 90/436/EEC) became effective in Denmark during the period commencing 1 January 1995 until 31 December 1999. The convention was applicable in relation to all EU member states. Denmark has ratified the extension of the convention as have some of the other EU member states. However the extension of the convention will not come into force until all EU member states have ratified it.

### **2611 Advance pricing agreements (APAs) and Binding Statement**

Practice has shown that it is impossible to obtain a unilateral APA on continuing transactions. So far it has only been possible to obtain an advanced ruling on single transactions, i.e. the transfer of assets. The ability for the authorities to agree on unilateral APAs requires new legislation. The guidelines issued by the Joint Transfer Pricing Forum under the EU Commission will likely accelerate the inclusion of a regulatory framework for APAs in Denmark.

The DTA are planning to issue Danish APA Guidelines during 2008. These guidelines will largely follow the recommendations from the Joint Transfer Pricing Forum under the EU Commission issued 26 February 2007. The Danish APA Guidelines will also present the possibility of unilateral APAs.

Currently, it is possible to apply for bilateral APAs with countries with which Denmark has tax treaties, by reference to the Mutual Agreement Article. The possibilities of obtaining a bilateral APA have never been better for the taxpayers. However preparing

an APA demands considerable resources and is therefore most useful in more complicated cases in which trade patterns are changed.

In addition, taxpaying companies have the possibility of applying for a binding statement with the DTA concerning the tax treatment and consequences for their actions either before or after any action taken by the companies. The request for a binding statement applies to questions on tax and indirect tax consequences and fees will apply for each request.

In general, a binding statement is normally provided by the DTA and the response will be provided within one month of the request. In the event of a request concerning principle contents of the tax regulations, the binding statement will be provided by the Danish Tax Assessment Committee (Skatterådet) and the response will be provided within three months. However, if upon the request for a binding statement by the taxpaying companies it is found that insufficient documentation has been provided to the DTA in order to provide a response or if the request is complicated, the DTA may extend its response time. A binding statement provided by the DTA is only binding for a maximum of five years.

As part of the recent Danish transfer pricing guidelines, it states that APAs concluded by Danish companies with foreign tax administrations must be disclosed towards the DTA as an important part of the transfer pricing documentation.

## **2612 Thin capitalisation**

The Danish Parliament has passed rules on thin capitalisation in Denmark. The thin capitalisation rules apply to the income year 1999 and onwards.

Thin capitalisation rules exist when a Danish company or a Danish permanent establishment has debt (controlled debt) to foreign companies or individuals who:

- directly or indirectly own more than 50% of the share capital or 50% of the votes in the Danish company; and
- the debt to equity ratio of the Danish company exceeds the ratio 4:1.

If these conditions are met, the interest on controlled debt, which exceeds the debt equity ratio of 4:1, is disallowed. The interest will not be re-characterised as a dividend, and will still be treated as an interest with respect to withholding tax, etc.

If the Danish taxpayer can prove that the debt is at arm's length, there will be no limitation on the right of deduction.

The term 'controlled debt' includes both debt directly provided by a related foreign company and debt where a related party has provided a guarantee to the third party in order to obtain the loan.

There are further amendments to the thin capitalisation rules that were effective from April 2004, and the principle amendments are as following:

- the thin capitalisation rules will also apply to Danish shareholders;
- the thin capitalisation rules will only apply if the controlled debt exceeds DKK10 million;
- the limitation of interest deductibility will only apply to the part of the controlled debt which should be converted into equity in order to meet the 4:1 debt/equity ratio (which remains the same);

- the consolidation rule now only applies to Danish companies which are still considered part of the same group when the foreign shareholders or an ultimate Danish parent company of the group is excluded; and
- a Danish company/group of an EU or EEA parent company which has been taxed in accordance with the existing rules between 1999 and January 1, 2004 may have their tax return(s) reopened upon application.

The 4:1 ratio is still calculated based on the fair market value of the company's assets. Furthermore, the thin capitalisation rules will still not apply if the loan is on arm's length terms.

Further to this additional amendments apply from June 2007, which includes but are not limited to the following change of regulations:

#### *Reduction of the corporate tax rate*

The corporate tax rate has been reduced to 25% and the rate applies from fiscal year 2007.

#### *Limitation on net financial expenses*

Interest expenses are limited in the following way and in the following priority:

- the current thin capitalisation rules will still apply. The new limit of DKK20 million (see below) will not apply to this current rule;
- as of 1 July 2007, it is only possible to deduct net financial expenses in a Danish jointly-taxed group equal to 6.5% of the tax value of qualifying assets at year-end. However, it is possible to deduct net financial expenses of DKK20 million; and
- in addition, as of 1 July 2007, the taxable income before interest deduction (EBIT) can not be reduced by more than 80% as a result of net financial expenses. Any unutilised allowed net financial expenses can be carried forward. The DKK20 million-limitation also applies to this rule (i.e. it is always possible to deduct DKK20 million in a year).

### **2613 Recent developments in Danish law**

In April 2008 the Danish Parliament was presented with bill L181, which includes a proposal to introduce unlimited tax liability for certain branches and transparent entities (i.e. reverse hybrids).

The proposal includes but is not limited to the following change of regulations. It is expected that there will be no major changes to the bill before it is enacted.

#### *The entities*

The Danish government aims to include certain foreign owned Danish transparent entities under Danish taxation, as if these transparent entities were companies. A transparent entity will be considered Danish if it:

- is registered in Denmark;
- has its place of residency in Denmark according to the articles of association or similar; or

- has its effective place of management in Denmark.

Transparent entities will often take the form of a registered branch, limited partnerships (K/S or P/S) or interessentskab (I/S), often broadly referred to as partnerships. However, the list is not exhaustive and the definition can comprise any entity regardless of name, as long as it is a legal entity.

There are two main conditions for transparent entities to be comprised by the proposed rules. The entity must be owned more than 50% (i.e. ownership share or votes) by one or more foreign non-transparent entities in countries:

- where the Danish entity is treated as a non-transparent entity for tax purposes; or
- that does not have an agreement to exchange information with the Danish tax authorities.

#### *The timing*

The rules will have effect in income years starting on or later than 15 April 2008 (i.e. for entities with the calendar year as financial year); the proposed rules will apply from 2009. However, if an election to treat a transparent entity as non-transparent is made after 15 April 2008, the rules will apply from the date it is effective in the participants' jurisdiction (or from 15 April 2008 if with retroactive effect to a date before that).

#### *The applications*

The main aim of the proposal is to avoid double non-taxation of certain aggressive US/Danish IP ownership structures, but it is likely to have a much broader impact. All existing branches and partnership structures with majority owners as described above will be comprised, regardless of the reason for their existence. This will likely both include some corporate structures as well as some private equity structures.

### **2614 Liaison with customs authorities**

The tax and customs authorities dealing with transfer pricing are part of the same unit (SKAT) and, therefore, information is exchanged between them. In fact, it is usual for a group of officials to audit a company at the same time, considering all aspects of taxation (i.e. income tax, VAT, customs duty, etc).

### **2615 OECD issues**

Denmark is an OECD member and has a representative on the Transfer Pricing Task Force. Denmark usually applies the OECD Guidelines.

# 27 Dominican Republic

## 2701 Introduction

With the enactment of Fiscal Rectification Law No. 495-06 (“Tax Reform”) of 28 December 2006, the Dominican Republic became the first country in the Caribbean that introduces the transfer pricing concept through the modifications made to Article 281 of the Dominican Tax Code.

The Tax Reform Law establishes that transactions between related parties should be made at arm’s length or market value, meaning that the prices paid between related parties should be similar to those that should have been paid by independent third parties. The law stipulates that if this criterion is not met the Tax Administration may challenge the values involved in the transactions. Furthermore if the accounting methods do not allow the assessment of the actual results of a local related party, then the taxing authority may impute a result based on the ratio of gross income in the local subsidiary relative to the total income generated by the headquarter company and its total assets.

## 2702 Statutory rules

The new transfer rules are based on the internationally accepted arm’s length standard. This legislation does not specify any methods that make reference to the Organisation for Economic Co-operation and Development (OECD) standards.

The following related party transactions are expressly subject to this law:

1. Inter-company payments made/received on goods and services;
2. Allocation of corporate expenses which must be deemed necessary to maintain and preserve the taxable income of the subsidiary; and
3. Financial and/or credit operations.

Tax Administration will be able to assess:

1. Prices that the branch or permanent establishment collects from its parent company or another branch or related company, when these prices do not reflect the amounts that independent entities collect for similar operations.
2. Prices paid or owed for goods or services rendered by the parent company, its agencies or related companies, when these prices do not reflect normal market prices between unrelated parties.
3. Corporate expenses distributed by the parent company to the branch or establishment in the country, when these expenses do not correspond with the amount or price that independent entities collect for similar services. These expenses will have to be necessary for maintaining and conservation of the income of the permanent establishment in the country.

## 2703 Legal cases

No transfer pricing court cases have been introduced.

**2704 Burden of proof**

The burden of proof lies with the taxpayer to demonstrate that the transfer policy complies with the general rules and the transactions have been conducted in accordance with the arm's length standards.

**2705 Tax audit procedures**

As stated before the Dominican legislation does not specify any methods for transfer pricing audits.

**2706 Risk transactions or industries**

Actually, there are no indications that certain types or particular industries are at higher risk than others. All multinationals are in risk or assertion.

**2707 Advanced pricing agreements (APAs)**

The Tax Administration shall allow for Advanced Pricing Agreement (APA) for taxpayers in the all-inclusive hotel industry. These APA agreements will be signed between the Tax Administration and this industry, which is represented by the National Hotel and Restaurants Association.

The APA agreements shall incorporate prices based on a standard parameter by zones, cost analysis and other variables that impact the Tourism industry. These shall apply for 18 months with subsequent APA being in force for up to 36 months. Such agreements are subject to renewal. In addition, the Tax Administration may challenge the prices included in the APA and, consequently, impose penalties stipulated in the Tax Code on taxpayers who do not meet the terms and requirements of the agreed APA. APA may also be obtained in other industries with foreign involvement such as pharmaceutical, power and insurance.

**2708 OECD rules**

The Dominican Republic is not a member of OECD; nonetheless the Dominican Republic generally follows the OECD Guidelines and models. As stated above the TP legislation in the Dominican Republic does not make allusion to the Organisation for Economic Co-operation and Development (OECD) standards.

# 28 Ecuador

## 2801 Introduction

Transfer Pricing (TP) rules apply to taxpayers undertaking cross-border operations from fiscal year 2005 onwards. Originally, TP regulations were introduced by a reform to the Regulations to the Internal Tax Regime Law. However, as of December 2007, these rules were introduced as part of the Internal Tax Regime Law by the Law for Tax Equality, published in the Supplement to Official Gazette No. 242, dated 27 December 2007. The regulations expressly recognise the guidelines established by the Organisation for Economic Co-operation and Development (OECD) as technical reference in TP matters.

## 2802 Statutory rules

Effective 1 January 2005, Ecuadorian taxpayers should be able to demonstrate that their transactions with foreign related parties are conducted following arm's length principles. Transfer pricing rules are applicable to all type of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions, reimbursement of expenses, and licensing of intangible property). TP rules apply to cross-border operations with foreign related parties for cumulative amounts greater than USD300,000 during any given fiscal year. Any adjustments arising from the application of transfer pricing regulations must be included in the tax return and affect taxable income.

According to TP rules, taxpayers must present a Transfer Pricing Annex (e.g. Special Information Return) within five days after the filing of the Income Tax (IT) return (which normally occurs in April of the following year), and a Transfer Pricing Report within six months after the filing date of the tax return (e.g. October).

The contents of the Transfer Pricing Annex and the Transfer Pricing Report are discussed below.

### *Related parties*

Related parties are defined as individuals or entities in which one of them directly or indirectly participates in the direction, control or capital of the other; or in which a third party, individual or entity participates in the direction, control or capital of the others.

In order to establish any relationship among entities, the tax administration will consider, in general terms, the participation in the companies' shares or capital, the holders of the capital, the entity's administration, the distribution of dividends, the proportion of transactions carried out between entities and the pricing mechanisms used in such operations. Especially, the regulations enumerate the following situations as related parties:

- Head offices and their subsidiaries, affiliates and permanent establishments,
- Subsidiaries, affiliates and permanent establishments among themselves,
- The parties that share the same individual or entity directly or indirectly in the direction, administration, control or capital of such parties,

- The parties that maintain common directive bodies with a majority of the same members,
- The parties with the same group of shareholders participating directly or indirectly in the direction, administration, control or capital of such parties,
- The members of the directive bodies of the entity with respect to the entity, as long as the relationships between them are different to those inherent to their positions,
- The administrator and statutory auditors of the entity with respect to the entity, as long as the relationships among them are different to those inherent to their positions,
- The entity with respect to the spouses and relatives (fourth degree of consanguinity and second degree of affinity) of the directing shareholders, administrators and statutory auditors, or
- The entity or individual with respect to the trusts in which it has rights.

The Ecuadorian law also deems transactions as being carried out by related parties, when such transactions are not carried out at arm's length principle, or when they take place with individuals or entities located in tax haven countries.

### *Comparability*

Operations are deemed comparable if no differences exist between their relevant economic characteristics that significantly affect the price or value of the goods and services or the arm's length margin; or, although there are such differences, these can be eliminated through the use of reasonable technical adjustments.

In order to verify whether the operations are comparable or if there are significant differences between them, the following factors should be considered when assessing the comparability of a transaction:

- The specific characteristics of the goods or services,
- The functions that each taxpayer performs, including the assets used and the risks undertaken,
- The terms and conditions (contractual or not) that exist between related and non-related parties,
- The economic circumstances of different markets, such as geographical location, market size, wholesale or retail, level of competition, among others, and
- Business strategies, including those related to market penetration, permanence and expansion.

### *Methods*

According to TP regulations, the following methods should be used when assessing the arm's length principle in transactions with related parties:

- Comparable Uncontrolled Price (CUP) Method
- Resale Price Method (RPM)



- Cost Plus (CP) Method
- Profit Split Method (PSM)
- Residual Profit Split Method (RPSM)
- Transactional Net Margin Method (TNMM)

TP regulations do not contain a best method rule; instead, it indicates that the methods must be used, individually or in combinations of any of them, in order to assess the arm's length principle. TP regulations determine that the application of the above mentioned methods should be interpreted based on the guidelines of the OECD, when it is not contrary to local legislation.

TP regulations include the use of the interquartile range and the adjustment to the median if the taxpayer's result falls outside the range.

### *Transfer pricing annex*

As stated above, taxpayers undertaking cross-border operations with foreign related parties for cumulative amounts greater than USD300,000 during the fiscal year must present a Transfer Pricing Annex within five days after the filing of the IT return. The information to be included contains:

- Identification of taxpayer, including Taxpayer Identification Number and Fiscal Year,
- Completion of standard questionnaire regarding international operations of taxpayer,
- Identification of foreign related parties, including name, address, fiscal residence, Taxpayer Identification Number in country of fiscal residence, and a description of the relationship with the party,
- Operations with foreign related parties, including type of operation, amount of operation, and method used to determine arm's length compliance, and
- Difference in the amount of reported operations resulting from the application of valuation method(s).

### *Transfer pricing report*

The Transfer Pricing Report should include the following information:

- The activities and functions performed by the taxpayer,
- The risks assumed and the assets used by the taxpayer to carry out such activities and functions,
- An explanation of the elements, documentation, circumstances and facts valued for the transfer pricing analysis or study,
- Details and amounts of the performed transactions subject to analysis,
- Details of the related entities abroad which the company performed the transactions subject to analysis,
- Method used to support its transfer pricing, stating the reasons and fundamentals which led to considering it as the best method for the transaction under test,

- The identification of every selected comparable to justify transfer pricing,
- The identification of the information sources used to obtain the comparable,
- Listing of selected comparable that were discharged, stating the reasons for such consideration,
- Listing quantification and methodology used to practice adjustments necessary on selected comparable,
- Median and the interquartile range,
- Profit and loss statement of the comparable entities corresponding to the commercial years considered for the comparability analysis, indicating the source of information,
- Description of the activities and characteristics of the business of the comparable companies, and
- Conclusions.

### **2803 Other regulations**

Additionally to the general TP regulations introduced by Executive Decree in December 2004, the SRI enacted Resolution 640 in January 2006 (published in the Official Gazette No. 188, dated 16 January 2006) establishing the contents of the Transfer Pricing Annex and the Integral Transfer Pricing Report, as described above.

### **2804 Legal cases**

No transfer pricing cases have yet been brought before the courts since the introduction of TP regulations in December 2004. Nevertheless, the Quito Chamber of Commerce initiated judicial procedures before the Fiscal Tribunal requesting the annulment of Executive Decree 2430 which introduced TP regulations, based on the fact that the taxation obligations established by the Decree could only legally and constitutionally be introduced through the enactment of a law.

On 25 October 2005, The Fiscal Tribunal sentenced the case declaring the partial annulment of the Decree with respect to the articles that established the presumption that transactions between taxpayers and entities established or located in tax heavens, as well as transactions that were not carried out at arm's length, are considered as related parties. In connection with this matter, the Tribunal accepted the argument that 'legal presumptions' can only be established through the enactment of a law. The rest of the regulations remain in full force.

However, as of 1 January 2008 this Sentence is no longer in force since transfer pricing rules were introduced as part of the Internal Tax Regime Law, not through a Regulation.

### **2805 Burden of proof**

In practice, the burden of proof lies with the taxpayer for filing the Transfer Pricing Annex and the Transfer Pricing Report.

### **2806 Tax audit procedures**

There are no specific tax audit procedures established for transfer pricing purposes.

Transfer pricing obligations are audited as part of regular tax audits conducted by the SRI.

Tax audit-related inspections are carried out first as desk reviews based on detailed information provided by the taxpayers and, subsequently, at the taxpayer's office. Taxpayers must make available all basic accounting records, auxiliary records as well as all sources of information supporting the financial statements, the tax returns and the TP Annex and Report.

Once the tax audit has been completed, inspectors prepare an assessment, confirming the declared taxable income and the tax paid or, alternatively, requesting payment of additional taxes arising from the objections resulting from the audit. Among these objections the administration could challenge the adequacy of the transfer pricing study and establish different transfer pricing adjustments for income tax purposes.

### **2807 Revised assessments and the appeals procedure**

Taxpayers have the right to file objections with the SRI against additional tax assessments established as a result of tax audits, within 20 days of receipt of the notification of assessment. The SRI must issue its resolution within 120 days of the appeal. The lack of response of the SRI within 120 days is considered a tacit acceptance of the claim presented by the taxpayer.

If this process before the SRI is unsuccessful, the taxpayer can appeal before the Fiscal Tribunal, which is organised into three chambers of three judges each. Each chamber processes claims and hands down judgments independently from the others. In the event that taxpayers do not agree with the judgment made by a particular chamber of the court, they have the right to appeal before the entire Tribunal (i.e., all three chambers). Only legal issues are discussed before the full court.

### **2808 Additional tax and penalties**

Failure to file the Transfer Pricing Annex or the Comprehensive Transfer Pricing Report on the established dates can result in a fine no lower than USD3,000 or higher than USD15,000. The same fine is applicable to cases where the information presented in the Annex and the Report is incorrect or differs from the information provided in the income tax return.

### **2809 Resources available to the tax authorities**

There is a unit within the SRI that deals specifically with transfer pricing issues, although it is our understanding that this especial unit is still in training. It is expected that transfer pricing audits could be initiated in the future.

### **2810 Use and availability of comparable information**

Comparable information is required in order to determine arm's length prices and should be included in the taxpayer's transfer pricing documentation. Ecuadorian companies are required to make their annual accounts publicly available by filing a copy with the local authority (e.g. the Superintendencia of Companies). However, these accounts do not necessarily provide enough or sufficient information on potentially comparable transactions or operations since they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign

comparables. This practice would be acceptable under Ecuadorian TP regulations.

### **2811 Limitation of double taxation and competent authority proceedings**

The domestic legislation is supplemented by the provisions of the double taxation treaties that Ecuador has signed with several countries (Brazil, Belgium, Chile, France, Germany, Italy, Romania, Spain, Canada, Mexico, Switzerland and the nations of the Andean Community: Colombia, Peru and Bolivia). These agreements generally include provisions on mutual agreement procedures, related parties and business profits.

### **2812 Advance pricing agreements (APAs)**

Ecuadorian legislation establishes the possibility of advance pricing agreements (APAs).

### **2813 Anticipated developments in law and practice**

#### *Law*

New transfer pricing rules will be put into effect that will change the minimum cumulative amounts of foreign operations with related parties that trigger the requirement for filing transfer pricing documentation, as follows:

Taxpayers with cross-border operations for cumulative amounts greater than USD1 million during any given fiscal year must file a Transfer Pricing Annex. Additionally, taxpayers with cross-border operations greater than USD5 million must also file a Comprehensive Transfer Pricing Report within two months after the filing date of the tax return (i.e. in October).

New regulations will also modify the required contents of the Comprehensive Transfer Pricing Report. These new regulations will be enacted during the first semester of 2008.

#### *Practice*

The tax authorities are expected to become more aggressive and more skilled in handling transfer pricing issues. Transfer pricing knowledge of tax inspector is expected to increase significantly as training improves and they start to gain experience in transfer pricing audits.

### **2814 Liaison with customs authorities**

Tax authorities and customs authorities may exchange information. Experience suggests, however, that the authorities do not in fact deal very closely with each other where transfer prices are concerned.

### **2815 OECD issues**

Ecuador is not part of the OECD, but according to TP rules its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are used as technical references for transfer pricing purposes.

**2816 Joint investigations**

TP regulations do not establish specific procedures for joint investigations.

**2817 Thin capitalisation**

As of 1 January 2008, thin capitalisation provisions must be considered by taxpayers. In effect, if the amount of a foreign loan exceeds three times the amount of the paid capital, the interest expense will not be considered as a deductible expense for income tax purposes.

**2818 Management services**

Where the amount of a management charge has been calculated on an arm's length basis, then the management fee would normally be tax deductible.

# 29 Estonia

## 2901 Introduction

The significantly amended Estonian Transfer Pricing Regulation became effective starting from 1 January 2007. It relies strongly on the principles laid down by OECD Guidelines and also overcomes several significant shortcomings of the previous guidelines, thus stipulating solid rules for implementing the Regulation in practice.

The arm's length standard for cross-border controlled transactions concluded between an Estonian company and associated non-resident entity was first introduced in 1998 but due to relatively vague tax legislation and the absence of formal transfer pricing documentation requirements, the tax authorities have not actively challenged the inter-company transfer pricing policies in the past.

It is expected that transfer pricing will become an increasingly important tax issue in Estonia in the near future. However, the Estonian transfer pricing practice is currently not yet very sophisticated, as both the taxpayers and the tax authorities are building their transfer pricing expertise.

## 2902 Statutory rules

### *Application of the regulation*

Estonian Transfer Pricing rules are stipulated in the Income Tax Act and in Regulation no 53 issued by Estonian Ministry of Finance on 10 November 2006. Effective from 1 January 2007, Estonian taxpayers are required to be able to demonstrate that both domestic as well as cross-border transactions with related parties were conducted at arm's length. Transfer pricing rules are applicable to all type of transactions.

Transfer pricing rules are applicable to inter-company transactions concluded between the following persons:

- An Estonian company and its related party;
- An Estonian sole proprietorship and its related party;
- An Estonian permanent establishment and its foreign head office;
- An Estonian permanent establishment and a party related to its foreign office;
- An Estonian company and its foreign permanent establishment.

### *Related parties*

Estonian tax legislation provides a rather broad and formal definition of related parties. The following companies and individuals qualify as related parties:

- An Estonian company and its group company;
- An Estonian company and a direct shareholder that owns more than 10% of the share capital, number of votes or rights to the profits of the company;
- An Estonian company and two or more direct shareholders, which qualify as related parties to each other and own on a combined basis more than 50% of

the share capital, number of votes or rights to the profits of the Estonian company;

- An Estonian company and another company that has a common shareholder which owns more than 50% of the share capital, number of votes or rights to the profits of both of these companies;
- An Estonian company and another person that each separately own more than 25% of the share capital, number of votes or rights to the profits of the same legal entity;
- An Estonian company and another legal entity that has exactly the same members of their respective management boards; and
- An Estonian company and its employees, members of management and supervisory board and direct relatives of these persons.

The list of the related parties provided above cannot be expanded further by tax authorities and thus, the transfer pricing regulation cannot be applied to transactions between formally unrelated parties even if in practice an 'economic relationship' between them is obvious.

### *Transfer pricing principles*

The Estonian Regulation is based on the arm's length principle that requires the prices charged between related parties to be equivalent to those that would have been charged between independent parties in the same circumstances. Should the transfer prices applied in the inter-company transactions not follow the arm's length principle, any hidden distribution of profits is subject to Estonian corporate income tax.

The Estonian Transfer Pricing Regulation should generally be in line with the principles laid down in the OECD Guidelines. However, there are some Estonia specific issues (e.g., preference of local comparables) that should be considered when applying the OECD Guidelines. Furthermore, sufficient attention should be paid to the present Estonian corporate income tax system, which taxes only direct and deemed profit distributions.

Due to the present Estonian corporate income tax system, transfer pricing adjustments are treated as deemed dividend distributions subject to corporate income tax. Thus, transfer pricing adjustments do not increase the taxable income of the taxpayer nor are they treated as non-deductible for corporate income tax purposes.

The Estonian Transfer Pricing Regulation provides guidelines regarding comparability of the transactions with respect to the functional analysis and contractual terms of the transaction as well as economic circumstances and business strategies. The Estonian Regulation also establishes guidelines for intellectual property, provision of inter-group services and cost contribution agreements.

### *Transfer pricing methods*

The Estonian Regulation introduces five transfer pricing methods that are the same as those in the OECD Guidelines:

- Comparable uncontrolled price method;
- Resale price method;

- Cost plus method;
- Profit split method; and
- Transactional net margin method.

In addition, the taxpayer is entitled to apply its own method provided that it achieves a more reliable result.

The Estonian Regulation recognises the 'best method rule' for selecting the applicable transfer pricing method. Thus, each transaction or group of transactions must be analysed separately in order to ascertain the most appropriate of the methods and there is no priority of the methods. Furthermore, the Regulation does not prescribe any obligatory method for certain types of transactions, and the taxpayer is also entitled to apply only one method for calculating transfer price for a transaction.

### *Estonian corporate income tax system*

Estonia has a rather exceptional corporate income tax regime that should be considered while applying the transfer pricing regulation. Under the Estonian corporate income tax regime, all undistributed corporate profits are tax exempt. This exemption covers both active (e.g., trading) and passive (e.g., dividends, interest, royalties) types of income, as well as capital gains from sale of all types of assets, including shares, securities and immovable property. This tax regime is applicable to Estonian companies and permanent establishments of foreign companies that are registered in Estonia.

In Estonia, corporate profits are not taxed until the profits are distributed as dividends or deemed profit distributions, such as transfer pricing adjustments, expenses and payments that do not have a business purpose, fringe benefits, gifts, donations and representation expenses. Registered permanent establishments (including branches) are subject to corporate income tax only in respect of profit distributions, both actual and deemed, as defined in domestic law.

Distributed profits are generally subject to 20% corporate income tax (20/80 on the net amount of profit distribution). The income tax rates are reduced from 20/80 in 2009 to 19/81 in 2010 and 18/82 in 2011.

The period of taxation is a calendar month. The combined corporate income tax and payroll tax return (form 'TSD' with appendices) must be submitted to the local tax authorities and the tax must be paid by the 10th day of the month following a taxable distribution or payment.

### *Documentation*

The Estonian Transfer Pricing Regulation introduces documentation requirements applicable starting from 1 January 2007. As a general rule, all Estonian group companies and permanent establishments are obliged to prepare transfer pricing documentation to prove the arm's length nature of the inter-company transactions.

An exemption applies to small and medium enterprises (SME) unless they have conducted transactions with entities located in low tax territories. A company or permanent establishment is deemed to be SME provided that the previous financial year consolidated results of an Estonian company or a permanent establishment together with its associated enterprises or head office are below all of the following criteria:



- annual sales below EUR 50 million;
- the balance sheet below EUR 43 million or
- the number of employees below 250.

Although the formal transfer pricing documentation requirements do not apply to SMEs, they may still be required to prove the arm's length nature of their inter-company transactions to the tax authorities in the course of a tax audit. There are generally no limitations and restrictions in relation to the form or type of evidence the taxpayer can submit to defend transfer prices.

The Estonian documentation requirements should generally follow the principles stipulated in the EU Council Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in EU. The master file and country specific files, including supporting documentation, should be prepared by the taxpayer with due diligence considering nature and extent of the controlled transactions.

The master file should contain a business profile of the group, a list of related parties with business profile descriptions, details of controlled transactions, a functional analysis, a list of intellectual property owned by the group, a description of the transfer pricing policy and a list of any applicable cost contribution and advance pricing agreements. Country specific file should include business profile of the taxpayer, description of intra-group transactions, comparability analysis, selection of transfer pricing method and identified comparables.

Transfer pricing documentation should be submitted to the tax authorities within 60 days of the request. The transfer pricing documentation does not have to be in Estonian, but the tax authorities may ask the taxpayer for a translation.

Besides the formal transfer pricing documentation and general requirement to disclose the transactions with the related parties in the annual reports, there are not additional reporting requirements related to transfer pricing in relation to inter-company transactions.

### **2903 Other regulations**

Taxpayers and tax authorities are encouraged *expressis verbis* to apply OECD Guidelines for interpreting and implementing the Estonian Regulation except where they are not in agreement with the Estonian Regulation.

In addition, the tax authorities have also issued guidelines of a general nature for the purposes of explaining the application of the Regulation.

### **2904 Legal cases**

Due to the novelty of the Estonian Transfer Pricing Regulation, no transfer pricing cases have yet been brought before the courts.

### **2905 Burden of proof**

As a general rule, burden of proof lies with the taxpayer, which is required to prove the arm's length nature of the inter-company dealings. If the taxpayer has submitted proper documentation, the burden of proof is shifted to the tax authorities, who have to demonstrate why the taxpayer's transfer prices are not arm's length and support it with adequate documentary evidence in order to challenge the transfer prices of the taxpayer. Once the tax authorities have proposed an alternative transfer pricing method

or comparables, the burden of proof is shifted to the taxpayer to defend arm's length nature of its transfer prices.

### **2906 Tax audit procedures**

Estonian tax authorities have tax inspectors that specialise in transfer pricing. Due to the newness of the Regulation, it is hard to predict the principles of selection of the companies or the controversial issues raised by the tax authorities during tax audits.

The transfer pricing audit procedures have to follow the general tax procedures established for tax audits. The tax authorities may request all relevant data such as accounting records and other supportive documentation and have interviews with the management and employees. Information may also be requested from third parties, including credit institutions.

The tax audit is usually finalised with the submission of a written report of the tax findings to the taxpayer. The taxpayer is entitled to file a written response accompanied by additional documentary evidence, if necessary. Any resulting transfer pricing adjustment is imposed by the appropriate local tax office of the tax authorities.

### **2907 Revised assessments and the appeals procedure**

Additional assessments and any penalties imposed by the tax authorities can be appealed by the taxpayer within 30 days of receipt of the tax verdict. The appeal may be submitted to the tax authorities that should review the appeal generally within 30 days. If the appeal remains unsuccessful, the taxpayer is entitled to submit new appeal to the court within 30 days of receiving the decision from the tax authorities. As an alternative, the taxpayer may submit its appeal directly to the court; appealing first to the tax authorities is not obligatory.

As a general rule, regardless of whether an appeal has been submitted, the taxpayer is required to pay the imposed tax within 30 days of receipt of the tax verdict. Under certain circumstances the tax authorities or court may postpone the payment of tax till the tax dispute is resolved. Should the appeal be successful while the tax has been banked at the tax authorities, overpayment of tax bears late payment interest amounting to 0.06% per day payable to the taxpayer.

### **2908 Additional tax and penalties**

Taxpayers are liable to self assess the arm's length nature of inter-company transactions. Any transfer pricing adjustment must be declared and tax remitted on monthly bases as the period of taxation is a calendar month. The combined corporate income tax and payroll tax return (form 'TSD' with appendices) must be submitted to the local tax authorities and the tax must be paid by the 10th day of the month following a taxable distribution or payment.

Tax arrears bear late payment interest (0.06% per day) and 20/80 corporate income tax (in 2009; 19/81 in 2010; 18/82 in 2011) will be levied on late payments interest paid. In certain circumstances transfer pricing adjustments may also trigger double taxation. There are no special transfer pricing penalties.

Tax returns are open for investigation generally for three years from their dates of submission. This statute of limitation can be extended for a further three years if the authorities discover intentional non-payment of tax.

**2909 Resources available to the tax authorities**

For the purposes of improving their transfer pricing expertise, transfer pricing trainings have been held for the tax inspectors. It is also understood that the tax authorities are entitled to use international databases for performing benchmarking studies.

**2910 Use and availability of comparable information**

Comparable information is required in order to substantiate the arm's length nature of the inter-company dealings and should be included in the taxpayer's transfer pricing documentation.

Estonian companies are required to make their annual reports publicly available by filing the copy with the local authority (Estonian Commercial Register). These annual reports can be used as comparables. In addition, taxpayers are entitled to use international comparables.

As a general rule, internal comparables are preferred to external comparables. In addition, local comparables are preferred to foreign comparables (e.g., Pan-European or global). The use of secret comparables is prohibited.

**2911 Risk transactions or industries**

Due to the newness of the Regulation, no specific transactions or industries that have been frequently challenged by the tax authorities can be identified. However, it can be assumed that companies earning profits below the average industry level are likely to be selected for further tax investigation.

**2912 Limitation of double taxation and competent authority proceedings**

There is no special regulation to provide relief from double taxation of domestic inter-company transactions. The general procedure of refunding overpayments of tax may be insufficient for some cases and may trigger double taxation.

Relief from double taxation in cross-border inter-company transactions can be sought through the tax treaties concluded by Estonia that in most cases include provisions for a mutual agreement procedure. Estonia has also ratified the Arbitration Convention (90/436/ECC) that should provide relief from double taxation related to tax disputes inside Europe.

**2913 Advance pricing agreements (APAs)**

Currently, there are no provisions enabling taxpayers to negotiate APAs with the tax authorities.

**2914 Anticipated developments in law and practice**

It is expected that the tax authorities will issue additional guidelines and interpretations for the purposes of applying the Transfer Pricing Regulation. In addition, it is expected that an option to conclude APAs will become available in a few years time.

**2915 Liaison with customs authorities**

In Estonia, both tax and customs authorities are within the authority of Estonian Tax and Customs Board. It is assumed that there is exchange of information between

these departments but there is no prescribed approach for the use of certain information of one area in the other area (i.e., transfer pricing analysis for customs purposes).

### **2916 OECD issues**

Estonia is not a member of the OECD. Nevertheless, the taxpayers and Estonian Tax and Customs Board are *expressis verbis* encouraged to apply OECD Guidelines for interpreting and implementing the Estonian Regulation in situations where OECD Guidelines are not in contradiction with the Estonian Regulation.

### **2917 Joint investigations**

In Estonia, the tax authorities have conducted joint investigations covering both taxation and customs of a taxpayer.

At this stage, we are not aware of any joint international transfer pricing tax audits conducted in cooperation with foreign tax authorities.

### **2918 Thin capitalisation**

There are no thin capitalisation rules in Estonia.

### **2919 Management services**

Estonia has not established any special transfer pricing regulation in relation to inter-company management services. As a result, the taxpayers are entitled to follow the principles introduced in the OECD Guidelines for the purposes of establishing the arm's length nature of inter-company management fees charged.

# 30 Finland

## 3001 Introduction

The bill containing new legislation on transfer pricing documentation rules was put into effect on 1 January 2007. Documentation rules will be applied to accounting periods starting on or after 1 January 2007.

The Finnish documentation rules conform to the principles established in the OECD Guidelines as well as the Code of Conduct for Transfer Pricing Documentation in European Union.

The Finnish Tax Authorities have set up guidelines on how to proceed with transfer pricing documentation in Finland. The guidelines were established 19 October 2007 in the Tax Authorities publication nr. 1471/37/2007.

## 3002 Statutory rules

### *Transfer pricing adjustment*

Article 31 of the Assessment Procedure Act (VML) prescribes the arm's length principle for related party transactions. According to Art 31 VML in the event a taxpayer and a related party have agreed upon terms or defined terms which differ from the terms that would have been agreed upon between independent parties and, as a consequence of this, the taxable income of the taxpayer falls below, or the taxpayer's loss increases, compared to the amount that the taxable income would otherwise have been, the taxable income may be increased to the amount that would have accrued in case the terms had followed the ones that would have been agreed upon between independent parties. Related party transactions are defined on the basis of direct or indirect control. The arm's length requirement applies also to transactions between the company and its permanent establishment.

### *Documentation*

The documentation rules are contained in Articles 14a – 14c of the Assessment Procedure Act and provide that documentation establishing the arm's length nature of transactions between related parties should be drafted on cross-border transactions. According to the rules the Finnish transfer pricing documentation should include the following:

- (1) Description of the business;
- (2) Description of related party relationships;
- (3) Details of controlled transactions;
- (4) Functional analysis;
- (5) Comparability analysis including information on comparables if available;
- (6) Description of the pricing method and its application.

The description of the business should contain a general description of the business

of the taxpayer and the group the taxpayer belongs to. The description could include recent history of the group, a description on the taxpayer's position on the market, and information on business environment and the taxpayer, any of which can be used to evaluate circumstances affecting the transfer pricing. It is separately stated in the government proposal concerning the transfer pricing legislation that it is important to describe the business strategy and changes to the business strategy. It should also be noted that the business description needs to be relevant to the transfer pricing of the company.

The description of the related parties should include information on related parties with whom the taxpayer has had business activities during the tax year, or whose business activities affect directly or indirectly the pricing of the transactions between the taxpayer and a related party. The information should include the basis for the related party relationship and the organisational structure of the group.

Details of controlled transactions should include the following information on intra-group transactions:

- type
- parties
- value in euros
- invoicing flow
- contractual terms and
- relationship to other transactions with related parties.

In addition, a list of relevant agreements including copies of the most important agreements, should be included, as well as a list of cost allocation agreements, Advance Pricing Agreements (APAs) and advance rulings, and any rulings issued by the tax authorities to the other party of the transaction.

The aim of the functional analysis is to analyse the transactions between related parties by taking into account the assets and risks involved. According to the government proposal identifying the intellectual property is important. It is stated that a detailed description of the so called 'tested party' and general description of the other party should be included, as well as a characterisation of the companies.

The comparability analysis compares the related party transactions to unrelated party transactions. The analysis should include the factors affecting the comparability, e.g. the functional analysis, the nature of the transferred assets or services, the terms and condition and economical factors affecting the parties. Information on the search for comparables should also be included, i.e. information on the selection criteria, arguments, factors affecting the comparability and any adjustments made.

The description of the pricing method and its application should include the reasoning for the selection of the method, as well as a clarification of the method applied. The clarification should include any calculations used to verify the arm's length nature and details on any adjustments made. Assumptions and conclusions made should also be described.

Transfer pricing documentation should be submitted to the tax authorities within 60 days from a request. However, a taxpayer would not be required to submit transfer pricing documentation earlier than 6 months after the end of the accounting period in question. Therefore, the earliest due date the tax authorities could set for submitting

transfer pricing documentation under the new legislation would generally be at the end of June 2008. Any additional information requests should be complied with within 90 days from a request.

Based on the above, no contemporaneous documentation during the tax year would be required. However, it is stated in the legislative proposal that a taxpayer should monitor its transfer prices during the tax year, as it is not possible to amend the taxable income downward on the tax return in Finland. During the tax year it is possible to make an adjustment to bring pricing into line with the arm's length principle, such an adjustment would be included in the calculation of taxable income.

A relief from the documentation requirement is being applied to small and medium-sized enterprises. These enterprises do not need to prepare transfer pricing documentation. The definition of small and middle-sized enterprises follows the European Commission recommendation 2003/361/EC; thus, the relief will, in principle, apply to companies belonging to a group with turnover of no more than EUR50 million or balance sheet of no more than EUR43 million and less than 250 employees. Employees include those employed in a group or company, full or part-time workers, seasonal workers and owners who participate in managing the company. The amounts of employees are expressed as annual working units, where a full-time worker is one unit, and the other workers are divided in partial units.

If the requirements of a small and medium sized enterprise are exceeded during a year, the documentation requirements will not be imposed during that year.

According to the Finnish Tax Authorities, the requirements for transfer pricing documentation can be fulfilled with an EU TPD.

In terms of the language to be used in the documentation, the proposal for legislation states that transfer pricing documentation should be accepted in Finland even if it was drafted in English. A translation to Finnish or Swedish should only be required when this is necessary for the purposes of conducting the taxation (of the entity in question).

#### *Disclosure on tax return*

Taxpayers are required to disclose on their annual tax return whether they have had related party transactions during the tax year in question and whether they are obliged to maintain transfer pricing documentation provided in 14a of the Assessment Procedure Act.

### **3003 Other regulations**

The tax authorities have 19 October 2007 published guidelines dealing specifically with documentation. The OECD Guidelines on transfer pricing, while not legally binding in Finland, are important in practice. Decisions of the Finnish courts, although they do not specifically refer to the OCED Guidelines, are compatible with them and furthermore, Finnish legal commentary also follows the principles in the Guidelines.

#### *Non-deductibility of economic support*

It should also be noted that Economic support given by a Finnish parent company to a loss-making foreign subsidiary has previously been deductible for tax purposes under certain conditions. An amendment to the Business income tax act has abolished

this opportunity. The amendment is applied to accounting periods ending on or after 19 May 2004.

Before the amendment, the economic support given to a foreign subsidiary was tax deductible if the general provision concerning deductibility of costs incurred in generating or retaining business income could be applied. Thus, if the support was incurred either directly or indirectly in generating or retaining business income of the parent company, it was deductible for tax purposes. In practice this meant that the subsidiary had to be genuinely in need of economic support and the support given by the parent company had to be given in the interest of the parent company as well.

According to the amended rules, any costs incurred in improving the economic status of the related party company without counter-performance are non-deductible for tax purposes. The amended rules expressly state that the support given to related party companies is not deductible for tax purposes. According to the amended rules, support given to a company is not deductible for tax purposes if the company giving the support or other companies in the same group or the above mentioned companies together own at least 10% of the share capital of the company receiving the support.

In practice the amended rules mean that support given to a foreign subsidiary is not tax deductible even if it is given in anticipation of future benefits. The clause is implemented specifically to limit the general clause on the deductibility of costs e.g., the grant of market penetration costs is not tax deductible as the contribution is made in the form of 'support' rather than as compensation for an activity performed.

### **3004 Legal cases**

There have been several cases brought to court which establish some principles for dealing with transfer pricing and illustrate how the arm's length rule can be applied in practice. Some of the rulings of the Finnish Supreme Administrative Court are set out below. There has not yet been any published legal case dealing with transfer pricing documentation.

#### *Case 1990/483*

A Finnish company paid penalty interest to its Swedish parent company in respect of payments made after the due date. The parent company had not paid penalty interest on similar late payments to the Finnish subsidiary. In these particular circumstances, the penalty interest was held to be a hidden distribution of profit as defined in Section 73 of the Assessment Act.

#### *Case 1986/3441*

A Finnish company that manufactured and marketed lures sold 90% of its products by exporting the majority to North America. In 1981 it established an Irish subsidiary. Two models in the product range were exported incomplete to Ireland, where they were finished and sold to the North American market. The Irish company benefited from favourable tax rates in the first 10 years of its activities.

In the next tax year, the parent company sold blanks to Ireland for FMK916,488 and, after production costs of FMK724,856, made a profit of FMK191,632 or a gross profit margin of 20.9%. The Irish company finished these blanks and sold them in the North American market for FMK4.3 million and, with associated costs of FMK1.9 million, the Irish company made a profit of FMK2.4 million or a gross profit margin of



55.8%.

The court held that the transfer price was different from what would have been agreed between two parties acting on an arm's length basis. The taxable profit of the Finnish parent was increased by Fmk 291,605 to take into account the hidden profit distribution to the subsidiary.

#### *Case 1993/3009*

A Finnish company, whose main activities were photographic development and wholesaling of photographic products, entered into a marketing services agreement with its US-resident parent company under which it received technical and marketing assistance in return for an annual fee. The fee was based on an apportionment of the parent company's marketing budget, split between the US and Finnish companies on the basis of their respective turnover. The agreement contained a clause limiting the maximum payment by the Finnish company to 1.5% of turnover.

In three consecutive years, the Finnish company paid marketing service charges equivalent to 0.59%, 0.44% and 0.33% of turnover. In return, it had received from the US parent access to a computerised quality control system, advice on the recovery of silver, various services for eliminating equipment defects and functional problems, and training planning services.

Based on the documentation presented, the Supreme Court found that it was necessary to have regard to the price that would have been paid to receive all of the services provided, if they could be obtained, and that it had not been proven that the agreement was on terms different from those that would have been agreed between independent parties. Consequently, the court overturned the additional assessments that were submitted by the tax authorities.

#### *Case 1994/1847*

A global group operated in 15 European countries in the business of manufacturing electrical fittings and special tools for computer-controlled automated systems. Its Finnish subsidiary imported wholesale products and distributed them in the local market. Under a licensing agreement, the company paid a royalty based on turnover to the US resident parent company. The tax authorities took the view that the activities of distributor and wholesaler did not justify paying a royalty. The company argued that the transfer price charged for goods did not take into account the research and development (R&D) costs that the parent incurred and therefore a royalty was justified. The company produced evidence that the lowest price paid by an unrelated dealer for the same products was significantly higher than the intra-group price plus royalty.

The court considered all of the services, rights and other benefits enjoyed by the Finnish company under the licensing agreement and the evidence provided by the company. It concluded that the authorities had not proved that the amount paid by way of royalties based on the principle of cost distribution between group companies was higher than it would have been between unrelated parties, or that the licence agreement contained terms that were not at arm's length. The additional assessments were rejected.

#### *Case 1999/4219*

A Finnish parent company had granted its Dutch subsidiary a licence to use its

trademark. Under the licensing agreement, the Dutch subsidiary paid the Finnish parent a royalty of 2% of the net income of the group. The Finnish parent also received dividends from the Dutch subsidiary. The Dutch subsidiary had sublicensed the trademark to other group companies and received a royalty of 5% of the company's net income.

The tax authorities took the view that the terms of the licensing agreement between the Finnish parent company and the Dutch subsidiary were not at arm's length. They viewed that other Finnish group companies had paid a royalty of 5% to the Dutch company in order to enable the Dutch company to pay tax-exempt dividends to the Finnish parent company.

Since the company could not present adequate reasons for the difference between the level of the royalties paid from the Dutch subsidiary to the Finnish parent company and the royalties paid from the other group companies to the Dutch company, the court held that the Finnish parent company and the Dutch subsidiary had in their licensing agreement agreed on terms that differ from the terms used between unrelated parties. The taxable profit of the Finnish parent was increased by FIM5 million of the dividends paid by the Dutch subsidiary.

### **3005 Burden of proof**

The burden of proof is said to lie with the party that can best provide the required evidence. Generally, however, the burden of proof lies with the taxpayer. Thus, where the authorities have questioned whether transactions between related parties have taken place at arm's length prices, the taxpayer, who in any event is the party best able to provide the evidence required, must prove his/her case.

### **3006 Tax audit procedures**

#### *Selection of companies for audit*

The tax authorities have not disclosed any information as to how they might select a company for a transfer pricing investigation. In fact, transfer pricing is just one topic that is considered in the course of an ordinary tax audit. As a general rule, the authorities try to audit the largest companies at least once every five years.

The provision of information and duty of the taxpayer to co-operate with the tax authorities

The tax authorities may request all data, material and property, which they believe is necessary to audit the tax return or to agree an assessment or appeal, such as books and records, other documents, etc. Information may also be requested from third parties, and certain entities, such as banks, investment and insurance companies, must disclose information on request.

#### *The audit procedure*

A tax audit would usually include a visit to the company's business premises and interviews with personnel, including examination of correspondence on issues arising during the investigation.

While the taxpayer has a right to be heard in the audit process, this does not amount to actual negotiation. The tax investigators make a decision as to the amount of the assessment, based upon the facts they have gathered from the taxpayer and

other sources. The tax investigators would normally present a preliminary report, against which the taxpayer may give a written response and thereafter the report is finalised. The final report, against which the taxpayer may also give a written response, may include a proposal for an adjustment. An adjustment is imposed by the local tax office as appropriate.

### **3007 Assessments and the appeals procedure**

An appeal may be lodged against any adjustment in the same way as against an ordinary assessment. A taxpayer has the right of appeal to the Assessment Adjustment Board in the first instance. The appeal must be made no later than the end of the fifth year following the year of assessment but in every case, however, within 60 days of receiving notification of the assessment. An appeal against a decision of the Assessment Adjustment Board may be made to the Administrative Court and must be made within similar time limits. Appeals against the decision of the Administrative Court must be made to the Supreme Administrative Court within 60 days of the decision and only if the court grants permission to do so. Leave to appeal to the Supreme Administrative Court would be granted on the basis of the following criteria:

- the appeal has an important bearing on similar cases or would secure uniformity of legal practice;
- an error in procedure or other error has taken place in the case, which by virtue of law requires the decision to be reversed; or
- there are other weighty grounds for granting permission to appeal.

### **3008 Additional tax and penalties**

A failure to comply with the documentation requirements could result in a tax penalty being applied. In case the required documentation or additional information is not submitted timely or if the information submitted is essentially incomplete or incorrect, a tax penalty of maximum of EUR25,000 could be imposed.

Penalties may be charged where an additional assessment is made. They are charged either by way of administrative fines or by imposition by the criminal courts. Administrative fines are levied in cases of deliberate or negligent returns and for failure to file returns on time. Penalty interest is charged at the market rate on any unpaid tax. Penalties, tax increases and penal interest on income tax paid in Finland are not tax deductible.

### **3009 Use and availability of comparable information**

No comprehensive Finnish databases containing third party comparable information are available. However, the tax authorities have subscribed to a commercial European database (AMADEUS), which is used for the purposes of obtaining comparable third party data. This data has been used as a basis for some suggested assessments. However, no standard practice for using comparable data has yet been formed and thus each transfer pricing case is considered on its own merits, together with any precedents set by rulings of the Supreme Administrative Court and in legal commentary. According to the legislative proposal concerning the new transfer pricing legislation, a comparability analysis should include the factors affecting the comparability, e.g.

the functional analysis, the nature of the transferred assets or services, the terms and condition and economical factors affecting the parties. Information on the search for comparables should also be included, i.e. information on the selection criteria, arguments, factors affecting the comparability and any adjustments made. It is also stated in the legislative proposal that, in accordance with the EU Code of Conduct on European transfer pricing documentation, pan-European comparables searches should not be disregarded off-hand.

### **3010 Risk transactions or industries**

There is no tendency to attack any one business sector. It is clear, however, that in the past there has been a tendency to examine management service fees and royalties, rather than the transfer price of goods.

The Finnish tax authorities have not, in practice, required a mark up to be added on management fees charged to foreign subsidiaries. However, there are indications that this practice has been changed and that a mark up should now be included on management fee charges as a general rule.

### **3011 Limitation of double taxation and competent authority proceedings**

Finland has made a reservation to the OECD Guidelines concerning the use of the competent authority process. This does not mean that the process will not be used at all but that it will not automatically be used. In fact, Finland has concluded several tax treaties, which include a competent authority clause.

In practice, competent authority cases have been rare. The most common source of complaint is the question of whether or not a permanent establishment (PE) exists in Finland and there have been only a few issues concerning transfer pricing. It is difficult to estimate the probability of obtaining relief in transfer pricing issues through the competent authority process and there have been cases where relief has been refused. In practice it has been difficult to obtain relief and the process has been very slow.

### **3012 Advance pricing agreements (APAs)**

Since 1 January 1997, amendments to the Assessment Procedure Act came into force, introducing a new system of advance notice available to the taxpayer from the Tax Office. This procedure will also cover transfer pricing matters, valuation issues and questions relating to tax avoidance legislation.

At present, in accordance with Section 84 of the Assessment Procedure Act, advance rulings on the tax consequences of proposed transactions can be given by the Central Tax Board (the Board). An advance ruling is given only on application by the taxpayer and in cases where the Board finds there is a point of importance either to the taxpayer personally or as a precedent. The Board may indicate the tax consequences of the proposed action but it will not issue advice as to the best way to minimise tax. In practice, the Board does not give advance rulings on valuation issues or tax avoidance legislation, both of which are relevant for transfer pricing.

**3013 Anticipated developments in law and practice**

The tax authorities are working on guidance notes on the new transfer pricing legislation. However, the exact contents and the publication date of the said notes are not known at the time of writing. It is likely, however, that guidance notes will include practical guidance on the application of the new legislation aimed at the tax authorities. It is likely that some further detail on e.g. the contents of what will be considered and appropriate documentation will be included in the notes.

**3014 Liaison with customs authorities**

There has been no general exchange of information between the income tax and customs authorities so far, although particular information may be exchanged at the specific request of the other party.

**3015 OECD issues**

Finland as an OECD member has approved the OECD Guidelines but has stated its reservations over the competent authority clause (see Section 2312).

**3016 Joint investigations**

It is possible that Finland could join with another country to undertake a transfer pricing investigation. This has previously happened with other Nordic countries.

# 31 France

## 3101 Introduction

Statutory rules on transfer pricing adopt the arm's length principle for cross-border related party transactions. In addition, there are a considerable number of court cases on issues that are relevant to transfer pricing and which aid in the interpretation and application of the legislation. In parallel with increased resources within the tax administration, recent legislative developments emphasises the focus of the French Tax Administration (FTA) on transfer pricing issues through new rules for documentation and Advance Pricing Agreement (APA) procedures. In February 2006, the French Revenue introduced administrative guidance relating to Mutual Agreement Procedures (MAP). A transfer pricing guide dedicated to small and medium enterprises was also released in November 2006. In addition, the FTA is currently developing new transfer pricing documentation requirements.

## 3102 Statutory rules

The following main statutory rules address transfer pricing:

- (1) Section 57 of the French tax code (Code Général des Impôts);
- (2) The concept of 'acte anormal de gestion' (an abnormal act of management) – the courts decide whether this concept applies by comparing the commercial practices of the company under review with what they judge to be 'normal' acts of management;
- (3) Section L 13 B of the Tax Procedure Code; and
- (4) Section L 188 A of the Tax Procedure Code. In theory, the tax authorities can choose whether to apply Section 57 or the concept of acte anormal de gestion when questioning a transfer pricing policy. In reality, this element of choice is likely to be removed by the limitations of each regulation. Section L 13 B reinforces the French Revenue powers of investigation by imposing information requirements in case of a tax audit involving transfer pricing. This law facilitates the application by the French Revenue of Section 57. Section L 188 A extends the statute of limitations when the French Revenue requests information from another state under the exchange of information clause of the applicable tax treaty.

### *Section 57*

Section 57 was introduced into the French tax code on 31 May 1933 and has been regularly updated since this date. It was most recently updated on 13 April 1996. It can only be applied in relation to cross-border transfer pricing issues. Enforcement of Section 57 requires the tax authorities to prove that a dependent relationship existed between the parties involved in the transaction under review and that a transfer of profits occurred. However, it is not necessary to prove dependency when applying Section 57 to transfers between entities in France and related entities operating out of tax havens.

Dependency can either be 'legal' or 'de facto'. Legal dependency is relatively easy for the tax authorities to prove. It is defined as direct control by a foreign entity of the share capital or voting rights of the French entity under review. It can also mean dependency through indirect control, such as through common management. De facto control results from the commercial relationship that exists between two or more enterprises. For example, where the prices of goods sold by A are fixed by B, or where A and B use the same trade names or produce the same product, there does not have to be any direct common ownership. However, the fact that a large proportion of two or more companies' turnover results from transactions conducted between themselves does not necessarily mean that there is de facto dependency. The Tax Administrative Court of Paris ruled on 13 February 1997 that there was de facto control in the following situation: one French company, in charge of the distribution of books published by a Swiss corporation, was using personnel and equipment provided by a subsidiary of the Swiss entity, had the same management as the Swiss entity, and had authority on the choice of books to be distributed.

A transfer of profits can be inferred where, for example, transactions occur at prices higher or lower than prevailing market prices. This includes all types of transactions, including commodities, services, royalties, management services, or financing.

#### *'Acte anormal de gestion'*

This concept was developed by the Conseil d'Etat (CE), the French supreme tax court in charge of corporate income tax issues.

To invoke the concept of an acte anormal de gestion, it is necessary to prove that a transfer of profits has actually taken place and that there was a deliberate intention to move profits or losses from one taxpayer to another. It can be applied to both domestic and international transfer prices as well as to corporations or branches.

Under this concept, a tax deduction can be refused for charges not incurred for the benefit of the business or not arising from normal commercial operations.

#### *Section L 13 B*

The Economic and Financial Act, published on 13 April 1996, contains procedures for transfer pricing examinations. This legislation gives the FTA a clear right to request information on the taxpayers' transfer pricing policy in the course of a tax examination when it has evidence upon which to presume that an indirect transfer of profits abroad has occurred, as defined by Section 57 of the French tax code. This procedure only applies in the course of a normal examination. There is no specific transfer pricing examination, nor any transfer pricing disclosure requirement in France.

Four types of information may be requested under this procedure:

- (1) The nature of the inter-company transactions;
- (2) The method for determining prices for transactions;
- (3) The activities of the foreign enterprises, companies, or joint ventures; and
- (4) The tax treatment of the inter-company transactions.

With this legislation, in the event of an insufficient response within 60 days from

Revenue request, the FTA will grant the taxpayer an additional 30 days notice. Thereafter, the sanctions imposed on the taxpayer will be twofold:

- (1) A EUR10,000 fine for each period under audit;
- (2) The right for the FTA to reassess the taxpayer's profits on the basis of the information at their disposal. This procedure, however, remains controversial. The burden of proof of the dependence and of the non arm's length character of the transactions rests with the FTA.

On 23 July 1998, the FTA published a regulation commenting on the provisions of Section L 13 B. This regulation specifies in particular that resorting to Section L 13 B is neither obligatory nor systematic – it takes place only if the tax inspector has not been provided with sufficient explanations during the tax audit.

With regards to the transfer pricing method used, any method invoked by the enterprise can be considered acceptable, provided that it is justified by contracts or internal memos describing the method; extracts of the general or analytical accounts; economic analyses (notably on the markets), the functions fulfilled, the risks assumed, and the comparables retained. The FTA still broadly interprets elements required to justify the transfer pricing method.

#### *Section L 188 A*

Section L 188 A provides for an extension of the statute of limitations, and is open to the authorities when they request information from foreign tax administrations before the end of the initial statute of limitations. The new statute of limitations expires either at the end of the year following the year when the information requested is obtained or failing response, at the end of the fifth year following the year that is audited. For example, if the financial year corresponds to the calendar year, intra-group transactions conducted in 2001 can in principle be investigated within the framework of the authorities investigating a company, up to 31 December 2004. If a request for information is put to a foreign tax authority in December of the year 2005, these transactions may remain open to reassessment for the years 2006 and 2007.

The extension of the statute of limitation applies if there is a request for information bearing on intra-group transactions or on entities established in countries with favourable tax regimes (French tax code Section 209 B), but also in cases of requests for information with relevance to the foreign assets, credits, income, or activities of a French taxpayer.

### **3103 Other regulations**

In addition to the legislation specific to transfer pricing described above, the following authorities are also relevant to the issue:

- The terms of various tax treaties;
- Sections of the French tax code, which deal with related issues such as transactions with entities in tax havens.

(Section 238 A limits the deductibility in France of commissions and other payments paid to entities located in tax havens (as of 1 January 2006, a company is deemed to benefit from a privileged tax regime when the difference between the foreign corporate tax and the tax that would have been paid in France exceeds 50%). Section 209 B



allows consolidation in France of profits and losses realised through enterprises located in low tax jurisdictions. This anti-tax haven regulation was amended in the Finance Bill for 2005 and was commented upon in a new administrative regulation on 16 January 2007. The scope of Section 238 A has been reduced. For instance, the French CFC rules cannot be applied if the foreign company is located in a Member State of the European Union, and if the arrangement in question is not an artificial arrangement set up only to obtain a tax advantage. In this new regulation, the FTA make a reference to the ICI and Cadbury Schweppes ECJ cases to explain the meaning of 'artificial arrangements' mentioned in the EU safeguard clause (Administrative regulation: 4 H-1-07).

- The first pure transfer pricing regulation was issued on 4 May 1973 in the form of a 'note' (this regulation is the main element of the FTA doctrine and in April 1983 the tax authorities finalised and published this commentary on their interpretation of the transfer pricing legislation once the Section 57 was amended to cover transactions with tax havens);
- A new regulation published on 23 February 2006 on bilateral and EU mutual agreement procedures;
- Regulations published on 7 September 1999 on bilateral Advance Pricing Agreements and 24 June 2005 on unilateral Advance Pricing Agreements; and
- The tax authorities' commentary on legal cases involving transfer pricing, which has been issued over the years in the form of 'directives' (a directive is an indication of how the tax authorities will interpret and apply legal decisions).

### **3104 New transfer pricing (TP) documentation requirements under consideration in France**

The French tax administration is currently developing new transfer pricing documentation requirements. The planned requirements may become effective as from 1st January 2009 or 1<sup>st</sup> January 2010. A first draft was released on February 1st, 2008. Prior to the issuance of the final law, the TP documentation requirements will remain subject to change.

#### *Planned TP documentation requirements*

The new documentation requirements envisaged in France have several important components regarding both compliance and enforcement. First, the planned legislation would require taxpayers to provide TP documentation immediately upon request (this could mean the first day of an audit) with a 30 day extension to provide a full documentation.

#### (a) Penalties

If at the end of this period (30 days) no documentation is produced or is deemed incomplete, the taxpayer would be subject to a EUR50,000 penalty per financial year under review. In addition, a penalty of 5% of the transfer pricing adjustment (in basis) will be assessed in the case of missing or incomplete documentation, with a minimum of EUR50,000 per year under audit. As these penalties do not

qualify as a "serious penalty", taxpayers may still elect to carry out the mutual agreement procedure (MAP). However, a penalty could be issued even if a MAP is in progress.

(b) Required documents

The list of required documents proposed in the text of the planned requirement is identical to the exhaustive list under the European Code of Conduct (ECC), which was developed on the basis of work in the EU Joint Transfer Pricing Forum. ECC sets out two types of files, a Masterfile documentation containing standardised information at the group level and country-specific versions of standardised documentation for each member states in which the taxpayer has related party transactions, including documents relevant for that country only. Under the new TP documentation requirements, the Masterfile would have to cover all inter-company transactions worldwide, not only transactions carried out within the European Union.

(c) Additional changes to the current regulations

In addition to the above requirements, the French administration may be proposing to amend the tax return to include a small questionnaire section which would require taxpayers to detail the nature of inter-company transactions and their amounts on a yearly basis.

Under the planned legislation, Section L13 B will not be repealed, but will continue to be applied only to small and medium businesses (SMBs).

### 3105 Legal cases

There have been several cases over the years that establish important principles for dealing with transfer pricing issues. These are summarised below:

*Parent-subsidiary relations: expenses invoiced by a foreign parent company*

#### **SA Borsumij Whery France, CAA (Cour Administrative d'Appel) Paris 11 February 1998**

The administration considered that the reimbursement of such a charge represented a transfer of profits abroad 'insofar as the French company has not substantiated the reality of the services, invoiced in a vague manner for services which the French company could perform itself'. The submission of 'incomplete documents of a general nature' was deemed to be insufficient. This analysis was then confirmed by the French supreme tax court.

*Parent-subsidiary relations: partnership*

#### **SA Cogedac, CE 23 November 2001**

A parent company and its subsidiary incorporated a partnership in which the subsidiary contributed its purchasing platform. 90% of benefits were attributed to the parent company. The CE ruled that the administration is entitled to reincorporate to the tax base of a French subsidiary the revenue allocated to the parent company. The important contribution of the subsidiary and its absence of interest are considered by

the French Supreme Court as an abnormal act of management (*acte anormal de gestion*).

### *Reality of services*

#### **SA Bossard Consultants, CAA Paris 17 March 1998**

A subsidiary company, which paid royalties for a licence of a trademark to its parent company, could not deduct part of the sums paid as a temporary increase of the royalties by one point because it could not justify the reality of the public relations and promotion activities in respect of the trademark that the temporary increase was purported to cover.

### *Date to use when appraising a transfer pricing transaction*

#### **CE (Conseil d'Etat) Ford France and CAA Paris 4 October 1994**

The transaction must be appraised on the basis of facts known (or facts that could have reasonably been known in the circumstances) at the time the contract was made. The use of hindsight is not permitted.

### *Comparable searches*

#### **Pharma Industrie, CAA Paris 12 July 1994, CE Galerie Vercel 28 September 1998, SARL Solodet, CE, 21 February 1990; Reynolds Tobacco, CAA Paris, 20 November 1990; SARL les fermiers de l'Aisne, CE, 12 February 1993, Lindt et Sprungli CE, 4 December 2002**

The Pharma Industrie case illustrates the type of comparison that the courts require from the FTA and taxpayers. The tax authorities used five products of similar commercial reputation, distributed by three companies operating in the same pharmaceutical sector with comparable turnovers, as comparable evidence in a transfer pricing dispute.

The CE is very careful when examining comparable situations. For example, the CE on 28 September 1998 refused to consider that situations were comparable when the FTA was relying on isolated French-based transactions when the situation under audit involved a long-lasting relationship between a French entity and its US subsidiary.

In Solodet, the comparison was rejected since the comparable products were sold in Germany rather than in France. It was judged that both the prevailing market conditions and the end use of the products in Germany were different, and that therefore the companies identified by the tax authorities were in fact comparable to the French company under review.

In Reynolds Tobacco, the 2-3% commission received by the French entity was deemed by the courts to be an arm's length amount, even though competitors were receiving around 8% for providing similar services. This was decided on the basis that the services provided by the French company were sufficiently, if only slightly, different, and this justified the lower rate charged.

The Tax Administrative Court of Paris decision in 1990, referred to above, is in line with the courts' approach to comparables. The tax court decided not to accept the position of the FTA as the data provided to support its approach was too vague. In particular, the transfer of ownership did not take place in the same manner in the

various comparable situations as it did in the taxpayer's situation.

In *Lindt & Sprungli*, the CE approved the position taken by the FTA, even though the FTA did not support its position by reference to independent comparable data, but rather through facts and circumstances of the case at stake.

#### *Concept of group interest*

**N° 2372, CE, 24 February 1978; Sovifram, CE 3 June 1992; Société Nord Eclair, CAA Nancy, 6 March 1996; CAA Lyon 24 February 1998; SA Rocadis, CE 26 September 2001.**

The French courts have always supported the tax authorities in refusing to accept the idea of the interests of the group as whole serving as sufficient justification for a particular intra-group transfer pricing policy. However, charges at cost were accepted by the courts when the charges were invoiced by a parent entity to a subsidiary, according to the 24 April 1978 CE decision.

The CE accepted the same approach on 26 June 1996, where the charges were invoiced by a subsidiary to a parent company. In a 6 March 1996 decision, the Nancy appeal court expressly accepted an invoicing of charges at cost between two sister entities. This conclusion may derive from the fact that the FTA was challenging the flow of invoices and suggested that the invoicing should have gone through the parent company, so that the loss was incurred by the parent entity rather than one of the sister entities.

In a decision in 1992, the CE mentioned that an offset could also be a valid justification for a loss made by the subsidiary when selling products acquired from its parent entity.

In a more recent decision, the Lyon Appeal Court denied the group concept approach because the tax administration was able to demonstrate that margins were significantly higher on third party transactions than on transactions entered into with the parent company, despite both groups of transactions being of similar size. The subsidiary was unable to provide evidence of services that had been provided by the parent company, which may have allowed the subsidiary to justify this difference in margins.

In the *Rocadis* decision in 2001, the CE accepted the concept of group of interest between the members of a distribution network. The CE did not adhere to the general group concept approach, but the French court reckoned with the specificity of functioning of this specific distribution network.

#### *Economic or commercial benefit*

**Boutique 2 M, CE 27 July 1988**

In a number of cases over the years, the courts have accepted taxpayers' arguments that their transfer prices did not satisfy the arm's length principle because they resulted in some economic or commercial benefit. For example, their prices increased market share.

In all instances where this argument is put forward, the deemed benefit must be specific and reasonable in relation to the loss or reduced revenue recognised by the French company. Where the taxpayer has only been able to prove a potential benefit,

the transfer pricing policy has been adjusted.

In such cases the burden of proof lies with the taxpayer. Various court decisions have established that this applies whether the tax authorities are attempting to enforce Section 57 of the tax code or the concept of 'acte anormal de gestion'.

#### *Legal protection of the intangible licensed as royalty payment*

##### **Bentone Sud, CAA Paris 15 June 1999**

Despite the fact that the patents were no longer protected and there was a lack of actual transfer of know-how, the Appeal Court of Paris accepted the deductibility of a licence fee covering patents and know-how, in addition to a trademark and a regular supply of equipment. The Court judged that the access to the trademark and the right to access products made by the licensor were a valid justification for the payment of royalty. This decision is unique.

Decisions such as Outinord, or the above-mentioned Lindt & Sprungli Court decisions, confirm that the lack of legal protection is a critical factor for the courts in appraising the arm's length nature of a royalty flow.

#### *Existence of a written agreement*

##### **Electrolux, CE 21 October 1991; Barassi, CAA Lyon 11 February 1995**

The Court was able to rule in Electrolux that the lack of a written agreement signed prior to transactions taking place was not relevant to the transfer pricing policy under dispute since the ongoing trade between the related companies under review supported the transfer price as described to the tax authorities. This decision was based on the provisions of the 'Code de Commerce', which recognise oral trade agreements as valid and binding.

Once an agreement has been signed, the parties must abide by it. If circumstances change and the terms no longer apply, it must be amended.

Despite the above Court decision, a contemporaneous written agreement is advisable in all instances.

#### *Sale of assets*

##### **N°17055, CE 21 November 1980; Berri Ponthieu, CE 21 June 1995**

In Berri Ponthieu, the Court decided that the sale of shares in a listed entity at book value, which was lower than the prevailing market value, was a non-arm's length transaction, even though the sale was a group reorganisation.

Similarly, the acquisition of shares at a price exceeding the market value is also a non-arm's length transaction, unless there are special circumstances.

#### *Sale of goods or services*

##### **SARL Rougier Hornitex, CE 26 June 1996; SNAT, CE 31 July 1992 Rouleau, CAA Bordeaux 27 December 2001**

The sale of products or services to related parties at a price below prevailing domestic or international prices is not considered an arm's length transaction.

In Rougier Hornitex, the Court decided that a sale at a loss of services and goods

invoiced by a subsidiary to a parent company, during the subsidiary's first two financial years, was not an 'acte anormal de gestion'. The price of the goods and services, even though generating operating losses, was not below the market price, and therefore was considered an arm's length transaction.

In the Rouleau case, the Court ruled that the tax authorities did not establish an abnormal act of management (acte anormal de gestion) by only referencing that the sales of goods and services were below the market price.

### *Commission*

#### **Vansthal France, CAA 11 March 1993**

A number of court decisions address situations where companies used related intermediaries whose activities did not justify the level of commission or remuneration paid to them. For example, the decision of the Court of Appeal in Nancy on 11 March 1993, disallowed a transfer pricing policy under which a 20–40% mark-up was added to payments to a Swiss entity, since in its capacity as a billing centre it bore no risk.

However, where taxpayers have been able to justify the nature and value of the services provided, the courts have invariably accepted the commission paid. For example, a 5% commission was found to be acceptable between A and B, where B was assisting A with promoting its exports to Italy (CE, 26 June 1985).

### *Royalties*

#### **Caterpillar, CE 25 October 1989**

In Caterpillar, a 5% royalty was judged to be an arm's length rate for both manufacturing and assembling operations. In this particular case, the Court refused to accept that there should be different rates for the two different activities.

#### **Cap Gemini CE 7 November 2005**

In Cap Gemini, the French tax Supreme Court stated that the FTA did not demonstrate the indirect transfer of benefit in the absence of comparability study. The criticised transaction consisted of a royalty-free licence of the Cap Gemini trade mark and logo. The Court considered that the fact that French subsidiaries were charged with a 4% royalty, whereas European and American subsidiaries were charged no or lower royalty, was not relevant. The Court considered that the value of a trademark and logo may differ depending of each situation and market. Different situations may request different royalty rates. In its ruling, the Conseil d'Etat reaffirmed that a transfer pricing reassessment must be based on solid evidence.

### *Commissionaire and permanent establishment (dependent agent)*

#### **Zimmer Limited, CAA Paris 2 February 2007**

In Zimmer Limited, the Administrative Court of Paris stated that a commissionaire of a UK principal company constituted a permanent establishment of that company in France. The French company, Zimmer SAS, distributes in France the products for Zimmer Limited and was converted into a commissionaire (acting in its own name but on behalf of Zimmer Ltd) in 1995. The FTA considered that Zimmer SAS constituted a permanent establishment of Zimmer Limited in France because the French entity

had the power to bind its UK principal in commercial transactions related to its own activities. Zimmer Limited should therefore be taxed on the profits generated in France according to Section 209 of the FTC and Article 4 of the double tax convention between France and UK.

Zimmer Limited contended that it had no permanent establishment in France. As a commissionaire, it was acting on behalf of its principal but in its own name. In that case, the commissionaire does not fall within the scope of Article 4.4 (contracts concluded in the name of the principal, and power to bind the principal), nor Article 4.5 (independent agent not acting in the course of its ordinary business).

The Court observed that, under the commissionaire agreement, the commissionaire 'could accept orders, display quotes and documents in tender offers and conclude sales contracts on behalf of Zimmer Limited without obtaining its approval' and that 'it could engage in price negotiations, grant rebates and discounts or payment modalities with current or new customers without prior approval.'

The Court further indicated that the fact that Zimmer SAS, pursuant to its commissionaire status, acted in its own name and could not actually conclude contracts in the name of the principal was not relevant when considering its ability to bind its principal in a commercial transaction pertaining to its own activities.

The Court stated that Zimmer SAS was a dependant agent of its UK principal because it was acting exclusively for and under the control and instructions of its principal regarding its commercial activity. Zimmer Limited was also assuming the risks of the activities.

The Court concluded that Zimmer SAS constituted a permanent establishment of Zimmer Limited in France and that accordingly, the taxation in France of the profits attributed to such permanent establishment for the years under audit was fully justified.

#### *Financial charges and revenue*

##### *Interest charges*

**N° 75420 and n° 77533, CE, 16 November 1988; Société Arthur Loyd, CAA Paris 1 February 1994; Montlaur Sakakini, CAA Lyon, 25 October 1995**

The interest rate charged to a subsidiary by a French entity must be comparable with the interest rate the French entity would receive from a French bank for an investment similar in terms and risk. The interest rate used by the courts as a reference in Montlaur Sakakini is the Banque de France's loan rate.

##### *Deferral of payments*

**Baker International, CAA Bordeaux 6 April 1994**

If interest is not charged on outstanding loans to a related company, this is considered either an 'acte anormal de gestion' or is subject to Section 57 of the tax code.

##### *Absence of charges for guarantees*

**Soladi, CAA Nancy 30 April 1998; Carrefour, CE, 17 February 1992**

It is deemed to be an abnormal act of management to provide a financial guarantee, free of charge, unless direct actual benefit for the entity providing this support can be

justified. In a decision of 17 February 1992, the French Supreme Court suggested a rate of 0.25% for this service while the FTA was seeking 1%. The remuneration asked for this service should be commensurate with the risk incurred, as well as with the market value of this service, irrespective of the actual cost.

### *Debt waivers*

#### **SA Les Editions JC, CE 11 February 1994**

The arm's length principle also applies to debt waivers. French based entities may waive all or part of outstanding loans to related foreign entities to the extent that they can justify some economic or commercial benefit as a result of this financial assistance.

### *Choice of the financing mode of a company's operations*

#### **SA Andritz, CE 30 décembre 2003, n° 23-3894**

The terms of Article 57 of the French Tax Code (FTC) do not have the purpose, nor the effect, of allowing the administration to assess the 'normal' nature of the choice made by a foreign company to finance through a loan, rather than equity, the activity of an owned or controlled French company, and to deduce, if the need arises, tax consequences (cf. Article 212 of the FTC – thin capitalisation).

### *Management charges*

#### *Allocation of charges*

#### **N° 2372, CE 24 February 1978**

Management charges must be shared among all of the group entities benefiting from the corresponding services. Not allocating charges among all receiving group companies is considered to be an 'acte anormal de gestion'. Management charges should generally be allocated on the basis of a detailed analysis, taking into account which of the services the company received. However, when such a breakdown would be a cumbersome exercise unlikely to result in an accurate allocation, the charges can be allocated on the basis of a less detailed calculation, such as turnover.

### *Justifying the services*

#### **Gibert-Marine, CAA Bordeaux 12 December 1995; n° 26241 CE 22 June 1983; SA Mat transport, CAA Nancy 5 July 2001**

The basis of fees paid for management services will be examined in a tax audit. The taxpayer will have to provide evidence about the nature, content, and value of the services rendered by the supplier to justify the fees paid and to receive a tax deduction for them. In this context, an invoice alone is not sufficient proof.

### *Payments for seconded executives*

#### **Oudot, CE, 30 March 1987; Ministerial commentary, 7 September 1987**

In Oudot case law, it was considered that the costs of an executive seconded from a



French company to a Swiss subsidiary should be charged to the Swiss company, unless the French entity could demonstrate a commercial or economic benefit from not doing so.

### **3106 Burden of proof**

As a rule, the burden of proof lies with the tax authorities, unless the transfer of profits concerns a tax haven, in which case the burden of proof is transferred to the taxpayer.

However, there is now a legal requirement for taxpayers to provide documentation supporting their transfer pricing policies. Though in theory the burden of proof lies with the tax administration, in practical terms the burden of proof has always fallen on the taxpayer where the tax authorities have deemed a profit shift to have taken place or inappropriate transfer pricing to exist.

### **3107 Tax audit procedures**

#### *Selection of companies for audit*

Generally speaking, transfer prices are audited as part of a formal tax audit on all issues. There are no rules as to which companies come under investigation. Major companies are audited every three to four years, unless in a loss-making situation where the statute bar limitation rules for corporate income tax are less crucial to the tax administration. Nowadays, almost all sectors are audited, including French wholly owned entities and subsidiaries of non-French based groups.

### **3108 The audit procedure**

Tax audits are generally carried out through the following procedure:

- (1) Written notice is sent to the taxpayer informing of the date of the auditor's first visit and the particular taxes and years under investigation. The taxpayer may use a professional adviser to assist during the investigation.
- (2) The auditor's site visits take place at the taxpayer's main premises, either the registered offices or the main place of operations. The auditor's on-site presence can last from a few days to several months, depending on the size of the taxpayer's business and the number and complexity of issues under review. There is no maximum limit to the time the auditor may spend on-site. The auditor may be assisted by information systems, specialists taken from a dedicated group within the tax administration, as well as by FTA transfer pricing experts.
- (3) Throughout the auditor's visit(s), regular dialogue takes place between the taxpayer and the tax inspector.
- (4) On-site investigations by the tax inspector cease when the inspector is satisfied that all outstanding questions have been answered. At this point, written notice of any underpayment is sent to the taxpayer.
- (5) The taxpayer must provide a written response to the notice within 30 days of receipt. In the response, the taxpayer must either accept or reject the proposed adjustment. If s/he chooses to contest the reassessment, the taxpayer must

set out detailed and convincing arguments to support his/her case. At this point, the taxpayer may ask to meet the tax inspector's superior. Such a request is generally not denied. After this meeting the taxpayer may then also request a meeting with the local head of the tax audit division, i.e. the Appeals Officer (Interlocuteur départemental).

- (6) After considering the written arguments of the taxpayer (and generally only after the meetings described above have taken place), the tax authorities will either reaffirm or amend their initial position in a letter. There is no time limit within which the tax authorities must provide their response.
- (7) In their final response the tax authorities are obliged to offer the taxpayer the opportunity to take his/her case to the 'Commission Départementale'. This body consists of representatives of the taxpayer and the tax authorities and is responsible for reviewing technical, as opposed to legal, tax issues. Both parties are entitled to submit reports to the Commission, which hears both arguments before issuing a decision (which is however not binding on the FTA).
- (8) The tax authorities are only allowed to raise an assessment to collect the tax once the Commission has reached its final decision, at the latest within 3 years from the date of the assessment notice (unless an application for MAP has been filed – see below under para. 2415).

### **3109 Revised assessments and the appeals procedure**

If the taxpayer still wants to appeal against the revised assessment, then s/he can submit a 'réclamation pré-contentieuse' (a claim prior to court action) to the tax authorities. If there is no response from the tax authorities within six months of the claim submittal, then the taxpayer can elect to take his/her case to court. Otherwise, s/he can wait for the tax authorities to release their decision, after which the taxpayer has two months from that date to take his/her case to court.

The first court in which the case can be heard is the Tribunal Administratif (TA). Arguments are submitted in writing, although either or both parties may be called to the actual court hearing. Like the Cour Administrative d'Appel (CAA), the TA may appoint an independent expert to review the facts presented by both parties before giving its judgment.

Either party may appeal the TA's decision; this appeal would be heard by the CAA. The plaintiff has two months from the announcement of the TA's decision in which to make an application to the CAA.

In very limited circumstances, either party can ask the CE to hear the case. The CE is the supreme corporate and income tax court, and once it has heard the case it will either issue its own final ruling or instruct the CAA to review the initial ruling decision reached by the TA.

Depending on the provisions of the particular tax treaty that applies, a taxpayer can at any time decide to pursue a competent authority claim instead of litigation. It is also possible to pursue both routes at the same time.

### **3110 Additional tax and penalties**

Interest at the rate of 0.40% per month, or 4.8% per year, is charged for late payment or underpayment of corporate income tax. These amounts are not deductible for the

corporate income tax basis

If the good faith of the entity is challenged, which tends to be frequent when transfer pricing issues are scrutinised, a penalty of 40% or even 80% of the tax avoided is levied (Pénalités pour manquement délibéré). This extra charge is obviously not deductible from the corporate income tax basis.

In addition, a transfer pricing adjustment may lead to VAT and 'taxe professionnelle' (local tax on business activity) consequences as well as a deemed dividend issue (depending on treaty provisions).

### **3111 Resources available to the tax authorities**

The resources available to the tax authorities to devote to transfer pricing investigations are currently increasing. Major multinational entities are audited by the Direction des Vérifications Nationales et Internationales or 'DVNI' (National and International Audit Administration).

The DVNI is responsible for auditing all companies with a turnover in excess of EUR152.4 million for industrial companies or in excess of EUR76.2 million for service companies.

The DVNI is composed of 30 auditing teams divided by sectors. Therefore, the level of industry specific knowledge is high. General tax auditors may be assisted by tax inspectors specialised in transfer pricing (30ème Brigade). They can also use dedicated teams in charge of computer assisted audit or audit of tax credits for research and development expenses.

### **3112 Use and availability of comparable information**

Various databases are available which contain the financial accounts of most of the companies, whether or not listed. These include InfoGrefe, Diane, and Amadeus databases.

The FTA has now extensive access to Diane and Amadeus. The inspectors specialised in transfer pricing commonly use these tools to check taxpayer's benchmarks or produce their own alternative comparable studies. The DVNI is increasingly inclined to accept or even perform pan-european benchmarks.

### **3113 Risk transactions or industries**

Although no public announcements are made with respect to the targeting of particular industries for transfer pricing investigations, currently companies in the pharmaceutical, computer (hardware and software manufacturers and distributors), and chemical business sectors are more likely to be examined. Conversion schemes with a transfer pricing element are closely scrutinised in audit situations.

The legal cases listed above illustrate that other sectors, such as retail, may also occasionally be investigated. In addition, it is worth noting that the DVNI's transfer pricing and financial inspectors have recently been put together on the same team to enhance efficiency in transfer pricing audits involving valuation issues.

### **3114 Limitation of double taxation and competent authority proceedings**

The FTA does not publish any data on competent authority proceedings.

### **3115 Advance pricing agreements (APAs)**

French tax regulations provide for official APA procedures. Between 1999 and 2004, only bilateral APAs were accepted. The rectifying Finance Bill for 2004 (Article 20) codifies the legal basis for APAs and extends their scope to unilateral APAs. The APA procedure is now included in the Tax Procedures Code (see Article L. 80 B 7° of the 'Livre des procédures fiscales'). Previously, the only domestic authorisation was through a 1999 FTA regulation. In addition, an Advance Pricing Agreement procedure requesting limited documentation and simplified monitoring is now available to small and medium size enterprises.

#### *Bilateral APAs*

In a regulation issued on 7 September 1999, the tax administration defines the conditions under which it would be willing to grant a bilateral APA. This can only be initiated with states that have signed a treaty with France containing a section equivalent to Section 25.3 of the OECD model treaty. This regulation is a fundamental change from prior opinion expressed by the central tax administration, where they saw an APA procedure as a breach of the principle of equality. Under this regulation, the application process can be initiated in France or in the other state. The application can cover all transactions or only certain transactions, covering all or part of the companies' operations (a product, a function, a type of transaction, or a business line). Through preliminary meetings with the FTA, the exact scope of the information (tax, financial, legal, industrial, commercial, etc) to be provided will be defined. A formal request can then be addressed to the FTA. Within two months of this application, the same application must be submitted to the other tax administration. An indicative list of information to be provided is included in this regulation, but the basic idea behind this list is to establish constant debate and exchange of information with the FTA as part of the review of the application. Once the review is completed, a draft ruling is issued for final approval by the taxpayer.

The ruling will define the parties, the transactions, the transfer pricing method(s) elected, the assumptions used, the revision formula, the date of application of the ruling and its duration (three to five years), and finally the contents of the annual report to be issued by the taxpayer. The ruling cannot have a retroactive effect, except within the limit of the financial year during which the application is made.

#### *Unilateral APAs*

Unilateral APAs, which until the rectifying Finance Bill for 2004 were not authorised in France, may now be accepted by the French administration. However, in a regulation issued on 24 June 2005, the FTA made it clear that they would still favour the conclusion of bilateral APAs. Unilateral APAs could be granted in cases such as:

- If the bilateral tax treaty does not provide for a mutual agreement procedure (MAP);
- If, despite the MAP provided in the bilateral tax treaty, the foreign competent authority refuses to conclude an APA; or
- For simple issues like management fees and allocation key issues.

Small and medium size (SME) enterprises: simplified APA procedure:

As the 'standard' APA procedure may be quite burdensome, a simplified APA procedure for SMEs is available as from 28 November 2006. The simplified procedure proposed by the FTA includes the following:

- (1) Fewer transfer pricing documentation requirements for the APA request. The documentation is limited to a legal chart of the group, the list of transactions and prices between related parties, functional analysis, description and justification of the transfer pricing method, and the financial statements of the foreign companies involved in the transactions.
- (2) The assistance of the FTA in the preparation of the functional analysis and in the choice of the appropriate transfer pricing method.
- (3) An economic analysis is also requested. During an experimental period, the FTA may perform the benchmarking analysis at the request of the SME.
- (4) Simplified content of the annual compliance report requested in the follow-up years of the APA, i.e., details of the computation of the remuneration and a statement on the substantial changes to the activity conditions described in the APA request (activities, functions performed, risks borne, legal/de facto dependence, assets used, accounting methods, etc.)

Only SMEs that meet the following two criteria are eligible for the simplified APA procedure:

- (1) SMEs with (i) less than 250 employees, and (ii) a net turnover of less than 50 million EUR or with assets which do not exceed 43 million EUR.
- (2) 25% or more of the capital or voting rights are not owned by one enterprise, or jointly by several enterprises that do not meet the conditions of the previous paragraph.

To determine whether the criteria are met, reference should be made to the financial year preceding that in which the request to initiate the procedure is submitted.

### **3116 Mutual agreement procedure (MAP)**

The rectifying Finance Bill for 2004 (Article 21) suspends the collection of taxes when, following a notice of reassessment, a competent authority procedure is undertaken by the taxpayer to eliminate double taxation (see Article L. 189 A of the Tax Procedures Code, 'Livre des procédures fiscales'). Prior to this amendment, after issuing a notice of reassessment the FTA had three years to issue a notice of collection, notwithstanding the taxpayer's undertaking of a competent authority procedure. In this situation, given the average length of a competent authority procedure in France (three years and seven months), the FTA had to collect the taxes before the outcome of the competent authority procedure. After receipt of the notice of collection, the taxpayer could, and still may, request to benefit from deferral of payment of taxes if appealing to domestic remedies. However, under the deferral of payment procedure, the taxpayer incurs interest for late payment from the date stated in the notice of collection.

Under the new tax collection regime, the 3-year statute of limitation (relating to issuance of the notice of collection) is suspended starting from the opening date of the competent authority procedure. The suspension holds until the end of the third

month following the date of the notice given to the taxpayer which states the outcome of the competent authority procedure. Suspension of tax collection applies to competent authority procedures pursuant to the relevant tax treaty and the European Arbitration Convention.

The suspension of tax collection is applicable to competent authority procedures opened as from 1 January 2005.

In February 2006, the French revenue issued a new regulation regarding Mutual agreement procedures. This very detailed regulation provides guidance pertaining to the scope, conditions, and implementation of the mutual agreement procedures in France. It also aims at applying the recommendations encapsulated in the Code of Conduct elaborated by the EU Joint Transfer pricing forum with respect to the implementation on the EU Arbitration Convention.

### **3117 Binding PE ruling**

The rectifying Finance Bill for 2004 (Article 19) extends the tax ruling procedure to permanent establishments (PE) (Article L. 80 B 6° of the Tax Procedures Code, 'Livre des procédures fiscales'). Under the extended procedure, foreign companies can request a ruling from the FTA stating whether or not their business activity in France constitutes a PE or a 'fixed place of business', according to the bilateral tax treaty between France and the parent company's country of residence. Not only can the ruling apply to subsidiaries, it can also relate to agents, whether or not they are independent (see Article 5 §6 OECD Model Convention), or branches, whether or not its only purpose is to hold and deliver the parent company's goods (see Article 5 §4 OECD Model Convention). When a request for a ruling is sent, the FTA has three months to reply. An absence of reply within that time period will be considered an automatic approval of the request. The French subsidiary of the foreign company will therefore not be deemed a PE in France, and the group will not be liable for corporate income tax in France, thus avoiding double taxation.

The approval binds the FTA, which cannot issue tax reassessments for periods prior to the ruling. This new procedure is however limited exclusively to taxpayers acting in good faith ('contribuables de bonne foi'), that is, taxpayers having provided all the useful elements to decide whether or not a business constitutes a PE and has not provided wrong or incomplete information. The tax authorities can change their decision regarding periods after the ruling, as long as the taxpayer is informed of that change. This procedure is applicable as from 1 January 2005 (see Decree of 8 September 2005).

### **3118 Liaison with customs authorities**

The tax authorities have the authority to use information gathered by the customs authorities when challenging a transfer pricing policy.

### **3119 OECD issues**

Historically, the French tax authorities have never published a formal interpretation of any transfer pricing guidelines issued by the OECD. Indeed, there has not yet been any commentary on the Guidelines issued in July 1995. At various times, however, such as at public seminars, the tax authorities have indicated that they do refer to the OECD principles during audits and settlement procedures.

An explicit reference to the OECD principles was made for the first time in the regulation of 23 July 1998. Reference to these principles is also made in the APA regulations referred to above.

The courts tend to use the OECD's principles as guidelines (TA de Lyon, 25 April 1990, Fisons).

### **3120 Joint investigations**

There is little information about joint investigations, although it is generally thought that the tax authorities participate more in these now than in the past. In particular, the French authorities tend to join forces with their counterparts in the US, Germany, Belgium, and the UK.

### **3121 Thin capitalisation**

To counter thin capitalisation situations more efficiently, the French 2006 Finance Bill adopted a new system applicable from January 2007. The scope of the old thin capitalisation rule had been limited by two major decisions of the French Supreme Court on December 2003 (Conseil d'Etat, *Andritz SA* and *Correal Gestion*) and by a Regulation dated 12 January 2005.

The new provisions provide for the repeal of the existing thin capitalisation legislation, and replacement by an entirely new set of rules, which will cover both the interest rate charged and thin capitalisation. These new thin capitalisation rules apply to all types of financing granted to a French entity by any French or foreign related party.

#### *Interest rate limitations*

Under the revised Article 212 of the CGI, the tax deduction of interest paid to related parties is limited to the higher of (i) the average annual interest rate charged by lending institutions to companies for medium-term (two years or more) variable-rates loans, or (ii) the interest that the indebted company could have obtained from independent banks under similar circumstances.

The arm's length criterion mentioned in (ii) is a new feature for France. This provision is likely to shift the burden of proof to the taxpayer, as the French tax authorities in practice will likely seek to apply the average annual interest rate. Once companies have passed this interest rate test, French indebted companies must pass a second test, namely the debt ratio.

#### *Debt ratio*

In addition, the new thin capitalisation rules provide that a portion of interest paid to related parties, which is deductible under the interest rate test, may be disqualified as a deduction if it exceeds all of the three following limitations during the same financial year:

- Interest relating to financing of any kind granted by related parties within the limit of 1.5 times the net equity of the borrower;
- 25% of the adjusted net income before tax ('résultat courant avant impôt', defined as operating income increased by financial income), before related party interest, amortisation, and certain specific lease payments; and

- Interest income received from related parties (there is no limitation on thin capitalisation grounds when the enterprise is in a net lending position vis-à-vis related entities).

The portion of interest which exceeds the above three limits may not be deducted in the accounting period, unless it amounts to less than EUR 150,000.

#### *Carry-forward of excess interest*

That portion of the interest expense which is not immediately deductible by the French enterprise in the accounting period in which it is incurred, may be carried forward without time limit for relief in subsequent years, provided that there is excess capacity in the subsequent years, based on the second limitation mentioned above. However, the excess amount is reduced by 5% each year, from the second accounting period following that in which the interest expense was incurred.

#### *Exceptions*

The new provisions provide for several exceptions.

These new rules do not apply to interest payable by banks and lending institutions, nor to certain specific situations (e.g. interest in connection with intra-group cash pools, or in connection with certain leasing transactions).

In addition, the thin capitalisation rules do not apply if the French indebted company can demonstrate that the debt-to-equity ratio of the worldwide group to which it belongs exceeds its own debt-to-equity ratio.

Also, deductibility of interest is facilitated within a French tax-consolidated group. The new thin capitalisation rules apply to each enterprise member of the group taken on a stand-alone basis.

However, any excess interest incurred by such an enterprise may not be carried forward by that enterprise. Instead, it is appropriated at the group level. Subject to certain limitations, the consolidating company may deduct extra 'disqualified' interest. Any remaining excess interest may be carried forward for possible deduction at the group level in future accounting periods, less the 5% rebate.

The FTA issued an administrative regulation regarding these new complex rules on 31 December 2007 (Administrative regulation: 4 H-8-07). The guidelines provide the French tax authorities' interpretation of Section 212 of the French tax code relating to thin capitalisation rules. They clarify the legal provisions and provide practical guidance on the computation of the three tests.

In particular, the guidelines state that Section 212 is applicable to permanent establishment of foreign companies. It provides clarification on how the debt to equity ratio would be applied in the case of permanent establishments where the entities do not have a share capital, *per se*.

The guidelines also detail the exclusion of "treasury centre" and "leasing agreements" from the scope of the thin capitalisation rules, as well as they describe the specific conditions under which the thin capitalisation rules would allow deduction at a tax group level (Section 223B of the French tax code) for those interests that have failed the three tests at the level of a subsidiary on a stand alone basis.



# 32 Georgia

## 3201 Introduction

Certain transfer pricing concepts have been included in the Georgian tax legislation since 1993 (Law of Georgia on Corporate Income Tax); although specific provisions related to transfer pricing are very limited. Further steps were taken by including some general transfer pricing rules in the Georgian Tax Code of 13 June 1997.

Similar provisions were incorporated into the latest Tax Code effective from 1 January 2005. In particular, Article 22 ('Principles of determining the price of goods (services) for taxation purposes') and Article 23 ('Interrelated Parties') provide the basis for transfer pricing control by the tax authorities.

## 3202 Statutory rules

### *Scope*

The Georgian tax authorities may evaluate transfer pricing involving the following types of transactions:

- between related parties;
- barter;
- import/export; and,
- supply of goods/services free-of-charge.

### *Basis for transfer pricing adjustments*

The tax authorities may apply transfer pricing regulations in the following cases:

- transactions between related parties, unless their relationship does not affect results of the transaction, and/or;
- transactions in which the tax authorities can prove that price declared by the transacting parties differs from the actual price.

### *Related parties*

The definition of 'related parties' is found in Article 23 of the Tax Code. Parties are recognised as 'related' if their relationship could affect the conditions or economic results of their activities, for example:

- the parties are founders (participants, shareholders, stockholders) of the same enterprise, and their total share value exceeds 20%;
- one party partially owns (directly or indirectly) the other, where such ownership exceeds 20 %;
- one party's enterprise is under the control of the other party;
- one individual is subordinate to another individual in terms of employment, or one individual is directly or indirectly under the control of another individual;

- both parties are subsidiary enterprises or are under direct or indirect control of a third party;
- the parties jointly control (directly or indirectly) a third party, or;
- the individuals are relatives.

### *Pricing methods*

The primary method described in the Tax Code is the Comparable Uncontrolled Price ('CUP') method; however, the Georgian Tax Code also refers to three additional methods that may also be used:

- Cost Plus;
- Resale Price, and;
- Comparable Profits.

It should be noted that there is little specific guidance or description in the legislation as to how these methods should be applied.

### **3203 Other regulations**

Not applicable.

### **3204 Legal cases**

In a recent case, the tax authorities imposed penalties on a company conducting an export operation. The penalties were imposed because prices indicated on the invoices were two to three times smaller than prices presented on various company related web-sites. Further, the tax authorities determined that the main vendor of the company's product was a related party, specifically, a relative of the CFO.

The company's appeal on the first stage was rejected by counsel for the Ministry of Finance, with arguments that the product's supply price significantly deviated from the actual market price. A final determination of the outcome of this case is not yet available at the time of this writing.

### **3205 Burden of proof**

The burden of proof remains with the taxpayer to confirm acceptability of the prices in place.

### **3206 Tax audit procedures**

Georgian tax authorities are allowed to conduct tax audit procedures only once a year, unless there is reliable information for a more frequent audit due to tax evasion. There are no specific regulations related to transfer pricing tax audits provided in the Georgian Tax Code.

### **3207 Revised assessments and the appeals procedure**

Currently, the appeals procedures for any tax-related matter are slow and unlikely to affect any change in the initial assessment. At this time, the court system is not a viable alternative.

**3208 Additional tax and penalties**

There are no specific penalty regulations for the violation of transfer pricing rules; however, transfer pricing adjustments made by the tax authorities during the course of a tax audit that would increase the taxable revenue of the taxpayer may be subject to tax underpayment administrative measures.

Specific measures would include (but would not be limited to) the following:

- profit tax – at 20% rate;
- VAT – at 18% rate;
- possible excise tax – depending on the nature of goods.

Please note that current tax legislation also imposes fines for the underreporting of income and the late payment of interest.

**3209 Resources available to the tax authorities**

Information on market prices is to be obtained from 'official sources', which may include the database of government bodies, information submitted by taxpayers, or any other reliable information. Under certain circumstances, the tax authorities have relied on information from other outside sources.

**3210 Use and availability of comparable information**

Based on experience, the mostly common procedure used by the tax authorities is to rely on information collected themselves from other similar taxpayers and/or information published by the State Statistics Committee.

Currently, Georgian tax authorities are trying to obtain extensive information from other similar markets worldwide.

**3211 Risk transactions or industries**

Manufacturing and export.

**3212 Limitation of double taxation and competent authority proceedings**

No current well-developed procedures.

**3213 Advance pricing agreements (APAs)**

Not currently an option.

**3214 Anticipated developments in law and practice**

Putting in place detailed transfer pricing regulations is not currently a priority for the Parliament, and a time frame for such regulations is not currently known.

**3215 Liaison with customs authorities**

The tax and customs authorities have recently been merged into one body overseen by the Ministry of State Revenues. It is too early to determine how much coordination will take place between the departments; although, a new unified database has been introduced recently that makes import/export information easily available to the tax

authorities.

### **3216 OECD issues**

Although OECD principles are not currently officially recognised, the Georgian tax authorities tend to follow the OECD Transfer Pricing Guidelines.

### **3217 Joint investigations**

No such procedures are known to be taking place at this time.

### **3218 Thin capitalisation**

No specific thin cap rule currently applies. There is a limit on annual interest deductions, which is currently capped at 24%.

### **3219 Management services**

Although the Georgian Tax Code does not specify transfer pricing regulations with regard to management services, such transactions may be scrutinised for elements of transfer pricing, given they are provided or received in one or more of the following manners:

- by related parties;
- on a free-of-charge basis, and/or;
- as part of a barter transaction.

# 33 Germany

## 3301 Introduction

The German legislation on transfer pricing establishes the principle of arm's length pricing for related party transactions. Presently, transfer pricing issues are mostly dealt with as part of routine tax audits, which are a regular event for almost every company. The approach of the tax authorities to transfer pricing issues, in particular to acceptable pricing methodologies and competent authority proceedings, is undergoing continuous change in response to international developments in these areas.

## 3302 Statutory rules

The statutory rules on transfer pricing are not found within one integrated section of the legislation but in several provisions in different statutes. The provisions include a definition of related parties and provide that where the assets or income of a German taxpayer are reduced by means of non arm's length transactions with related parties, the income of the German taxpayer may be adjusted accordingly.

The statutory references, which have been in place for decades, incorporating the above rule are as follows:

- Section 1 Paragraph 1 of the Foreign Tax Act or *Außensteuergesetz* (AStG) – definition of related parties and adoption of the arm's length standard; and
- Section 8 Paragraph 3 of the Corporate Income Tax Act or *Körperschaftsteuergesetz* (KStG) – hidden profit distributions.

In 2003, additional transfer pricing legislation was passed by the German Parliament, incorporating the following new statutory references:

- Section 90 Paragraph 3 of the General Fiscal Code or *Abgabenordnung* (AO) – documentation requirements for cross-border transactions with related parties including permanent establishments (PE); presentation requirement within 30 [missing some text?] respectively 60 days upon request; empowerment of German Revenue to promulgate details in a formal decree with force of law;
- Section 162 Paragraph 3 of the AO – consequences of inadequate or non-presentation of documentation (assumption of need for profit adjustment; income estimation by use of least favourable point in a price range); and
- Section 162 Paragraph 4 of the AO – penalty of 5–10% of profit adjustment (with certain ceilings/restrictions) in case of non-compliance with documentation requirements.

With effect from 2008 onwards, the German legislation comprehensively amended Section 1 Paragraph 3 of the Foreign Tax Act with respect to transfer pricing by introducing specific rules including the following:

- Transfer pricing methods – The statute puts an emphasis on the three traditional transfer pricing methods, which should be primarily used;
- Comparability and adjustments of transfer pricing ranges – if no fully comparable data exists, transfer pricing ranges need to be narrowed. When a taxpayer selects a transfer price outside of the range, the adjustment will be made to the median of the range;
- The so-called hypothetical arm's length test, i.e., if no comparable arm's length prices can be determined for an inter-company transaction, the tax payer will have to apply a "hypothetical arms length test". Under such test, the transfer pricing range would be typically between the minimum price for one party in the transaction and the maximum price for the other party. If no other value can be substantiated by the taxpayer, the arithmetic mean of the range will be selected as the arm's length price;
- Business restructurings regarding the treatment of cross-border transfers of business functions – The statute addresses cases where operative functions such as production, distribution and/or R&D etc. are shifted from a German entity to a foreign country, or are reduced (as in the case of transforming a fully fledged production entity to a contract manufacturer). In these cases, an exit charge will increase the taxable income. The exit charge will be calculated by taking into account the future "profit potential" of the functions transferred. Under the new rules, the lost profit potential of the German party transferring the functions and the gained profit potential of the foreign party assuming the functions would form the (price) range from which the exit charge would be determined. By considering the profit potential of the foreign party, foreign location benefits such as lower costs (including labour costs and tax savings) would increase the exit charge; and
- Retroactive price adjustments – If intangibles are subject to an inter-company transaction and if the profits attributable to the intangibles after the transaction develop differently than originally envisaged, it will be assumed that third parties would have agreed on an adjustment mechanism. The authorities can then apply such (assumed) adjustment mechanism for up to ten years after any transaction, and assess different transfer prices.

The 2008 legislation also revised Section 8a of the KStG regarding thin capitalisation rules. These rules have been replaced by a general limitation on interest deductions.

In addition to the adoption of formal statutes by parliament, the authorities are authorised to issue so-called ordinances ("*Rechtsverordnungen*") on specific matters, which have statutory character in that they are binding for taxpayers and tax courts. With respect to transfer pricing, an ordinance was published in 2003, providing guidance and binding interpretation on the type, contents and scope of the documentation required ('*Gewinnabgrenzungsaufzeichnungsverordnung*' – GAufzV). In addition, the 2008 amendment to Section 1 Paragraph 3 of the Foreign Tax Act empowers the authorities to issue an ordinance specifying further details regarding the new transfer pricing rules; the authorities have prepared such an ordinance on business restructuring and are expected to formally publish the ordinance during 2008.

### 3303 Other regulations

The tax authorities have no power to issue legally binding regulations on transfer pricing matters unless formally empowered by explicit provisions of law. They are, however, authorised to promulgate general regulations, decrees on special topics, proclamations, etc. on any issue as considered appropriate, including transfer pricing matters. All such promulgations are binding only on the tax authorities and this tool is used extensively by the authorities to achieve an equal interpretation and application of statutory law and court decisions. While such promulgations have no legally binding effect for the public, they indicate the position that the tax authorities will take on the respective subject matter. Consequently, such promulgations have considerable relevance in tax practice.

From a transfer pricing perspective, the regulations set out below are of particular interest.

#### *Administration principles*

On 23 February 1983, the Federal Minister of Finance published the 'Principles Relating to the Examination of Income Allocation in the Case of Internationally Affiliated Enterprises' ("Administration Principles"). These Principles contain both the general rules on the international income allocation where related parties are involved, and an extensive discussion on the rules of law governing income allocation. Also included are positions on various types of inter-company transactions. The original version of the Administration Principles contained also guidelines on cost sharing arrangements, methods of adjustment and related procedural aspects; but these sections have been replaced by new regulations (see below).

The Administration Principles generally follow the 1979 OECD Guidelines. During their years of use, the Principles have become influential in the treatment of inter-company transactions in tax audits. The Principles have been accepted by the public as a reasonable basis for transfer pricing planning, although ongoing disputes between taxpayers and the tax authorities remain in certain areas. The Principles have been in the process of being revised for some time, to incorporate developments since 1979, and in particular to catch up with the 1995 OECD Guidelines.

#### *Further guidelines*

On 24 December 1999, the 'Principles Relating to the Examination of Income Allocation in the Case of Permanent Establishments of Internationally Operating Companies' ('Administration Principles on PEs') were published. On 30 December 1999, the revised Principles on Cost sharing Agreements were published. On 9 November 2001, a new chapter, without precedent in the original Administration Principles, was issued on international secondments. On 29 September 2004, the Federal Ministry of Finance issued its 'Principles on the Attribution of Capital to Branches of International Banks' to replace the relevant section in the 1999 Administration Principles on PEs.

On 12 April 2005, the Federal Ministry of Finance published the 'Principles for the Audit of the Income Allocation between Related Parties with Cross-Border Business Relationships with Reference to the Obligation to Determine Transfer Prices and Cooperate with the Tax Administration, Amendments to Transfer Prices, as well as their Implications in terms of Competent Authority and EU Arbitration Procedures' ("*Verwaltungsgrundsätze-Verfahren*" or 'Administration Principles-Procedures'). These

Principles contain the tax authorities' interpretation of questions regarding the documentation of the facts and circumstances that relate to relevant transfer pricing arrangements. Importantly, these Principles refer to the requirements to document the appropriateness of transfer prices. Taxpayer's documentation of the appropriateness of transfer prices must be exclusively oriented towards the arm's length principle and is the core of the Administration Principles-Procedures. In this respect, the Decree also contains requirements for database analyses and benchmarking studies.

### 3304 Legal cases

Transfer pricing issues have historically been settled by compromise or negotiation long before they reach the courts; hence, there have been very few court cases on the subject. Recently, there seems to have been a decline in settlement by compromise and, if this trend continues, it is likely that more transfer pricing disputes will reach the courts.

There are two levels of courts and any cases that are heard by the courts may last several years before a final decision is reached by the Federal Tax Court or *Bundesfinanzhof* ('BFH'), i.e. the higher court. Decisions by the BFH establish a binding precedent on the lower tax courts on a particular subject. However, while it is questionable from a constitutional point of view, the German tax authorities do not always accept BFH decisions as binding and may publish instructions that a certain court case is not to be applied by the tax authorities to other cases.

Most published court cases on transfer pricing issues deal with the interpretation of the arm's length principle and the tax consequences resulting from a violation of this principle. In substance, the courts typically verify whether transactions between affiliated parties are based on up-front (written) agreements and result in an income allocation comparable to that arising from transactions between third parties. The test question commonly asked by the court to establish this is whether an orderly and diligent manager (*ordentlicher und gewissenhafter Geschäftsleiter*) in exercising the required professional diligence would have provided a comparable advantage to a third party.

One of the most important transfer pricing cases decided by the BFH in the last decades is the judgment on 17 February 1993 (I R 3/92), which was published in the *Federal Tax Gazette* 1993 II p. 457. This case established an important principle that was summarised by the court itself as follows:

*'... an orderly and diligent manager will, for the corporation managed by him, introduce to the market and distribute a new product only if he can expect, based on a prudent and pre-prepared economic forecast, a reasonable overall profit within a foreseeable period of time with due consideration to the predictable market development.'*

The decision covers a variety of aspects, including the treatment of marketing expenses and the permissible scope of start-up losses. In many respects, the decision is significant for German distribution affiliates of international groups, which are in a continuous overall loss position. Such a loss-making affiliate should anticipate encountering difficulties in convincing tax auditors that losses incurred over several years would have been accepted in dealing with true third parties.



This decision covered the market introduction of a new product by an already established company, and stated that typically a market introduction phase, where losses are acceptable, should not be longer than three years. In contrast to this, a BFH decision dated 15 May 2002 stated that a start-up loss phase resulting from market influences of a newly-founded company can be substantially longer on a case by case basis. The typical start-up phase of three years is thus regularly extended in case of newly-founded companies. As a consequence, the overall total period after which an independent business manager would expect profitability could be assumed to be (somewhat) longer than in the case of the above-mentioned BFH decision dated 17 February 1993.

An even higher impact on German transfer pricing practices and procedures results from the BFH decision of 17 October 2001 (I R 103/00, published in the *Federal Tax Gazette* 2004 II p. 171). Not only does this judgment refine principles established in the case on 17 February 1993, it also provides substantial guidance on procedural issues such as the judicial revision of data introduced by the tax authorities, of (secret) comparables, the burden of proof, the consequences of lacking cooperation by the taxpayer, the scope of transfer pricing documentation requirements, as well as the determination of arm's length transfer prices within acceptable ranges. Further references to this judgment will be made in the following sections. It needs to be understood that the German legislator has reacted to this decision, in particular by introducing statutory transfer pricing documentation requirements in Section 90 Paragraph 3 of the AO and promulgating penalties in cases of non-compliance with these obligations in Section 162 Paragraphs 3 and 4 of the AO. To this extent, the principles of the BFH decision dated 17 October 2001 are no longer unrestrictedly applicable to the years 2003 onwards. However, it should be emphasised that even after the introduction of statutory documentation requirements, the burden of proof for transfer prices not being at arm's length is still with the tax authorities, and that the other findings of the BFH in its 17 October 2001 decision remain in force.

One of the regional tax courts, the tax court of Cologne, rendered an important decision on 22 August 2007 on the need of up-front (written) agreements for inter-company transactions. The court states that German national law clearly requires to have such agreements in place in order to avoid income adjustments. However, the Court also clearly acknowledges that Germany will not be able to uphold such a formalistic position under a double tax treaty where the emphasis is put on whether – irrespective of the fulfilment of formalities such as written agreements – transfer prices are arm's length. The decision is mostly read to underline the fact that the German tax authorities will generally not be able to attack transfer prices solely for the lack of inter-company agreements. It is interesting to note that the tax authorities have not appealed the court decision, and seem thus to acknowledge its findings. Nevertheless, in practice it remains advisable to enter into upfront agreements with respect to inter-company transactions.

### **3305 Burden of proof**

As a matter of principle, the taxpayer has to prove compliance with German tax law for all business transactions, including transfer pricing. In its aforementioned decision of 17 October 2001, the BFH provides guidance on the allocation of the burden of proof. The taxpayer only has to prove the underlying facts of a transaction, which

includes presentation of the functions and risks and a description of how the transfer price for the transaction was determined. The tax authorities, on the one hand, have the onus to prove that the transfer price is, or is not, arm's length. If the taxpayer should not fully comply with his/her obligation to present all facts, the tax authorities may conclude on the other hand that the pricing has been determined by the affiliation of the parties; however, the latter does not in itself allow the tax authorities to conclude that the transfer price is not arm's length, and the authorities are left with the need to determine the proper pricing by means of a comparability study or an appropriate estimation.

The 2003 legislation has introduced a rebuttable assumption that, in the absence of appropriate documentation, the actual income from inter-company transactions is higher than the income declared. If the taxpayer is not able to refute this assumption, the tax authorities may have to estimate the arm's length result, and if in this case the income can be determined only within a certain price range, the authorities may use the least favourable end of the price range; this mechanism represents one of the penalty elements for non-compliance with documentation rules, which is a potentially heavy detriment for a taxpayer who has not fulfilled his/her legal documentation obligation compared to a taxpayer who has done so. The latter would benefit from the 17 October 2001 BFH decision, which still provides the right to use the most favourable end of the price range in case of an estimation; from 2008 onwards, however, even in these cases a correction could be made at least to the median of a range if the taxpayer had agreed on prices outside of the appropriate range.

However, in this respect it should be mentioned that even the 'Administration Principles-Procedures' dated 12 April 2005 do not allow the taxpayer to generally choose the most favourable value in a range of transfer prices or margins in the frame of an estimation. The tax authorities require that this exploitation of the range in the sense of the most favourable value for the taxpayer depends on the degree of comparability of the respective third party data. For this purpose, the tax authorities may narrow the range to the detriment of the taxpayer, if an unlimited comparability of all third party data within the range is not given.

The above rules only apply to the regular price determination process. However, in criminal prosecutions, it is, of course, the tax authorities that have to prove that the conditions of tax fraud or other criminal offence are met including the taxpayer's criminal intent.

### **3306 Tax audit procedures**

The German tax authorities do not normally perform tax audits specifically for transfer pricing issues but examine transfer pricing during the normal tax field audits, which are performed at regular intervals. With the exception of small business entities, all German enterprises are generally subject to regular tax field audits, which usually cover three to five consecutive years. It can already be observed that an increasing number of tax audits do focus on transfer pricing and tighter investigations by tax auditors into transfer pricing issues occur in the light of extensive new rules and a nationwide transfer pricing program for tax auditors; this trend is likely to strengthen further in the future.

Since the introduction of legal documentation requirements, companies should be prepared to be asked to submit the documentation of their cross-border transfer

prices within the limits of Section 2 Paragraph 6 of the *GAufzV* already on receipt of the official advance notice (*'Prüfungsanordnung'*) of the tax audit. The time limit of 60 days (respectively 30 days in case of so-called extraordinary transactions) for submitting this documentation starts in these cases with this official advance notice being issued. However, an unspecified global request for documentation is not allowed; companies should consider to object if confronted with such an unspecified global request.

The provision of information and duty of the taxpayer to co-operate with the tax authorities

### *Information*

The tax authorities can request any information considered relevant to all the transactions throughout the audit period and the taxpayer is obliged to co-operate with the authorities. Where the investigation concerns cross-border transactions, there is an increased obligation on the German taxpayer to co-operate in that information on foreign affiliated parties must be provided if requested. Where it is not provided even though the German taxpayer would have had the possibility to obtain such information, the tax authorities are entitled to estimate 'appropriate' transfer prices based on simplified methods, which may result in an adjustment of taxable income. The authorities may not, however, enforce the provision of information either through the imposition of further penalties or through other similar measures.

The 2008 legislation introduced the notion that, if foreign related parties will not disclose information, which is relevant for the transfer prices of a German entity, the transfer prices of the German entity can be estimated at the end of the range which is most disadvantageous for the German taxpayer. It is, however, somewhat unclear how far-reaching the wording of the new rule can be interpreted.

### *Documentation requirements*

Over the years, the tax authorities have attempted to introduce additional, partly contemporaneous documentation rules for the specific purpose of supporting transfer prices. As an example, the revised cost allocation principles of 30 December 1999 request unprecedented documentation of all relevant facts. In its decision of 17 October 2001, however, the BFH emphasised that German procedural law in force at the time of judgment did not provide a legal basis for such special transfer pricing documentation. The 2003 legislation on documentation should be seen as a direct response of the authorities to that verdict of the Court.

The 2003 legislation has brought Germany on a procedural level comparable to a growing number of other countries and provides an efficient tool for more structured tax audits by the authorities.

The new rules request documentation as to type, contents and scope of cross-border transactions with related parties, including the economic and legal basis for an arm's length determination of prices and other business conditions. Documentation must be prepared within a 'reasonably short period' (in German *'zeitnah'*) for extraordinary transactions such as corporate restructurings as well as material long-term contractual relationships, which implies that no time limit is set for the preparation of ordinary current transactions. Within a 'reasonably short period' in this sense means that documentation for extraordinary transactions must be prepared within

six months at the latest after expiration of the business year in which the respective transaction took place.

Documentation for all types of transactions must be presented to the authorities upon their request typically in the course of a tax audit. The time limit for presentation is 60 days following the request (respectively 30 days in case of so-called extraordinary transactions); extensions may be granted for special reasons.

The new law is applicable for fiscal years starting after 31 December 2002, i.e. in most cases from 1 January 2003 onwards. However, the provisions on unfavourable estimates as well as on penalties took effect only one year later, i.e. from 1 January 2004 onwards.

### **3307 Field audits in practice**

Field audits are in most cases carried out at the premises of the taxpayer. The tax auditor notifies the taxpayer of the intended visit and the scope of the audit typically some weeks before the audit commences. Depending on the size, complexity and availability of information, an audit may take between a few days and many months. Effective 2002, special procedures have been established to allow spontaneous VAT audits with no advance warning to the taxpayer. Depending on the results, such a special audit may be continued as a regular tax audit covering also other taxes, including transfer pricing.

As of 1 January 2002, unprecedented new legislation has taken effect with a fundamental impact on the future conduct of tax audits. Forthwith, the tax authorities are entitled to access the electronic records of taxpayers who have to make available their data. At their election, the authorities may take direct access or may request the taxpayer to process and evaluate data at their specification. Finally, the authorities may also require copies of all data in a form suitable for further processing.

As a result of the field audit, the tax auditor summarises the findings and any tax adjustment considered necessary in a written report. It is common tax audit practice that the tax auditor, before finalising the report, continues to correspond with the taxpayer and/or his/her advisers in order to try to settle all the issues of concern; regularly, also a final meeting will be held between all parties involved to evaluate the material findings. It should be noted that negotiation is an important element of most tax audits and that currently, in most cases, a final settlement is reached by compromise.

In case of internationally affiliated companies, the examination of cross-border transfer prices is increasingly the focus of tax audits. Hence, the tax risks resulting from transfer prices not being at arm's length should not be underestimated in particular against the background of respective sanctions that may apply in such cases. In this respect, the quality of the documentation of the appropriateness of transfer prices increases in importance, as it may result in minimising the risk of income corrections. Simply said, the better the documentation of transfer prices with regard to their arm's length character, the lower the risk of income corrections. In addition, it should not be neglected that a solid transfer pricing documentation may add the advantage of shortening the duration of a tax audit.

### **3308 Revised assessments and the appeals procedure**

The tax auditor is not authorised to issue revised assessments for the years under

audit. The final report, including suggestions for any tax adjustment, is presented to the local tax office where the revised tax assessments are prepared, usually in accordance with the recommendations of the tax auditor.

The taxpayer may appeal against the revised assessments and ultimately any appeal would be heard first by the regional tax court and then, if admitted, by the Federal Tax Court.

### **3309 Additional tax and penalties**

Any unfavourable transfer pricing adjustment will result in an increase of taxable income, which often requires treatment as hidden dividend distribution. To the extent that a hidden dividend could not be funded out of available tax equity, the imputation tax system in force until the end of 2000 resulted in a gross-up with potentially a very high tax burden. The imputation system has been substituted from 2001 onwards, and, unlike in the old system, the regular new corporation tax rate of 15% (through 2007 25%) as well as trade taxes will now be applied to any profit adjustment (unless balanced by tax loss carry-forwards) with no unfavourable gross-up. To the extent a transfer pricing adjustment will indeed be treated as a hidden profit distribution, additional withholding taxes may become due; even if double tax treaties or supranational law (e.g. the EU Parent-Subsidiary-Directive) provide for reduced withholding tax rates, such reduction may only be achieved by a formal application.

Penalties other than interest charges are generally unknown under the present laws as part of the taxation process and may be an issue in criminal proceedings only. However, with respect to transfer pricing documentation, a penalty regime has been implemented with effect from 2004 under the 2003 legislation. In strict legal terms, a surcharge (no penalty for criminal misconduct) between 5 & 10% of a profit adjustment must be raised, with a minimum of EUR5,000. In case of late presentation of appropriate documentation, the maximum surcharge is EUR1 million, with a minimum of EUR100 for each day after the 30 / 60 days time limit is exceeded.

### **3310 Resources available to the tax authorities**

Central authority for all international tax matters, including transfer pricing, lies with the Federal Tax Office (*Bundeszentralamt für Steuern*). The Federal Tax Office collects all information and data of relevance for international taxation and transfer pricing issues. This central extensive statistical information is confidential and is available to the tax administration only. In local tax audits, matters of international importance may be presented by the local tax auditor to the Federal Tax Office for review, and expert auditors of the Federal Tax Office with specialisation in transfer pricing or other international tax matters may assume responsibility for respective segments of local tax audits. The Federal Tax Office relies entirely on internal expertise rather than on outside consultants or other experts.

In recent years, the German Revenue has identified transfer pricing as a strategic area of the highest importance and considerable efforts are being made to strengthen this area, both from a manpower/experience and an organisational point of view. Internationally affiliated taxpayers are being increasingly investigated by tax auditors with special cross-border experience, and that experience includes transfer pricing. The responsibility for larger companies (which typically have international group affiliations) also lies with special regional tax offices, which have an increasing

transfer pricing expertise.

### 3311 Use and availability of comparable information

In determining an arm's length price, Section 1 Paragraph 3 Foreign Tax Act states that primarily the traditional transactional pricing methods (comparable uncontrolled price (CUP) method, resale price method (RPM) and cost plus (CP) method) should be used. Profit-related transfer pricing methods have been a controversial area in the past. However, there is a growing tendency in tax audit practice to accept the use of profit-related pricing methods. This trend seems to be supported cautiously also by the BFH, which has accepted in its decision of 17 October 2001 that a certain profit benchmark may be used for the years under review.

The Administration Principles also explicitly acknowledge that, under certain conditions, the use of other methods may be appropriate. Specifically, the Administration Principles-Procedures allow the use of a profit split (PSM) or the transactional net margin method (TNMM) for specific cases; the latter can be applied if (i) no standard method is applicable, (ii) an enterprise carries out only routine functions, and (iii) at least a limited comparability exists with the comparable data.

The Administration Principles-Procedures also allow companies to apply profit-related transfer pricing methods to the extent that useful comparable data cannot be determined on the basis of the so-called standard methods. However, the application of the comparable profits method (CPM) is explicitly rejected, i.e. transfer pricing methodology has to be strictly transactional to the extent possible by, e.g., using the TNMM instead of the CPM.

The application of the transfer pricing methods depends *inter alia* on the structure of the company under review. The German tax authorities differentiate between three categories of companies:

- (1) Companies with routine functions and no considerable contribution to the value chain
  - allowed methods: standard methods and TNMM
- (2) Companies with an entrepreneur-type structure (so-called strategy leaders).
  - allowed methods: standard methods with respect to its affiliates, profit split method between companies of the same structure.
- (3) Companies, exercising more than routine functions, without having the profile of an entrepreneur.
  - allowed methods: standard methods, determination of transfer prices based on internal planning data with arm's length profit forecasts.

Hence, Germany follows the international trend of using profit-related transfer pricing methods for the determination of arm's length transfer prices; however, certain restrictive conditions must be fulfilled. This happened *inter alia* against the background that it is becoming more and more difficult in competent authority or arbitration proceedings to reject profit-related pricing methods where other countries are applying such methods.

When no comparables are available, the 2008 legislation confirms the concept of the so-called hypothetical arm's length test, which had been established in the past

by German courts: Applying the hypothetical arm's length test, a transfer pricing range would be typically seen to be between the minimum price for one party in the transaction and the maximum price for the other party; with the price expectations of the parties based on the net present value of forecasted future income. If no other value can be substantiated by the taxpayer, the mean of the range will be taken as the arm's length price.

### *Availability*

With regard to the availability of published financial data such as company accounts, except for publicly traded entities, few German corporations are inclined voluntarily to publish any meaningful financial data, or to comply with general European publication requirements. Owing to the lack of penalties for non-compliance, only a relatively small percentage of German corporations fulfil the publication requirements and, where information is published, there is not usually enough detail for it to be of real use.

However, an increasing number of German companies are prepared to publish their financials in databases. Hence, databases have a larger quantitative basis and their meaningfulness for comparability studies has increased. At the same time, databases contain more detailed company information so that database-supported comparability studies are gaining importance in defending appropriate transfer prices to the tax authorities. However, the Administration Principles-Procedures require that the search process of a database analysis has to be comprehensible and examinable for a tax auditor. It must not be limited to a mere database screening but requires a manual or qualitative screening. The overall guiding principle is 'quality is more important than quantity of comparables'. Only under these circumstances will the tax authorities accept database-supported comparability analyses.

In the past, the German tax authorities have relied entirely on self-collected information. However, reflective of the evident international development, they have recently started to use information available on publicly accessible databases. Still, to the extent the tax auditor resorts to other taxpayers' data for examining the arm's length character of transfer prices, the taxpayer is not entitled to be informed of this data for reasons of taxpayer confidentiality. As a result, this data has a reduced value of proof with regards to income corrections in a tax audit.

### *Secret comparables*

In its landmark decision of 17 October 2001, the BFH had also to deal with secret and anonymous comparables. Different from the lower Tax Court decision on the same subject matter, the BFH held that the use of secret or anonymous data is not per se violating German tax procedures. The tax authorities may, therefore, use secret data. However, the BFH imposes an important restriction on this rule. Due to strict procedural secrecy provisions, the authorities are effectively prevented from an unrestricted disclosure of the sources of secret data. As a result, the reliability and quality of such data may be substantially reduced in court and other public proceedings. As a way out of this procedural restriction, the tax authorities have gradually moved towards a more intensive use of publicly available data and, consequently, towards profit-based benchmarking studies.

### **3312 Risk transactions or industries**

In accordance with German law, transactions with related parties should conform to the arm's length standard and thus the transfer prices of all transactions could be challenged. In practice, they are subject to review in regular tax audits. As part of their evaluation of functions and risks, the tax authorities will scrutinise transactions with an increased risk profile. Although not always caused by a particular risk profile but rather by size and importance, tax audits focus increasingly on particular industries, e.g. automotive and pharmaceuticals.

### **3313 Limitation of double taxation and competent authority proceedings**

Competent authority provisions are an integral part of the extensive German treaty network and proceedings normally follow the pattern of Article 25 of the OECD Model Tax Convention. Retroactive adjustments arising from transfer pricing issues, which may result in a reduction of German taxes, may be allowed even where tax assessments have already become final and would not, in accordance with domestic tax law, otherwise be allowed. Depending on the complexity and/or importance of the subject matter, a competent authority proceeding may take between a number of months to several years.

The Administration Principles-Procedures dated 12 April 2005, explicitly mention that in case of an imminent double taxation caused by transfer pricing corrections of a foreign or national tax authority, the opening of a mutual agreement or EU arbitration procedure may help to remove this double taxation by means of corresponding counter income corrections. For this purpose, in case of a transfer pricing correction intended by a national tax audit, the company must be immediately informed of this correction so that it can turn to the foreign tax authority and discuss the possibility of a corresponding counter correction with them. Should the foreign tax authority not agree to such a correction, the taxpayer can apply for a mutual agreement or to the EU arbitration procedure.

Further details on mutual agreement and EU arbitration procedures are set out by the tax authorities in a circular letter of 13 July 2006.

In case of an imminent transfer pricing correction intended by the foreign tax authorities, the German taxpayer is obliged to inform the German tax authorities. Should German transfer prices change correspondingly, such changes would have to be documented according to Section 5 number 4 of the *GAufzV*. Should the German tax authorities not see themselves in a position to effect the corresponding counter-correction, the company has the opportunity to apply for a mutual agreement or EU arbitration procedure in order to avoid double taxation. In case of a foreign transfer pricing correction, the company has to submit all documents relevant to this correction to the German tax authorities.

It should be noted that, although the success of competent authority proceedings depends on the voluntary consensus of both tax authorities involved, the German authorities are unlikely to reject a compromise. In addition, Germany has commenced to include in the negotiation of a new tax treaty the position that mutual agreement procedures should contain an arbitration element, i.e. that they cannot end without a binding and final decision to avoid double taxation.



Like all other EU member states, Germany has to observe the European Arbitration Convention on Transfer Pricing Matters. The EU Arbitration Convention is based on the 'Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Transfers of Profits between Associated Undertakings' and entered into force on 1 January 1995 for a duration of five years. The extending protocol of 1999 was not ratified until 1 November 2004 and therefore the EU Arbitration Convention was paused between 1 January 2000 and 1 November 2004. Based on the protocol, the EU Arbitration Convention was applied retroactively and double taxation caused by transfer pricing adjustments in this period has been covered.

### **3314 Advance pricing agreements (APAs)**

The attitude of the Federal Ministry of Finance on APAs has recently changed very positively insofar as the Ministry actively welcomes and supports APAs for transfer pricing purposes in Germany. This has to be seen against the background that the determination of arm's length transfer prices in an APA serves to avoid lengthy disputes between the participating Revenues in treating cross-border transfer prices. A further benefit of an APA is that it may considerably shorten the length of tax audits since the transfer pricing system as such will not be challenged. In addition, APA reporting requirements and documents of an APA can be used to fulfil German transfer pricing documentation requirements.

However, it should be emphasised that the Federal Ministry of Finance is typically not prepared to grant unilateral APAs in transfer pricing issues, since unilateral APAs have no binding effect on the other country concerned. Therefore, the German tax authorities are instructed to only grant APAs on a bilateral or multilateral basis. This necessitates the respective other country to participate in the APA procedure and effecting APA proceedings on the legal basis of Article 25 OECD Model Tax Convention in the sense of an (anticipated) mutual agreement procedure.

Germany has now also 'APA Guidelines' in the sense of formal regulations on how to apply for, negotiate and grant an APA. On October 5, 2006, Germany's Finance Ministry released a long-awaited circular on bilateral and multilateral APAs, which was designed to facilitate the processing of APAs and to establish more certainty for taxpayers. The circular offers taxpayers and practitioners comprehensive guidance on obtaining an advance accord. With the new circular, the APA application process is also expected to be shorter than in the past: tax authorities are aiming to issue within nine months a German position paper in a bilateral APA, with a closed bilateral agreement expected in about 18 months.

Within the Federal Ministry of Finance, the competence for APA applications and for granting an APA has been centralised in one department and is no longer allocated over several state-specific departments. This centralised department is located within the Federal Office of Finance in Bonn. It has to be considered that in addition to the Federal Ministry of Finance, the local tax office (including the tax auditor) is regularly involved in an APA procedure. In addition, expert auditors for international tax issues from the Federal Office of Finance may be involved in the proceedings.

In 2007, Germany introduced the following fees for its APA program:

- In general, the fee for an APA amounts to EUR20,000 (basic fee), which will also become due, if an APA will not be issued as set out in the application process. In case of multilateral APAs, the fee will incur for each country involved.

- The fee for an extension of an already existing APA amounts to EUR15,000 (extension fee).
- Amendments to an APA application will give rise to a fee of EUR10,000 (amendment fee).
- Reductions to the fees are possible in cases concerning small enterprises.
- Finally, the German tax authorities will closely examine any unilateral APA granted by a foreign tax authority that has detrimental tax effects in Germany, unless the German tax authorities themselves actively participated in the APA process.

### **3315 Anticipated developments in law and practice**

#### *Law*

With respect to the concept of the transfer of functions under the new Section 1 Paragraph 3 Foreign Tax Act, the German authorities are planning to issue two more layers of rules. In addition to an ordinance that is expected during 2008, the authorities have announced that they will issue comprehensive guidelines which will contain further details.

The German tax authorities are also continuing their work on a revision of the Administration Principles following international developments. The Administration Principles have already been revised with regards to Chapters 7, 8 and 9 via new decrees. In a next step, Chapter 5 (intangible assets) is intended to be revised. As can already be seen from the Administration Principles–Procedures dated 12 April 2005, it is expected that in a continuing revision of the 1983 Administration Principles, Chapter 3 which deals with the supply of goods and services, will support the application of profit-related methods for the determination of transfer prices under certain circumstances. Here, German tax authorities increasingly follow international trends.

#### *Practice*

Further changes can be observed in the approach of the German tax authorities to transfer pricing issues. As practical training and experience of tax auditors are increasing, the profile of transfer pricing issues in tax audits is raised. It is also expected that taxpayers will request, and the Revenue will have to get involved in an increasing number of competent authority, arbitration proceedings and APAs.

### **3316 Liaison with customs authorities**

In the past, income tax and customs authorities have normally worked independently of each other with little or no communication or exchange of information. However, this is gradually changing, and it can no longer be excluded that transfer pricing adjustments may result in a reassessment of customs duties, or vice versa.

### **3317 OECD issues**

Germany is a member of the OECD and has approved the OECD Guidelines on transfer pricing despite having previously expressed reservations on certain sections of the Guidelines, such as those dealing with profit-based pricing methods.

**3318 Joint investigations**

The tax treaty provisions and additional EU provisions on the exchange of information, competent authority, arbitration and consultation proceedings provide a procedural framework for the German tax authorities to join another country in a joint investigation of a multinational group for transfer pricing purposes. For practical reasons (e.g. lack of manpower and language problems), such simultaneous audits are likely to be restricted to exceptional cases. Currently there is close communication with other EU member states and the US Tax Administration on issues of mutual interest, and this will impact on alliances for joint audits.

**3319 Thin capitalisation / limitations on interest deductions**

The 2008 legislation revised fundamentally Section 8a KStG, which formerly dealt with the thin capitalisation of companies. The thin-capital rules that restricted the deduction of interest on shareholder loans are replaced with effect from 1 January 2008 by an interest deduction limitation rule. Under the new rules, the allowable net interest expense is restricted to 30% of taxable income before interest, taxes on income, depreciation and amortisation. There is no limitation on the deductibility of interest in the following circumstances:

- where the net interest expense is less than EUR1 million,
- where the company is not part of a group and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense, or
- where the company is a member of a group but its borrowings do not exceed the borrowing ratio (as shown by the financial statements under a common accounting convention such as IFRS or US GAAP) by more than 1% and interest paid to any one shareholder of more than 25% does not exceed 10% of the net interest expense.

Similar principles apply to corporate holdings in partnerships and there are related party and right of recourse rules for shareholders to catch back-to-back financing and other perceived abuses.

Any net interest expense that has been disallowed on a given year because it exceeds the 30% threshold, may be carried forward for relief in future years. The net interest expense is then treated as a net interest expense of the year concerned, with the same conditions applying.

The interest limitations are effective for accounting years commencing after 25 May 2007 (adoption of the bill by parliament) and ending after 31 December 2007.

Prior to 2008, the thin capitalisation regulations of Section 8a of the KStG provided for a generally available 'safe harbour' debt to equity ratio of 1.5:1. Within this safe harbour, interest on loans received from (or guaranteed by) shareholders or affiliates were deductible for tax purposes. However, no safe harbour was allowed where the interest charged was based on profit or turnover rather than on a fixed percentage of the principal. In connection with the thin capitalisation legislation, there were complex anti-avoidance provisions, among others, on intra-group debt push downs.

# 34 Hungary

## 3401 Introduction

Hungary became a member of the OECD in May, 1996 and of the European Union on 1 May 2004.

Hungary first introduced transfer pricing legislation in 1992, in Section 18 of the *Corporate and Dividend Tax Act* (CDTA). Section 18 of the Hungarian CDTA prescribes the use of the arm's length principle (referred to as the 'customary market price') when setting the consideration associated with business contracts between affiliated companies.

Hungary as an OECD Member State has acknowledged that the arm's length principle as defined in Article 9 of the OECD Model Tax Convention is the international transfer pricing standard to be used.

The tools at the disposal of the Tax Authorities to monitor compliance include notification requirements, documentation, and tax audits. In addition to the incremental tax that becomes payable, the costs of non-compliance with transfer pricing rules include tax penalties of 50% of the adjustment as well as interest on late payments of tax.

## 3402 Statutory rules

On 1 January 2003 a new subsection introducing transfer pricing documentation requirements was added to Section 18 of the CDTA. This provision was followed by more detailed regulations contained in *Decree No. 18/2003 of the Ministry of Finance*. These regulations require taxpayers to document each related party agreement, with respect to the method in which the arm's length price was determined, by the time that the corporate income tax return is due. Such documentation needs to be updated for changes in the relevant circumstances that could cause unrelated third parties to renegotiate the pricing terms and conditions.

The penalty for non-compliance with the transfer pricing documentation requirements is detailed in Section 172 (4) Act XCII on the rules of taxation and is a default penalty of HUF2 million if the taxpayer fails to document its transfer pricing methods or retain the relevant documents. The Tax Authorities have explained that non-compliance includes lack of documentation, 'barely prepared' documentation or documentation prepared that does not meet the requirements determined in the law. The documentation must cover each agreement and the agreements cannot be consolidated unless the terms of supply or performance are the same under the agreements or their subject matter is closely related.

The basis of imposition of the default penalty is the subject of a continuing controversy on the issue of whether the correct interpretation of the Decree would impose the default penalty in respect of each absence of documentation of each agreement rather than per default identified in a tax audit. The Tax Authorities have stated they interpret the imposition of a default fine based on the number of agreements for which documentation is not in place, counting each instance as a default.

According to *Decree No. 18/2003 of the Ministry of Finance*, Hungarian transfer pricing documentation should include the following items:

- (1) general corporate information on the taxpayer and the related parties that were involved in the related party transactions;
- (2) details on the related party transactions, including the terms and conditions of the inter-company agreements;
- (3) an analysis of the industry in which the taxpayer operates, including a description of the market, its players, the level and nature of competition, and any government regulations on the market;
- (4) an analysis of the functions performed, risks assumed and assets owned by the taxpayer;
- (5) the reason for selecting the transfer pricing methodology applied in reviewing the arm's length nature of the related party transactions;
- (6) the criteria used in selecting the comparable data, and the data used in setting the arm's length benchmark against which the related party transactions are reviewed;
- (7) the arm's length price and any adjustments used to improve the comparability of the benchmarking data with the related party transactions;
- (8) a declaration of any judicial or administrative proceedings currently in progress; and
- (9) the date on which the documentation was prepared or amended.

### **3403 Other regulations**

#### *Simplified documentation*

For inter-company transactions that do not exceed HUF50 million in value, net of VAT, the Ministry of Finance Decree allows the use of simplified documentation, which has to include: data on the related parties, the subject matter, date, terms and conditions of the underlying agreement, benchmark study, and the date when the documentation was prepared.

#### *Exceptions*

The requirement for documentation does not apply to individuals, small or micro enterprises (as defined in Section 3, Act XCV of 1999), individuals and transactions conducted on the stock exchange or at an officially set price (however, cases of insider trading, fraudulent attempts to influence exchange rates or applying prices in breach of legal regulations are not exempt).

### **3404 Legal cases**

There has been little in the way of legal cases dealing with transfer pricing in Hungary.

### **3405 Burden of proof**

Since the introduction of transfer pricing documentation requirements the burden of proof has passed on to the taxpayer. Taxpayers are required to support their related

party transactions with specific documentation which has to be in place within five months of the end of the accounting period for which a corporate income tax return is filed.

As the documentation rules are clear as to the level of detail and approach that is required taxpayers are faced with carrying out a detailed analysis of their related party transactions.

In the event that adequate documentation is in place, it is up to the tax authorities to demonstrate that the method selected, the search criteria and the uncontrolled comparables identified are not applicable. This assumes that the functions are correctly determined and the financial analysis and implementation of related party agreements are correctly disclosed.

### **3406 Tax audit procedures**

There is no public knowledge of the details of any major focused transfer pricing audits. Standard tax audits have raised queries regarding the degree of compliance with the related party documentation regulations, with increasing numbers of questions regarding the transfer pricing methodology selection.

Facing budgetary pressures, the Government has been under pressure to step up enforcement activities. At the same time in recent submissions on creating a sustainable investment climate, the Government has emphasised that it will also seek to address taxpayers concerns of transparency in the enforcement of legislation. In regards to penalties, Hungarian tax authorities have been active in publicising that:

- (i) penalties should not be considered to be a one time payment as an alternative to compliance; and
- (ii) taxpayers will now be held to due dates which have previously not been strictly enforced.

The penalties were introduced to encourage taxpayer compliance with the legislation in the belief that the penalty would never have to be imposed. Non-compliance with the legislation in practice has resulted in the recent public campaign of the tax authorities to educate tax payers of what is to come.

Examples of non-compliance include the imposition of penalties for not having adequate transfer pricing documentation in place (i.e. the HUF2 million penalty) and the requirement to have the documentation in place within five months of the accounting period end for which Corporate income tax declarations are required to be submitted.

### **3407 Revised assessments and the appeals procedure**

Almost all Hungarian taxes are levied by self assessment. In other words, the taxpayer must file the return and make any payment by the due date, without waiting for a formal assessment or payment demand from the Tax Authorities.

In Hungary a Tax Authority audit can be started at any time during the five years following the end of the year in which the return was originally due. The statutory period of limitations for starting a tax audit is therefore six calendar years from the year-end date. The tax auditors generally make field visits to the taxpayer's premises lasting several weeks and covering a span of three to five years. Their findings are discussed with the taxpayer and its representatives.

The Tax Authority will issue minutes on their findings, and the taxpayer has 15 days to file its response to the minutes. The Tax Authority then issues its first-level resolution. Appeals against the first-level resolution have to be filed within 30 days to a higher authority within the tax administration. A second-level resolution may be issued by the Tax Authority following the appeal against the first-level resolution. The taxpayer can then submit appeals against the second-level resolution to the relevant court.

### **3408 Additional tax and penalties**

Failure to comply with the Hungarian transfer pricing documentation regulations is subject to a penalty of HUF2 million (approx. USD11, 000).

Adequate and timely documentation should not be underestimated as an indicator of the taxpayer's good faith if transfer prices are queried. Good faith will clearly have a bearing on the resolution of a transfer pricing dispute.

Transfer pricing adjustments (assuming they are in favour of the tax authority) could not only increase the tax liability of the taxpayer but also result in a tax penalty of 50% on any additional tax payable plus interest on late payment of tax at twice the base rate of the National Bank of Hungary. As of 1 April 2008 the base rate of the National Bank of Hungary was 8.25%.

In addition to the above there is also the risk of double taxation when a 'corresponding adjustment' is not accepted in the other tax jurisdiction involved.

These risks exist for qualifying agreements in any of the years open to scrutiny by the tax authority under the Hungarian statute of limitations, which is five years.

### **3409 Resources available to the tax authorities**

The tax authorities set up a central transfer pricing unit in 2006 to carry out transfer pricing specific audits and assist in local general tax audits where a transfer pricing issue has been identified. This unit also works closely with the department of large taxpayers, which looks after the largest taxpayers in Hungary. As of 1 January 2007 the Tax Authority's Directorate of High Importance Taxpayers, has sole jurisdiction in cases defined by law, as well as in cases involving taxpayers regarded as 'high importance' under separate legislation and is responsible for conducting centralised inspections.

According to the Decree No. 37/2006 of the Ministry of Finance, high importance taxpayers include credit institutions and insurance companies organised as joint-stock companies and, (except for state entities, sole proprietors, and private persons defined by the Personal Income Tax Act) taxpayers with tax obligations (i.e. all tax obligations of a company including those collected and payable by the company) of HUF2,200 million or more, provided that they are not subject to bankruptcy, liquidation, or winding-up proceedings on the last day of the year preceding the tax year.

The largest 3,000 taxpayers in Hungary can expect tax audits at least every three years.

### **3410 Use and availability of comparable information**

The tax authorities have introduced a number of external databases which they use to assist in their tax audits. The two major publicly available Hungarian databases are KJK-Kerszöv DVD Cég hírek and IM Online, where public financial information can

be downloaded on Hungarian companies. The Tax Authorities also use Bureau van Dijk's Amadeus database and have developed their own internal database on the basis of the financial information received during tax audits.

### **3411 Risk transactions or industries**

Tax authorities have publicly stated that they consider entities that are either loss making or show an accounting profit of less than 2% of Gross Revenues as subject of particular attention in transfer pricing audits.

### **3412 Advance pricing agreements (APAs)**

Hungary adopted legislation regarding advance pricing agreements on 1 January 2007. The Decree No. 38/2006 of the Ministry of Finance details the procedure for making applications for advance pricing agreements. An application form is available at the Hungarian Tax Authorities website (Form 07APIAC can be downloaded at [www.afeh.hu](http://www.afeh.hu)).

#### *Procedure*

The applications for advance pricing arrangements are lodged with the Tax Authorities Central Office and are required to be co-signed by a tax advisor, a tax expert (a registered professional tax specialist in Hungary), a chartered tax consultant or a lawyer. The application is subject to the following fees:

#### *Fees*

The fees are 1% of the arm's length price determined by the Authority with the following limits from 1 January 2008:

- HUF5 million for an unilateral APA but no more than HUF12 million
- HUF10 million for a bilateral APA but no more than HUF17 million
- HUF15 million for a multilateral APA but no more than HUF20 million

The application should be accompanied by a copy of the receipt certifying payment of the application fee in full, duly signed by the issuing bank.

If an application for an advance pricing arrangement is dismissed, the Tax Authority will refund 75% of the application fee to the taxpayer within 15 days of the resolution on the dismissal of the application (usually 30 days after the issue of a resolution).

The Tax Authority has a statutory right to negotiate an extra payment in the event that an application is incomplete or is in non-compliance with the provisions of the Decree, to reimburse the Tax Authority's additional costs incurred with respect to the procedure. The Decree specifically requires that any such cost reimbursement requires the Tax Authorities to provide an itemised breakdown of costs including labour, consulting fees and other costs incurred for the purposes of the procedure.

#### *Notification to the local tax office*

All applications for an advance pricing arrangement are automatically notified to the local tax office dealing with the day to day tax affairs of the taxpayer.



### *Appeals*

Appeals against the first instance resolution (ruling) must be addressed to the Chairman of the Tax Authority and filed with the Tax Authority's Central Office. If, following an unsuccessful appeal, the resolution (ruling) is not cancelled, amended, corrected, replaced or complemented as requested in the appeal, the decision on the appeal must be prepared and presented to the Chairman by a tax authority unit organisationally independent and separate from the unit that prepared the first instance resolution. This provides some comfort that there will at least be a peer review of unsuccessful appeals.

### *Bilateral and multilateral procedures*

In bilateral and multilateral procedures, the taxpayer will not be involved in the exchange of information or multilateral procedure between the Hungarian Tax Authority and the foreign tax authority or authorities. The Tax Authority does however have the right to request the applicant to supply, within eight days, any additional information at the applicant's disposal that is considered material for the purposes of assessing the APA application, or for clarifying new facts, data or circumstances, if any, that may emerge in the course of such procedures.

### *Verification audit*

Once an application has been received and is determined to be complete, the Tax Authorities should be expected to carry out a verification audit within 30 days or acceptance of a complete application. This period can, as would be expected, be extended.

*Note:* There is an Annex to Decree No. 38/2006 of the Minister of Finance that sets out the details to be included in the advance pricing agreement application.

### *Advance pricing arrangement in practice*

The Tax Authority requires information requested in the Decree to be supplied in advance of the submission of the application for advance pricing agreements and it is usual for a preliminary meeting to be held with the Tax Authorities to explain the background of the application and clarify any initial queries that the Tax Authority may have in respect of the information provided. The Hungarian Tax Authorities are in practice generally helpful in ensuring a smooth APA procedure for the Tax Payer.

An interesting point to note is that there appears to be a very clear preference to the traditional methods of Comparable Uncontrolled Price method, Resale Price and Cost Plus methods. The Decree detailing the documentation rules clearly considers a hierarchy of methods.

### **3413 Anticipated developments in law and practice**

The Hungarian transfer pricing legislation continues to develop as part of the general harmonisation with the EU legislation and directives and therefore taxpayers can anticipate significant developments in the future both in terms of the quality of the tax audits and legislative background. The last year has already seen an increase in the quality of tax audits and imposition of default penalties where documentation is either incomplete or not available. This is expected to be a continuing trend.

**3414 OECD issues**

The Decree No 18/2003 of the Minister of Finance on Documentation states that it is based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and related protocols which include the OECD Transfer Pricing Documentation Guidelines. Therefore the OECD transfer pricing developments should be seen to play a major part in the development of transfer pricing legislation and practice in Hungary.

**3415 Thin capitalisation**

Under Paragraph j) in Section 8 (1) of the Hungarian Corporate Tax Act, interest on liabilities in an amount pro-rated to the portion of such liabilities that exceed three times the equity capital results in an increase to the corporate tax base.

For purposes of thin capitalisation, liability means the average daily balance of outstanding loans (with the exception of liabilities due from financial institutions) and outstanding debt securities, while equity capital means the average daily balance of subscribed capital, capital reserve, profit reserve and tied-up reserves.

# 35 Iceland

## 3501 Introduction

Iceland has no direct transfer pricing legislation but it is a member of the OECD and subscribes to the principles contained in the OECD Guidelines. However, there are no direct references in Icelandic tax law or in other legislation to the OECD Guidelines.

Due to the rapid increase in foreign investments in recent years by Icelandic financial institutions, airline companies, software companies and companies engaged in retail and other various industrial activities, the management of these companies is becoming more and more aware of the needs and opportunities of a carefully structured transfer pricing policy.

At the same time, foreign investment in Iceland has increased rapidly, mainly in the energy related industries.

Icelandic tax authorities are showing an increased interest in implementing rules and regulations on this issue, which will likely be based on the principles of the OECD Guidelines.

## 3502 Statutory rules

There are no collective statutory rules in Iceland which are specifically aimed at transfer pricing. The statutory authority for addressing transfer pricing issues is found in the application of general legal concepts, such as the anti-avoidance rule. In Article 57 of the Icelandic Income Tax Act No. 90/2003 (originally included in the tax code in 1971) there is a general anti-avoidance rule stating that business transactions between all parties should be based on the arm's length principle. With reference to the general concept of this Article tax authorities can, in cases where transfer prices are not arm's length, adjust the taxpayers' revenues and expenses so as to reflect market value. These adjustments can be performed only within the domestic statute of limitation period, i.e. six years. Authorities have thus based its transfer pricing conclusions on Article 57.

The Income Tax Act includes several separate rules that can be identified as transfer pricing rules but those rules generally concern transactions between individuals and not companies, for example a rule that obligates employees who receive their wages in kind to account for them on their tax return based on market value.

The VAT Act also includes separate rules that can be identified as transfer pricing rules as they address issues concerning how to price products when transactions between related parties occur.

Transfer pricing issues will not be addressed unless there is a statutory rule that can be built upon.

## 3503 Other regulations

### *Double tax conventions*

In addition to domestic legislation, transfer pricing principles are stated on all double tax conventions that Iceland has entered with foreign countries. These principles are

based on Article 9 of the OECD Model Tax Convention.

### *Regulations*

There are no published regulations relating to transfer pricing.

### *OECD Guidelines*

Iceland is a member country of the OECD and has embraced the OECD Guidelines for transfer pricing purposes. In Iceland it is expected that the OECD Guidelines and the newly confirmed Code of Conduct for Transfer Pricing Documentation in the EU will likely have an impact in the future.

## **3504 Legal cases**

Several legal cases concerning transfer pricing have reached the State Internal Revenue Board. A few cases have also reached the District Courts and the Supreme Court of Iceland. There are no transfer pricing cases currently being processed through the courts.

In some legal cases of different nature, it is established that transfer pricing issues can be addressed on the grounds of Article 57 of the Income Tax Act, even though the rule is considered a general anti-avoidance clause. These cases also establish the arm's length principle for transactions between related parties.

## **3505 Burden of proof**

The tax authorities carry the full burden of proof when trying to establish that a transfer pricing adjustment is needed.

## **3506 Tax audit procedures**

Tax audit procedures can be based on pre-determined tax-audit programs or a random inspection of tax returns.

The tax authorities can request any information on the taxpayer and the taxpayer must co-operate with the tax authorities on all tax audit procedures. The normal tax audit is performed by local tax offices located around the country but sometimes a tax audit is performed by the Directorate of Internal Revenue and the Directorate of Tax Investigations. Tax audits can be performed only within the domestic statute of limitation period, i.e. six years.

## **3507 Revised assessments and the appeals procedure**

The taxpayer has the right to an appeal to the Local Tax Office. This appeal must be set forth within 30 days from the decision date. If that deadline is not met by the taxpayer, then he/she can file a complaint to the Director of Internal Revenue. Tax authorities have two months to process the complaint. When a decision has been made the taxpayer can either appeal to the State Internal Revenue Board within three months or take the case to the courts. The taxpayer can also wait for the decision of the State Internal Revenue Board and then appeal it to the courts.

## **3508 Additional tax and penalties**

Penalties in the range of 15-25% on top of the tax base, are applied where an

adjustment is performed based on either a transfer pricing tax audit or a general tax audit.

### **3509 Resources available to the tax authorities**

There is no special transfer pricing unit operating within the Icelandic tax authorities.

The tax authorities have employees who are able to review any of the transfer pricing transactions brought to its attention through tax audits or requests for binding rulings.

Icelandic tax authorities have participated in Nordic collaboration meetings on transfer pricing issues and are formal participants in a Scandinavian workgroup researching and developing rules on transfer pricing.

### **3510 Use and availability of comparable information**

No comprehensive databases containing third party comparable information are available in Iceland.

The financial statements of all Icelandic companies are publicly available and the financial information contained therein can be used in searching for comparable information.

There is no legal demand for documenting transfer pricing policies for Icelandic companies when determining its transfer prices but there is a legal demand for all transfer pricing issues to be based on the arm's length principle.

### **3511 Risk transaction or industries**

There are no particular transactions that run a higher risk of being subject to investigation than others, although cases regarding inter-company loans and fees seem to be at the forefront.

### **3512 Limitation of double taxation and competent authority proceedings**

The tax authorities can reopen a tax assessment on request if there has been a transfer pricing adjustment in a country with which Iceland has a treaty-connection. Those issues are addressed in the mutual agreement procedure provisions in double taxation treaties aiming to avoid double taxation. Currently tax authorities do not follow any formal procedures, but in general proceedings have worked well with a good flow of information between countries.

### **3513 Advance pricing agreements (APAs)**

No advance pricing agreements (APAs) have been entered in Iceland and no formal procedure for obtaining such agreements exists.

However, it is possible to obtain a binding ruling from the tax authorities or the Ministry of Finance according to Act 91/1998 in connection with a particular transfer pricing issue that has not yet been executed.

### **3514 Anticipated developments in law and practice**

No changes in law have been presented. Icelandic tax authorities are however showing an increased interest in implementing rules and regulations on this issue, which will

likely be based on the OECD Guidelines.

### **3515 Liaison with customs authorities**

There is no formal co-operation between the tax authorities and the customs authorities on transfer pricing issues. However, these may join forces if deemed necessary.

### **3516 OECD issues**

Iceland is a member country of the OECD and has as such embraced the OECD Guidelines for transfer pricing.

When dealing with transfer pricing issues in the past, Icelandic authorities have not based their decisions or referred to the OECD Guidelines.

The transfer pricing rule stated in all of Iceland's double taxation conventions is based on Article 9 of the OECD Model Tax Convention.

### **3517 Joint investigations**

Icelandic authorities have not participated in any formal joint investigations in connection with transfer pricing issues. However, it is not unlikely that they will do so with other Nordic countries in the future.

### **3518 Thin capitalisation**

There are no statutory rules on thin capitalisation in Iceland.

### **3519 Management services**

General arm's length principles apply for charging management fees to Icelandic companies.

# 36 India

## 3601 Introduction

A separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 (Act), covers intra-group cross-border transactions and is applicable from 1 April 2001. In view of the code, transfer pricing has become the most important international tax issue affecting multinational enterprises operating in India. The regulations are broadly based on the OECD Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements and contain harsh penal provisions for non-compliance.

## 3602 Statutory rules and regulations

The Indian Transfer Pricing Code prescribes that income arising from 'international transactions' between 'associated enterprises' should be computed having regard to the 'arm's length price.' It has been clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price. The terms 'international transactions,' 'associated enterprises' and 'arm's length price' have been defined by the Act.

### *Type of transactions covered*

In general, the Indian tax authorities do not believe that there is a threat of Indian tax base erosion from domestic transactions, because any shifted income is ultimately subject to tax in India. Consequently, the legislation mainly applies to cross-border transactions.

Section 92B of the Act defines the term 'international transaction' to mean a transaction between two (or more) associated enterprises involving sale, purchase or lease of tangible or intangible property, provision of services, cost sharing arrangements, lending/borrowing of money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises. The associated enterprises could be either two non-residents or a resident and a non-resident. Further, a permanent establishment (PE) of a foreign enterprise also qualifies as an associated enterprise. Accordingly, transactions between a foreign enterprise and its Indian PE are within the ambit of the code.

### *Definition of 'associated enterprises'*

The relationship of 'associated enterprises' is defined by Section 92A of the Act to cover direct/indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations where the same person (directly or indirectly) participates in the management, control or capital of both the enterprises.

In addition to this definition, certain other specific parameters have been laid down, based on which two enterprises would be deemed as associated enterprises.

These parameters include:

- direct/indirect holding of 26% or more voting power in an enterprise by the other enterprise or in both the enterprises by the same person;
- advancement of a loan, by an enterprise, that constitutes 51% or more of the total book value of the assets of the borrowing enterprise;
- guarantee by an enterprise for 10% or more of total borrowings of the other enterprise;
- appointment by an enterprise of more than 50% of the board of directors or one or more executive directors of an enterprise, or the appointment of specified directorships of both enterprises by the same person;
- complete dependence of an enterprise (in carrying on its business) on the intellectual property licensed to it by the other enterprise;
- substantial purchase of raw material/sale of manufactured goods by an enterprise from/to the other enterprise at prices and conditions influenced by the latter; and
- the existence of any prescribed relationship of mutual interest (none prescribed to date).

Further, in certain cases, a transaction between an enterprise and a third party may be deemed to be a transaction between associated enterprises, if there exists a prior agreement in relation to such transaction between the third party and an associated enterprise or if the terms of such transaction are determined in substance between the third party and an associated enterprise. Accordingly, this rule aims to counter any move by taxpayers to avoid the transfer pricing regulations by interposing third parties between group entities.

### *The arm's length principle and pricing methodologies*

The term 'arm's length price' is defined by Section 92F of the Act to mean a price that is applied/is proposed to be applied to transactions between persons other than associated enterprises in uncontrolled conditions. The following methods have been prescribed by Section 92C of the Act for the determination of the arm's length price:

- comparable uncontrolled price method (CUP);
- resale price method (RSM);
- cost plus method (CPM);
- profit split method (PSM);
- transactional net margin method (TNMM); and
- such other methods as may be prescribed (no additional method has yet been prescribed).

No particular method has been accorded a greater or lesser priority. The 'most appropriate method' for a particular transaction would need to be determined, having regard to the nature of the transaction, class of transaction or associated persons, functions performed by such persons, and other relevant factors.

The legislation requires a taxpayer to determine an arm's length price for all international transactions. It further provides that where more than one arm's length



price may be determined by applying the most appropriate transfer pricing method, the arithmetic mean (average) of such prices shall be the arm's length price of the international transaction. Accordingly, the Indian legislation does not recognise the concept of 'arm's length range' but requires the determination of a single arm's length price. However, some flexibility has been extended to taxpayers to adopt any price falling within 5% of the arithmetic mean of uncontrolled prices. Further it has been clarified that transfer pricing provisions will not be applicable where the application of arm's length price results in a downward revision in the income chargeable to tax in India.

### *Documentation requirements*

Taxpayers are required to maintain, on an annual basis, a set of extensive, information and documents relating to international transactions undertaken with associated enterprises. Rule 10D of the Income Tax Rule, 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer. Such requirements can broadly be divided into two parts.

The first part of the Rule lists out mandatory documents/information that must be maintained by a taxpayer. The extensive list under this part includes information on ownership structure of the taxpayer, group profile, business overview of the taxpayer and associated enterprises, prescribed details (nature, terms, quantity, value, etc.) of international transactions, and relevant financial forecasts/estimates of the taxpayer, etc. The Rule also requires the taxpayer to document a comprehensive transfer pricing study. The requirement in this respect includes documentation of functions performed, risks assumed, assets employed, details (nature, terms and conditions) of relevant uncontrolled transactions, comparability analysis, benchmarking studies, assumptions, policies, details of adjustments, explanations as to the selection of the most appropriate transfer pricing method, etc.

The second part of the Rule requires that adequate documentation be maintained that substantiates the information/analysis/studies documented under the first part of the Rule (discussed above). This part of the Rule also contains a recommended list of such supporting documents, which includes government publications, reports, studies, technical publications/market research studies undertaken by reputed institutions, price publications, relevant agreements, contracts, correspondence, etc.

Taxpayers having aggregate international transactions below the prescribed threshold of INR10 million are relieved from maintaining the prescribed documentation. However, even in such cases, it is imperative that the documentation maintained should be adequate to substantiate the arm's length prices of international transactions.

All prescribed documents and information have to be contemporaneously maintained (to the extent possible) and must be in place by the due date of the tax return filing. Corporates are currently required to file their tax returns on or before 31 October following the close of the relevant tax year. However, the Indian Union Budget 2008 proposes to change the due date of the tax return filing to 30 September following the close of the relevant tax year. The prescribed documents must be maintained for a period of nine years from the end of the relevant tax year, and must be annually updated on an ongoing basis.

The documentation requirements are also applicable to foreign companies deriving income liable to Indian withholding tax.

### *Accountant's report*

It is mandatory for all taxpayers, without any exception, to obtain an independent accountant's report in respect of all international transactions between associated enterprises. The report has to be furnished by the aforesaid due date of the tax return filing. The form of the report has been prescribed. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. Further, the accountant is required to certify the correctness of an extensive list of prescribed particulars.

The Authority for Advance Rulings (AAR)<sup>13</sup> has recently delivered a Ruling in the case of Vanenburg Group B.V., wherein one of the questions raised before the AAR was whether the Indian transfer pricing legislation would be attracted if the taxpayer's income were not chargeable to tax in India.

Vanenburg Group B.V., a non-resident investment company incorporated in Netherlands, desired to reorganise its share holding in group companies and in this regard, it proposed to transfer its entire shareholding in one Indian subsidiary to another group company outside India. In response to an application made by Vanenburg, the AAR held that as per the provisions of the Double Taxation Avoidance Agreement ('DTAA') between India and the Netherlands, no capital gains would arise in India pursuant to the above re-organisation. The AAR further held that the provisions relating to the determination of the arm's length price are machinery provisions, which would not apply in the absence of liability to pay tax, and accordingly, Vanenburg would not be required to comply with the transfer pricing legislation in respect of income, which is not chargeable to tax in India.

Based on this ruling, a possible view exists that where it is established that the income is not subject to tax in India (under the provisions of the Act/DTAA), the taxpayer would not be required to comply with the legislation relating to the maintenance of transfer pricing documentation and furnishing of Accountant's Report.

It is relevant to note that though the ruling is binding only on the applicant who had sought it, the same does carry a certain degree of persuasive value.

### **3603 Burden of proof**

The burden of proving the arm's length nature of a transaction primarily lies with the taxpayer. If during assessment proceedings, the tax authorities, on the basis of material, information or documents in their possession, are of the opinion that the arm's length price was not applied to the transaction, or adequate and correct documents/information/data were not maintained/produced by the taxpayer, the total

---

<sup>13</sup> A scheme of Advance Rulings has been introduced under the Act in order to provide the facility to non-residents and certain categories of residents, of ascertaining their income tax liability, planning their income tax affairs well in advance and avoiding long drawn and expensive litigation, An Authority for Advance Rulings has accordingly been constituted. The non-resident / resident can obtain binding rulings from the Authority on question of law or fact arising out of any transaction / proposed transactions which are relevant for the determination of his tax liability.

taxable income of the taxpayer may be recomputed after a hearing opportunity is granted to the taxpayer.

### **3604 Tax audit procedure**

Transfer prices are investigated by specialised Transfer Pricing Officers in the course of general tax audit procedures. A certain percentage of tax returns are selected for detailed audit. A notice to this effect has to be statutorily dispatched to the taxpayer within 12 months from the end of the month in which the return is filed. The Union Budget 2008 has proposed that such a notice should be dispatched to the taxpayer no later than six months from the end of the month in which the return is filed. Such notice specifies the records, documents and details that are required to be produced before the tax officer.

Once an audit is initiated, the corporate tax Assessing Officer (AO) may refer the case to a Transfer Pricing Officer (TPO) for the purpose of computing the arm's length price of international transactions. Such reference can be made by the AO wherever s/he considers it necessary to do so. However, this can be done only with the prior approval of the Commissioner of Income Tax. In accordance with prevailing internal administrative guidelines of the revenue authorities, all taxpayers having an aggregate value of international transactions with associated enterprises in excess of INR150 million are referred to the TPO for detailed investigation of Transfer Prices. The threshold of INR150 million may be reviewed on an ongoing basis.

The TPO would then send a notice to the taxpayer requiring the production of necessary evidence to support the computation of the arm's length price of the international transactions. The prescribed documentation/information maintained by the taxpayer on transfer pricing would have to be produced within 30 days before the tax authorities during the course of audit proceedings. The period of 30 days can at most be extended to 60 days.

The TPO would undertake a detailed scrutiny of the case, taking into account all relevant factors, e.g. appropriateness of the transfer pricing method applied, correctness of data, etc. The TPO is vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, compelling the production of books of account / other relevant documents and information.

After taking into account all relevant material, the TPO would pass an order determining the arm's length price of the taxpayer's international transactions. A copy of the order would be sent to the AO as well as the taxpayer. On receipt of the TPO's order, the AO would compute the total income of the taxpayer by applying the arm's length price determined by the TPO, and pass an order within the time limit prescribed for completion of scrutiny assessments.

Normally, scrutiny assessments are required to be completed within an upper time limit of 33 months from the end of the relevant tax year. However, scrutiny assessments involving transfer pricing audits would have to be completed within 45 months from the end of the relevant tax year, compared to the upper limit of 33 months in case of scrutiny assessments not involving any transfer pricing audits. This indicates that the Revenue intends to increase its emphasis on transfer pricing audits.

Three years of transfer pricing audits have concluded and the fourth round of transfer pricing audits will be completed by October 2008.

### 3605 Revised assessments and appeals procedure

A taxpayer who feels aggrieved by an order passed by the AO may appeal to the Commissioner of Income Tax within 30 days of the date of receipt of the scrutiny assessment order. The office of the Commissioner is like a quasi-judicial authority where both the Revenue and the taxpayer make representations in support of their claims. The decision of the Commissioner is reflected in an appellate order. If the taxpayer still feels aggrieved, they have the right to appeal to the Appellate Tribunal, thereafter to the jurisdictional High Court, and finally to the Supreme Court. A similar right to appeal also rests with the Revenue.

### 3606 Additional tax and penalties

The following stringent penalties have been prescribed for non-compliance with the provisions of the Transfer Pricing Code:

- for failure to maintain the prescribed information/documents – 2% of transaction value;
- for failure to furnish information/documents during audit – 2% of transaction value;
- for adjustment to taxpayer's income – 100% to 300% of the total tax on the adjustment amount; and
- for failure to furnish an accountant's report – INR100,000.

Further, taxable income enhanced as a result of transfer pricing adjustments does not qualify for various tax concessions/holidays prescribed by the Act.

### 3607 Legal cases

Since the enactment of the transfer pricing legislation with effect from 1 April 2001, three rounds of transfer pricing audits have been completed by Indian tax authorities till date. Given that the transfer pricing legislation in India is relatively new, there are not many precedents with regard to various transfer pricing issues. There have been, however, in the recent years, a few noteworthy judicial cases, which have established important transfer pricing principles. The same are summarised below:

#### (a) Morgan Stanley and Co.

The Supreme Court of India, in the case of the investment bank Morgan Stanley & Co., USA (MS Co.) had the opportunity to examine whether MS Co. had a Permanent Establishment (PE) in India under the India-USA Tax Treaty, as a consequence of the back-office operations outsourced by it to its captive Business Process Outsourcing (BPO) unit in India ('MSAS'), and if yes, whether the payment of arm's length remuneration by MS Co. to MSAS extinguished MS Co.'s liability to be taxed in India.

In this case, MS Co., which was engaged in financial advisory, corporate lending and securities underwriting services, outsourced some of its activities to MSAS. MSAS was to support the main office functions of MS Co., which included equity / fixed income research, account reconciliation and providing IT enabled services to it. MS Co. sent certain staff to India for stewardship activities to ensure that its standards of quality are met. MS Co. also sent its staff on

deputation to MSAS (as and when requested by MSAS), where such employees continued to be employed by MS Co. and their salaries and fees paid directly by MS Co.

The Supreme Court ruled that MS Co. did not have a Fixed Place PE or an Agency PE in India under the Tax Treaty, as a consequence of the back-office operations outsourced to MSAS. Further, the visit by employees of MS Co. to MSAS for stewardship activities was also not found to create a PE in India under the Tax Treaty. However, with reference to the personnel of MS Co. on long-term deputation to MSAS, the Supreme Court held that as such personnel continued to be employees of MS Co., having a lien on their jobs with MS Co., the employees could result in MS Co. having a Service PE in India.

As regards profits attributable to the PE, it was observed by the Supreme Court that as MSAS was remunerated at operating cost plus arm's length mark-up determined using TNMM, and as the transfer pricing analysis of MSAS adequately reflected the functions performed and the risks assumed by it, no further profits would be attributable to the PE. Here, it would be necessary to ensure that all operating costs are adequately captured in the cost base, on which the mark-up is to be applied, before a taxpayer can be said to be at arm's length.

However, there have been two judicial cases in the recent past, which diverge from the above principle. In the case of SET Satellite Singapore, it was held by the Income Tax Appellate Tribunal (Appellate Tribunal) that payment of arm's length remuneration to a dependent agent PE does not necessarily extinguish the tax liability of the non-resident in India. Further, in the case of Rolls Royce Plc, the Appellate Tribunal has disregarded the argument of the taxpayer that payment of arm's length remuneration to a PE extinguishes the tax liability of the non-resident in India, and has proceeded to attribute the profits of Rolls Royce Plc that can be said to accrue or arise directly or indirectly through the operations of its PE in India.

(b) Mentor Graphics (Noida) Private Limited

The Mentor Graphics case illustrates the importance of carrying out a detailed transfer pricing analysis of the specific characteristics of the international transaction with the associated enterprise, including an analysis of the functions, assets and risks, and affirms that a mere broad comparison is not enough.

In the present case, the taxpayer had carried out a detailed transfer pricing analysis and had chosen a set of comparables. Such set was however rejected by the TPO, and a new set of comparables was chosen by the TPO. The TPO's set was also upheld by the Appellate Commissioner.

The Appellate Tribunal, while reviewing the analysis and comparables set of both the taxpayer and the TPO, has laid down certain important principles, which will have far reaching implications on almost all transfer pricing cases in India. The broad principles have been outlined below:

- The Appellate Tribunal has recognised that transfer pricing is not an exact science in which mathematical certainty is possible; some approximations

cannot be ruled out. It needs to be prima facie shown that the transaction was properly examined, comparable prices were objectively fixed, in a bona-fide/honest manner, as required by law.

- Reiterating the principles laid down in the case of Aztec Software and Technology Services Limited, the Appellate Tribunal has observed that risks are an important consideration in any transfer pricing analysis, which are related to the economic principle that the greater the risk, the higher the return. In case of material differences in risks between the controlled enterprise and comparables, the identified comparables are not correct if appropriate adjustments for differences are not possible. Significant risks like market risk, contract risk, credit and collection risk, risk of infringement of IP etc. are critical factors to be considered. Adjustments may also be necessary for differences in working capital, risks and growth, R&D expenses, etc.

The Appellate Tribunal held that, as Mentor Graphics was a captive software development service provider to Ikos Systems USA, most of the business risk such as contract risk, market risk, credit risk, warranty risk, price risk, etc. were borne by Ikos. Further, the intellectual property right to all the intangibles that were provided to Mentor Graphics for carrying out software development services was owned by Ikos. Therefore, the Appellate Tribunal held that the TPO failed to appropriately consider functions, assets, intangibles etc. while selecting the comparables, and accordingly, the order of the TPO was not sustainable.

- The Appellate Tribunal noted that the TPO had considered as comparables, companies having dealings with related parties. Further, it was not made clear why certain comparables chosen by the taxpayer were rejected by the TPO. The Appellate Tribunal observed that the TPO could undertake a fresh search only if the comparables chosen by the taxpayer were insufficient or deficient. The Appellate Tribunal thus held that there was lack of application of mind and arbitrariness in the TPO's order.

On the other hand, the Appellate Tribunal observed that Mentor Graphics had carried out a proper screening and a detailed analysis while choosing comparables. Based on the in-depth examination, the Appellate Tribunal constructed a smaller set of comparables from the taxpayer's set. Here the Appellate Tribunal specifically mentioned that high profit and high loss makers were not being selected as the taxpayer worked in a no risk environment. The Appellate Tribunal deleted the adjustment made by the TPO and upheld the transfer price of the taxpayer.

The Appellate Tribunal thus held that once a taxpayer undertakes appropriate due diligence in preparing a transfer pricing analysis to justify the arm's length nature of its international transactions, the analysis cannot be arbitrarily rejected during audits based on inferences and presumptions. The case law also gives recognition that the no risk, captive, contract software development support service provider characterisation of the taxpayer is an appropriate evaluation from a transfer pricing perspective.

In the backdrop of significant transfer pricing audit adjustments in India in the recent past, the Ruling comes as a welcome relief to taxpayers, as it provides some assurance that taxpayers undertaking due diligence and detailed/robust analysis are

better placed to face intense transfer pricing audits in India.

(c) Development Consultants Private Limited

The Appellate Tribunal recently pronounced its ruling in the case of Development Consultants, an Indian construction and engineering services company, approving the 'tested party' concept and the use of foreign benchmarking studies adopted by Development Consultants. While the taxpayer succeeded in getting its transfer pricing adjustment cancelled/reduced, the observations made by the Appellate Tribunal provides positive guidance for all taxpayers using such methods in their transfer pricing defence.

The significant conclusions of the Appellate Tribunal are summarised below:

- Considering the procedural requirements to submit contemporaneous documentation, the Appellate Tribunal took a pragmatic view to clarify that there was no lack of opportunity for the tax authorities to verify in depth and detail, the documents, evidences and other explanations filed by the taxpayer.
- In an important step towards the judicial development of the Indian transfer pricing legislation, the Appellate Tribunal affirmed that in order to select the most appropriate method for determining the arm's length price, it is first necessary to select the 'tested party' which will be the least complex of the controlled taxpayers engaged in the transaction and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables. The Appellate Tribunal noted the concept of 'tested party' referring to section 1.482-5 of the US transfer pricing regulations.
- The Appellate Tribunal also took on record the foreign benchmarking exercise conducted by the taxpayer and observed that the benchmarking exercise had been examined by the TPO and Commissioner of Appeals but they had not been able to refute or controvert the analysis of the taxpayer. While accepting the foreign benchmarking exercise, the Appellate Tribunal recognised that no transfer pricing adjustment should be made if the tested party earns margins within the arm's length level, as determined though the foreign benchmarking exercise, after allowance of the 5% flexibility from the arithmetic mean, as per provisions of the Indian transfer pricing laws.

The ruling focuses on the importance of the 'tested party' concept which otherwise has not been dealt with by the Indian transfer pricing legislation, but is commonly used in almost all Indian transfer pricing documentation. It also upholds the use of foreign benchmarking studies, which is always necessary in case of taxpayers having foreign associated enterprises as the 'tested party'. The TPOs have often been hesitant to use or review foreign benchmarking studies, but this ruling strengthens the taxpayer's position for using such benchmarking studies.

The importance of performing a detailed functional analysis and understanding of the taxpayers' business is also reflected in the ruling, as the TPO or the Commissioner of Appeals had failed to recognise or appreciate the true functional character of the various parties to the international transactions.

In the backdrop of intense transfer pricing audits in India, the ruling comes as a welcome relief to taxpayers, as it provides some assurance that the TPOs should take more care and diligence while dealing with transfer pricing matters and while

making substantial adjustments, and that the TPOs should also recognise the taxpayers' analysis and views so as to avoid unnecessary litigation and dispute on mere factual issues.

(d) Cargill India Private Limited

The Appellate Tribunal recently examined the provisions of the transfer pricing regulations relating to maintenance of information and documents and their furnishing before the transfer pricing authorities for determining the arm's length price. The case relates to Cargill India Pvt. Ltd. where the TPO levied penalty under Section 271G of the Act on account of non-submission of documents within the prescribed time as required under section 92D of the Act read with Rule 10D of the Rules.

The Appellate Tribunal, while reversing the levy of penalty on account of non-submission of documents, arrived at certain fundamental conclusions, which will have far reaching implications on almost all transfer pricing cases in India.

The Appellate Tribunal clarified that the documents and information to be kept and maintained as per Rule 10D is voluminous and it would only be in rarest cases that the information and documents prescribed under all the clauses of Rule 10D would be attracted in a particular case. Therefore, the taxpayer and the tax authorities, depending upon the facts and circumstances of the case, are required to consider relevant information and documents needed for determining the arm's length price.

The Appellate Tribunal further observed that, having regard to the purpose of the regulations, a notice issued by the TPO requiring the taxpayer to furnish any prescribed information/documents, cannot be vague or nonspecific. Such a notice must require the taxpayer to furnish specific information, which according to the TPO, is necessary for determination of the arm's length price of the international transactions of the taxpayer, and should be issued after examination of documents on record and proper application of mind. The Appellate Tribunal noted that such a notice issued under section 92D(3) is a serious notice as non-compliance of the same could lead to imposition of penalty, and accordingly specifying the information and documents in the notice was important. Further, the specific clause of the Rule or the details of the international transaction relating to which default was committed by the taxpayer, should also be stated in the show cause notice in order to treat it as valid, and to enable the taxpayer to file a proper reply in defence.

This ruling by the Appellate Tribunal is a step in the right direction, as it focuses on the meaningful construction of the procedural provisions of the Indian transfer pricing regulations in order to achieve the purpose of the regulations.

### **3608 Resources available to the tax authorities**

There is a special transfer pricing team within the Indian tax authorities that deals with transfer pricing issues. The team comprises trained TPOs who deal with transfer pricing issues arising during the course of an audit. Indian tax authorities are actively training their staff to increase competency in handling transfer pricing issues.



**3609 Use and availability of comparables' information**

Taxpayers are required to maintain information on comparables as part of their transfer pricing documentation to demonstrate that the pricing policy complies with the arm's length principle. Comparable information is a crucial element for defending transfer pricing in India. Indian revenue officials have indicated that, to the extent possible, Indian comparables should be used. Use of foreign comparables is generally not acceptable, unless the tested party is located overseas. In some cases, the TPOs have exercised their power [under Section 133(6) of the Act] to obtain private information from other taxpayers and used the same comparables for the taxpayer undergoing audit.

*Availability of comparable information*

The quality of comparable information available in Indian databases is reasonable. A few agencies that work in tandem with government departments provide electronic databases giving detailed financial and descriptive information for companies listed on the stock exchange. Some databases also give summary information on unlisted companies. It is also possible to obtain information about Indian public companies from the Registrar of Companies (RoC) upon payment of statutory fees.

**3610 Liaison with customs authorities**

The Indian Ministry of Finance had constituted a Joint Working Group, comprising officers from Income Tax and Customs to suggest measures for co-operation between the Income Tax and Customs departments. Based on the recommendations of the Working Group, the Ministry of Finance has laid down that periodic meetings should be held between Income Tax and Customs personnel, to discuss joint issues requiring attention.

The Ministry of Finance has also decided that exchange of information in specific cases would be done and for this purpose, officers from the two departments would be nominated at each of the four metros. Further, officers from the two departments would make available to each other, databases relating to related parties/associated enterprises on a 'need to know' basis. The Ministry of Finance has also decided to develop and organise training programs to train the officials of both the departments to familiarise them about the treatment of transfer pricing matters in the other department.

The above action by the Ministry of Finance can be seen as the first clear statement of intent of the Government of India towards addressing transfer pricing matters in a harmonious manner between the Customs and the Income Tax Departments (as Transfer Pricing Officers have, in the past, expressed a view that the price accepted by other authorities is not conclusive evidence for determining the arm's length price for transfer pricing purposes). This also suggests that going forward, Customs and Income Tax authorities would be coordinating and exchanging information with each other on transfer pricing matters. Such increase in liaison between the two departments makes it imperative for companies operating in India to plan and document their transfer prices comprehensively based on valuation principles contained in the Customs as well as Income Tax laws and also deal with both authorities in a harmonious and seamless manner.

### **3611 Risk transactions or industries**

No transactions or industries are excluded from the possibility of a transfer pricing investigation. Software development, business process outsourcing, banking, telecommunication, pharmaceutical and automobile (and ancillary) are some of the industries which have been subject to intense transfer pricing audits in recent times. Outsourcing companies rendering core/high-value services to associated enterprises need to carefully analyse and set their transfer prices. Further, specific situations like sustained losses, business strategies, transactions with entities in tax havens, royalties and management charges paid should be sufficiently documented.

### **3612 Thin capitalisation**

The arm's length principle applies to loans and interest charges. However, at present, there are no rules that specifically deal with thin capitalisation and no set permissible debt to equity ratios in the Act or the Transfer Pricing Code.

### **3613 Management services**

In view of India's exchange control rules, charging management service fees to Indian residents beyond the prescribed threshold requires regulatory approval. It may be possible to obtain regulatory approval for such charges, based on transfer pricing documentation proving the arm's length nature of the charge. Management service fees charged to Indian taxpayers are tax deductible if charged on an arm's length basis, subject to limitations under the domestic tax law. Management charges to Indian taxpayers are generally scrutinised in detail during transfer pricing audits. To mitigate the risk of disallowance, the charge should be evidenced by extensive supporting documentation proving that the services were rendered and were necessary to the business of the recipient of the services (the benefit test).

Where an Indian taxpayer is providing such services, the taxpayer should be compensated on an arm's length basis.

### **3614 Limitation of double taxation and competent authority proceedings**

Most Indian tax treaties contain an 'associated enterprises' article that contains relieving provisions which require one country to reduce the amount of tax charged to offset the enhanced tax liability imposed by the other country to reflect the arm's length standard. This article refers to competent authority provisions (contained in the relevant mutual agreement procedure (MAP) article of the treaty) for consultation between authorities of both countries to prevent double taxation of taxpayers. MAP/competent authority provisions are an integral part of India's extensive treaty network.

Indian competent authorities have started participating in MAP proceedings with competent authorities of other countries. The increasing use of MAP by taxpayers and the resulting effective resolution of issues between the competent authorities and the taxpayer is an encouraging step in the Indian scenario.

### **3615 OECD issues**

India is not a member of the OECD. However, India has been invited to participate as an Observer in the OECD's Committee on Fiscal Affairs, which contributes to setting

international tax standards, particularly in areas like tax treaties and transfer pricing. India's transfer pricing legislation broadly adopts the OECD principles. Tax offices have also indicated their intent of broadly following the OECD Guidelines during audits, to the extent the OECD Guidelines are not inconsistent with the Indian Transfer Pricing Code.

### **3616 Joint investigations**

There is no evidence of joint investigations having taken place in India. However, almost all Indian tax treaties contain provisions for the exchange of information and administrative assistance, under which the Indian tax authorities may exchange information with other countries for transfer pricing purposes. Further, with increased transfer pricing awareness, joint investigations may be undertaken by the Indian tax authorities in the future.

### **3617 Anticipated developments in law and practice**

Revenue officials have indicated the possibility of introducing, in the future, rules on cost contribution arrangements (CCA), thin capitalisation and international transactions with associated enterprises based in tax havens.

### **3618 Advance pricing agreements (APAs)**

There are currently no provisions enabling taxpayers to agree pricing policies in advance with the tax authorities. The Indian Ministry of Finance is evaluating the introduction of an APA programme in India. However, setting up of the institutional mechanism and training of relevant manpower may prolong its introduction.

# 37 Indonesia

## 3701 Introduction

Indonesia has adopted the arm's length standard for transactions between related parties. As the tax system is based on self assessment, the burden of proof lies with the taxpayer, not the tax authorities.

## 3702 Statutory rules

For income tax purposes, the legislation dealing with transfer pricing is found in Article 18 of the 1983 Income Tax Law, as revised by the 1994 Income Tax Law and further by Income Tax Law No. 17/2000.

Article 18 states that the tax authorities may adjust a taxpayer's taxable income for related party transactions that are not carried out on an arm's length basis. Related parties are deemed to exist in the following circumstances:

- where a taxpayer directly or indirectly participates in 25% or more of the capital of another taxpayer, or where a company participates in 25% or more of the capital of two taxpayers, in which case the latter two taxpayers are also considered to be related;
- where a taxpayer directly or indirectly controls another taxpayer or there are two or more taxpayers under common control;
- where there is a family relationship by blood or marriage.

For value added tax (VAT), a virtually identical provision is included in Article 2 of the 1983 VAT Law as revised by the 1994 VAT Law and further revised by Income Tax Law No. 18/2000.

## 3703 Other regulations

A circular issued by the Directorate General of Taxes (DGT) entitled 'Directives for the Handling of Transfer Pricing Cases' (Circular No. SE-04/P, 7/1993) contains guidance for tax auditors on what types of profit manipulation practices should alert them to the possibility of transfer pricing issues requiring investigation. While this represents the official policy of the tax office, it would theoretically be overridden by the law if the two were in conflict.

A new step was taken by the Indonesian Government in early 2008. Government Regulation No. 80/ 2007, which was issued on 28 December 2007 and effective from 1 Jan 2008, explicitly states that taxpayers engaging in transactions under common control must maintain documentation which proves adherence to the arm's length principle. At this stage however, the type of documentation required and how to test the arm's length nature of particular transactions is still unclear. The Minister of Finance (MOF) will elaborate further on this issue in a MOF regulation currently being drafted. What is clear is that the Indonesian Tax Office has stated in the 2007 tax administration law that documents requested in a tax audit must be delivered within a month of the request. This could mean that transfer pricing documentation submitted after 30 days can be ignored.

**3704 Burden of proof**

Indonesia operates on a self assessment system with companies setting their own transfer prices. The burden of proof lies with the taxpayer to prove that the original price has been set at arm's length.

**3705 Tax audit procedures**

Audits are a significant feature of tax administration in Indonesia because of the self assessment system. The tax office has ten years within which to audit and issue assessments (and additional assessments if new facts, previously undisclosed, are found).

So far, the tax authorities have not undertaken any audits specifically relating to transfer pricing. Nevertheless, tax audits conducted in relation to overall tax compliance will invariably focus on inter-company transactions, especially where there are transactions with non-residents. Where there appear to be price discrepancies between intra-group transactions and third party transactions, corrections of transfer prices will be included in the audit findings.

Specific transfer pricing audits are rarely conducted; however, transfer pricing reviews generally take place as part of a broader tax audit.

Tax audits are conducted both through desk reviews and visits to company premises by the tax authorities. These may involve meetings and/or correspondence, and settlement of the audit may in many cases take place through formal negotiation rather than litigation. The conduct of the taxpayer may influence the outcome.

The tax authorities also have the power to perform investigations. An investigation is a tax audit that takes the form of a raid. No prior authorisation or permission from the Indonesian courts is required for such raids to be undertaken and no prior announcement or warning is given to the target company. Investigations are generally used only where fraud or evasion is suspected and are not common in Indonesia. Experience has shown that the main trigger of an investigation by the tax authorities has been information obtained by them through their information network or provided to them by informants such as disgruntled former employees.

*Selection of companies for audit*

There is an extensive system of tax audits. Taxpayers claiming refunds are automatically subject to tax audits. A tax return that indicates a loss will generally also trigger a tax audit.

*The provision of information and other duties of a taxpayer*

The tax authorities have wide ranging statutory powers to call for information relevant to an audit, such as accounting records, agreements, supporting documents and tax returns.

**3706 Tax objections and the appeals procedure**

Tax auditors will adjust related party transactions where they believe the price differs from an arm's length price. Taxpayers have the right to object to assessments raised by the tax office. The objection must be lodged in writing within three months of the

issuance of the assessment and should be addressed to the DGT at the particular office from which the assessment was issued. The DGT has 12 months to issue a decision in relation to the objection. Under the 2000 Tax Administration Law, the DGT's decision supports the position of the tax service office, and the tax in dispute must first be paid within one month of the date of the assessment irrespective of taxpayer's disagreement or submission of a tax objection.

This, however, is no longer the case. Under the 2007 Tax Administration Law, which was effective from 1 January 2008, taxpayers are only required to pay as much as they agreed to with the tax auditors during the tax audit's closing conference. If the taxpayer did not agree with any of their corrections, taxpayers do not need to pay anything.

However, taxpayers need to exercise care when deciding how much to pay. This is because an unfavourable DGT decision on the objection will give rise to an administrative penalty of 50% of the underpaid tax. The penalty will grow to 100% if an appeal is lodged and the decision is not in the taxpayer's favour.

Taxpayers may appeal to the Tax Court against DGT decisions on their objections. In order to have the Tax Court hear the appeal, the taxpayer must pay 50% of the total tax assessment. An uncertainty prevails regarding the minimum amount to be paid for filing an appeal. According to the 2007 Tax Administration Law, the same rule should apply: taxpayer's pay only as much as agreed in the closing conference. However, the Tax Court Law, which governs tax appeals, demands a minimum payment of 50% of the tax due. Which rule will survive is presently unclear. However, given the uncertainty, taxpayers have little choice but to pay the 50% amount to ensure that their case is not thrown out on a technicality.

Currently, the Tax Court is the best arena for taxpayers to receive fair hearings. If the appeal to the Tax Court is still unsuccessful, taxpayers can appeal to the Supreme Court, provided that certain criteria are met.

It is worth noting that Indonesia has a civil law system in which the courts do not operate on the basis of precedence and their decisions are not published. Furthermore, tax cases cannot be appealed beyond the Tax Court or Supreme Court or in any civil court other than the State Administrative Court. This court deals with complaints by persons adversely affected by government decisions and has rarely, if ever, been used in tax cases.

### **3707 Tax penalties**

A system of penalties exists. Penalties are imposed for late payment of tax up to a maximum of 48% of the unpaid tax, being 2% per month. In criminal cases, fines of 200-400% of the unpaid tax are possible, as is imprisonment.

### **3708 Resources available to the tax authorities**

There is no unit within the tax authorities dedicated specifically to transfer pricing issues, although tax auditors will usually have received some training in transfer pricing. Transfer pricing related inquiries are undertaken by the relevant tax audit department without assistance from external advisers.

### **3709 Use and availability of comparable information**

Comparable information may be used to demonstrate that a particular price is an

arm's length price. However, with the exception of certain sectors, such as banking and insurance, there is very little publicly available financial data. The tax authorities do not tend to use profit comparisons in order to justify transfer pricing adjustments, although abnormally low profits or losses may be triggers that lead to selection for audit.

### **3710 Risk transactions or industries**

There are no excluded transactions. For certain industries where the tax authorities foresee possible difficulties in establishing levels of actual profit arising in Indonesia, they have the power to impose taxes based on deemed profit. Marine or international aviation companies, oil and gas drilling companies, and foreign representative offices are included under this principle/regulation (Article 15 of the 1983 Income Tax Law, as revised by the 1994 Income Tax Law and further by Income Tax Law No. 17/2000).

Although most of the transfer pricing issues challenged in tax audits in Indonesia have focused on cross-border transfer pricing, it should be noted that the law also covers transfer pricing taking place within the country. Examples of where the tax office may use these provisions are in respect of luxury sales tax imposed on domestically produced luxury goods, transactions subject to value added tax, or profit shifting to utilise losses.

Currently, there is a new requirement for companies to disclose transactions with related companies for tax purposes. The disclosures are quite detailed and illustrate how the tax authority is following a number of other countries in the Asia-Pacific region, particularly Japan, Korea, China, the Philippines, Singapore, Malaysia and Australia, which have some form of disclosure requirements in their annual income tax returns.

The statement requires taxpayers to disclose transactions under special relationships, which are classified as:

- (1) purchase of goods;
- (2) sale of goods;
- (3) purchase/use of services;
- (4) sale/provision of services;
- (5) lease of tangible goods;
- (6) use of intangible goods; and
- (7) other transactions.

For each type of transaction, information is to be provided about:

- (1) whom the transaction is made with;
- (2) the value of the transaction;
- (3) which method was applied in determining the relevant transfer price, unless an advance pricing agreement (APA) is applicable. If an APA is applicable, this should be noted and information provided about:
  - (a) the reference number of the APA document;
  - (b) the period under which the APA is applicable;

- (c) what types of transactions are covered under the APA and with whom the transactions are made; and
- (e) what method is used for the determining the transfer price for each transaction type.

The new one-part tax return form also requires taxpayers to disclose loans from or to shareholders or affiliated companies, including the loan amount and interest rate. This new requirement seems to be consistent with plans to issue a debt-equity rule.

It is currently unclear whether the tax authorities will use the disclosures for selecting candidates for transfer pricing audits as has been happening in other countries where disclosures are required.

### **3711 Limitation of double taxation and competent authority proceedings**

The competent authority process may be considered once the domestic appeal process has been exhausted. However, the competent authority process has rarely been used in Indonesia because companies in the past have usually received satisfactory settlements on appeals made to the Tax Court and also because transfer pricing assessments were fairly uncommon until a few years ago.

### **3712 Advance pricing agreements (APAs)**

As from 1 January 2001, the Indonesian Income Tax Law includes a provision that authorises the Indonesian DGT to enter into an APA, which is valid for agreed periods and is renegotiable. An APA can involve a foreign tax authority. This provision specifically allowing APAs is a welcome development, although in practice there have been few signs that the DGT has seriously begun to focus on APAs, i.e. no APAs have yet been concluded. As is the case in many other countries, unilateral or bilateral APAs can be an advantageous way of resolving transfer pricing uncertainties before they become acrimonious disputes.

### **3713 Anticipated developments in law and practice**

It is anticipated that further rules and regulations, e.g. approaches to transfer pricing methodologies, will be issued in the near future. It is also anticipated that the tax authorities will show increasing interest in conducting transfer pricing audits in the next few years.

### **3714 Liaison with customs authorities**

Although the income tax authorities and customs authorities both fall under the MOF, there does not appear to be a routine exchange of information between them.

### **3715 Joint investigations**

No information is available on the DGT's willingness to participate with tax authorities from foreign countries in joint investigations of taxpayers. However, the DGT, according to the 'Exchange of Information' article in double taxation agreements, is not precluded from carrying out investigations.



# 38 Ireland

## 3801 Introduction

For many years, Ireland has been regarded as a favourable location for investment in Europe. The success of government initiatives to attract foreign direct investment is reflected in the large number of multinational corporations (MNCs) that have established significant operations in Ireland. The monetary value of international related party transactions between Irish resident companies and their overseas affiliates is undoubtedly enormous.

Recent strong growth in the Irish economy can be attributed in part to these MNCs, and it would be true to say that foreign-owned subsidiaries dominate the taxpayer landscape in Ireland. The significant value of transactions between Irish taxpayers and their overseas related parties has a profound effect on Ireland's tax base.

The transfer pricing provisions in the Irish tax legislation are only of limited application, and few resources are devoted to the issue by Ireland's tax authority, the Revenue Commissioners (the Revenue). Yet transfer pricing is a significant issue both for MNCs operating in Ireland and for Irish companies investing abroad, despite the absence of local regulation and scrutiny. This is due to the transfer pricing regulations in place in overseas jurisdictions where the affiliates trading with Irish companies are located.

At the time of writing, speculation that Ireland is to introduce broad based transfer pricing legislation has yet to be realised.

## 3802 Statutory rules

With one exception, transfer pricing provisions in Irish tax legislation are specific to particular transactions or to particular categories of taxpayer.

### *Section 1036*

One general transfer pricing provision is contained in Section 1036, Taxes Consolidation Act 1997. This Section applies where, for example, an Irish company carries on business with an overseas affiliate and, through the control exercised over the Irish company, the Irish company produces either no profits or less than the ordinary profits that might be expected to arise. In these circumstances, the overseas affiliate will be chargeable to Irish income tax in the name of the Irish company as if it were an agent of the Irish company.

Although a broad based section, Section 1036 is not supported by any Revenue guidance on the application of the legislation, and definitions of key terms such as 'close connection' and 'substantial control' included in the section are not provided. Further, the section focuses on whether the profits realised by an Irish company are commensurate with the ordinary profits expected, rather than whether the prices for the international related party transactions entered into by the Irish company are at arm's length.

Owing to these uncertainties, it is not believed that this Section is applied in practice.

### *Companies engaged in businesses qualifying for incentive tax rates*

Specific transfer pricing provisions have been enacted for Irish companies qualifying for Ireland's incentive tax rate of 10%. Initially known as 'manufacturing relief', the incentive tax rate has been expanded to include a number of other activities. The activities qualifying for the incentive tax rate, all of which need to be carried on in Ireland, include:

- industrial manufacturing; and
- international services operations.

In the case of an Irish company qualifying for the incentive rate of 10%, the transfer pricing provisions seek to prevent any overstatement of taxable income arising to it from trading transactions with an affiliated company.

The relevant legislation enables the Revenue to recompute the income of 'the buyer' and 'the seller' where the price for the related party transaction is found to be non-arm's length. Separate provisions apply depending upon whether the company qualifying for the incentive rate is purchasing from or selling to the related party.

Where the company that qualifies for the incentive tax rate is buying from a related company, and the Revenue find that the price paid by the 10% company is lower than an arm's length price (such that the profit of the 10% company is inflated), the Revenue can recompute the income of both the 10% company and its related party supplying the goods or services.

In the situation where the 10% company is selling goods (or services qualifying for the 10% tax rate) to a related company and the Revenue find that the price charged by the 10% company is in excess of an arm's length price (such that the profit of the 10% company is again inflated), the Revenue can recompute the income of both the 10% company and its related party acquiring the goods or services.

It is important to note that for manufacturing and international services operations approved on or before 31 July 1998, the relief will expire on 31 December 2010. Thereafter, the transfer pricing provisions detailed above will cease to apply.

### *VAT and transfer pricing*

On 2 April 2007, the Irish government enacted anti-avoidance legislation in relation to transactions between connected persons. This recent legislation gives the Irish Revenue authorities the power to impute an open market value to the amount on which VAT is chargeable on a supply of goods or services. The legislation is a transposition of Article 80 of EU Council Directive No. 2006/112/EC, an EC Directive that member states were not necessarily obliged to enact locally.

These rules intend that the correct amount of VAT is paid over to the Irish Revenue authorities by Irish companies that are classified as 'VAT exempt'. A VAT exempt company does not charge VAT on supplies made but it is equally not entitled to a deduction for VAT costs incurred. As such, VAT charged on 'inputs' is a real cost to a VAT exempt company. Since VAT is charged on the value of supplies the irrecoverable VAT costs of a VAT exempt company are in direct proportion to the value of supplies made to it. The Irish Revenue authorities may impute open market value where they consider the amount on which VAT has been accounted is undervalued. These rules also aim to ensure that the correct amount of VAT is paid over to the Irish Revenue authorities by ensuring an appropriate amount of deductible VAT is claimed by Irish

companies that make both exempt and taxable supplies.

It should be noted that these rules apply solely for the purposes of the VAT Acts. In other words, should the Irish Revenue authorities increase the value of services supplied to a VAT exempt Irish company, the adjustment to the transaction value will only apply for the purposes of calculating the VAT – the amount that is included as an expense in the P&L (and hence as a tax deduction) appears to be unaffected.

#### *Other domestic transfer pricing provisions*

Other anti-avoidance provisions have been enacted for:

- the transfer of land between connected persons;
- the charge to capital gains tax on the sale of assets to connected persons;
- the transfer of trading stock to a connected person at the time a trade is discontinued; and
- the exemption from tax in Irish tax legislation for income arising from certain qualifying patents.

In the last point the provisions apply where the payer and beneficial recipient are connected, and state that the exemption will only apply to as much of the payment as would have been made by an independent person acting at arm's length.

### **3803 Other regulations**

The Revenue have not produced any regulations, Statements of Practice or other guidance materials in relation to the legislative provisions detailed above.

Most of Ireland's tax treaties were negotiated using the OECD model treaty current at the time of negotiation and thereby contain an 'Associated Enterprises' Article. However, it would appear that the Revenue accept that Ireland's tax treaties are mechanisms for relieving double taxation rather than for imposing additional tax and that a transfer pricing adjustment provided for under the terms of an international tax treaty should not be implemented where such an adjustment is not supported by an equivalent domestic law provision.

### **3804 Legal cases**

Although Ireland's transfer pricing legislation is of limited application, the decision of the Irish High court in the case of *Belville Holdings Limited v Cronin* in 1985 suggests that the Irish courts may impose arm's length pricing in transactions between related parties.

The transaction considered in this case was the provision of management and other head office services by Belville Holdings Limited, an Irish company, to its Irish resident subsidiary companies. As well as holding shares in subsidiaries, Belville Holdings Limited carried on a trade of managing its subsidiaries and providing finance to them. For all periods up to the year ended 30 October 1978, the total expenses incurred by Belville Holdings Limited were apportioned between the subsidiaries and recharged to them. This company policy changed with effect from the period commencing 1 November 1978, whereby only the operating expenses directly incurred for the benefit of the subsidiaries were recharged – other expenses not specifically allowable to the subsidiaries were borne by Belville Holdings Limited. This had the

effect of trading losses being incurred by Belville Holdings Limited following the change of policy.

The case focused on two accounting periods, the period ended 30 June 1979 and the year ended 30 June 1980, in which Belville Holdings Limited and all but two of its subsidiaries realised trading losses. Belville Holdings Limited did not receive management fees from its subsidiaries in these periods. However, the two profitable subsidiaries paid over their entire profits in each period to Belville Holdings Limited, as dividends. Under tax legislation in force at the time, Belville Holdings Limited, by virtue of the trading loss it incurred in each period, claimed a repayment of the tax credits attaching to the dividends received from its two subsidiaries.

The Inspector of Taxes rejected the repayment claim of Belville Holdings Limited. The Revenue took the view that the losses of Belville Holdings Limited were not genuine trading losses, on the basis that Belville Holdings Limited had arranged its policy for recharging its management expenses to facilitate the claim for repayment of the tax credits. This position was upheld in the Appeal Court, which relied on the UK case of *Petrotim Securities Limited v Ayres* (1963) in stating that notional management fees equivalent to the market value of the services provided by Belville Holdings Limited should be included as assessable income of Belville Holdings Limited.

On appeal by Belville Holdings Limited to the High Court, the judge upheld the position of the Appeal Commissioners that notional management fees should be included in the tax computation of Belville Holdings Limited. However, the High Court also found that there was no evidence to uphold the Appeal Commissioner's arbitrary estimation of the market value of the services provided, which was set at 10% of the income of each of the two subsidiaries. For this reason, the High Court upheld the appeal of Belville Holdings Limited but crucially did not refer the matter back to the Appeal Commissioners to reconsider a more appropriate valuation of the notional management fees.

The issue later arose as to whether the High Court division in Belville Holdings Limited had definitively found in favour of the taxpayer or whether the High Court intended to refer the matter back to the Appeal Commissioners. A Supreme Court hearing found that the High Court decision could only be interpreted as being in favour of Belville Holdings Limited.

In conclusion, although the Irish courts never ruled on an appropriate market value for the notional management fees, the case of *Belville Holdings Limited v Cronin* indicates that the Irish courts may support the Revenue in applying arm's length pricing for transactions between connected persons. No other such cases have come before the Irish courts since 1985 and without more extensive transfer pricing legislation, it is doubtful whether the Belville Holdings case could be applied to transactions between an Irish company and an international related party.

### **3805 Burden of proof**

Under Ireland's self assessment system, the burden of proof in the event of a Revenue audit will fall on the taxpayer.

### **3806 Tax audit procedures**

#### *Selection of companies for audit*

The Revenue are permitted by legislation to carry out an inspection of tax returns filed under self assessment. The purpose of this inspection is to satisfy the Revenue that the returns are complete and accurate. The Revenue are not obliged to disclose why they have picked a particular company or tax return for inspection. However, the selection of a return for inspection does not mean that the Revenue have evidence that tax has been underpaid. In many cases the return is selected for audit for straightforward reasons, such as the level of turnover or profits generated by the company or the industry sector in which the company operates.

It would be unusual for the Revenue to audit an Irish taxpayer for the sole reason of reviewing the arm's length nature of its international related party dealings. Rather, transfer pricing issues may be considered as part of a general corporation tax audit.

The annual corporation tax return form does not require Irish companies to disclose details to the Revenue on the type and value of the international related party dealings entered into by the taxpayer.

#### *The provision of information and the duty of the taxpayer to cooperate*

The Revenue auditor is fully entitled to inspect any original record of transactions conducted in the period under audit, which is relevant to the company's tax position, or any document that links these original records to the company's finalised financial statements.

Recent legislation has significantly widened the auditor's inspection powers. The auditor is now entitled to inspect any document that relates to the company's business, and not just those records the company is obliged to maintain for tax purposes.

### **3807 The audit procedure**

The Revenue will conduct the audit under the terms of the Charter of Taxpayer's Rights. Under the Charter, the Revenue are obliged to approach the audit on the assumption that the company is fully tax compliant and its returns are correct. Prior to commencing the audit, it can be expected that the Revenue official will have carried out a detailed review of the company's tax files under all tax heads. The auditor will also have conducted a review of any information contained within the Revenue, regarding the company's industry sector.

Also relevant to the audit procedure in Ireland is the Revenue's Code of Practice for Revenue Audits, which sets out the procedures to be followed by the Revenue in their conduct of an audit and in reaching a settlement with the taxpayer. In notifying the company of its intention to undertake an audit of the company's tax affairs, the Revenue give the company until a specified date to decide whether or not it needs additional time to prepare a written disclosure of any negligent underpayments of tax. In the context of a Revenue audit, a disclosure states the amounts of any tax liabilities previously undisclosed for the taxheads or periods within the scope of the audit enquiry, together with the company's calculation of the associated interest and penalties arising from the undisclosed liabilities. The disclosure must be accompanied by payment of the total liability arising in respect of tax, interest and penalties. Details

on the calculation of interest and penalties are set out under 'Additional tax and penalties' below.

Audits generally commence with an opening meeting between the company and the Revenue official(s) carrying out the audit. In the situation where the taxpayer decides to make a written or verbal disclosure in relation to the returns under review, this will be presented to the auditor at the opening meeting. The auditor may ask for more information concerning the disclosure.

The initial audit work is likely to be devoted to checking the accuracy of any disclosure made by the taxpayer, following notification of the Revenue audit. The auditor will then commence the inspection of the books and records supporting the tax return being audited.

### 3808 Revised assessments and the appeals procedure

Following the audit, the Revenue may make an assessment where they are dissatisfied with a return or returns made by the company. Generally, a time limit of four years applies to the making of assessments where a full return has been made.

Where a taxpayer is dissatisfied with an assessment raised by the Revenue, the taxpayer has the right to appeal against the assessment. This appeal must be in writing and be made within 30 days of the issue of the assessment. The appeal can be resolved by reaching agreement with the Revenue, or by means of a hearing in front of the Appeal Commissioners.

Depending upon the decision of the Appeal Commissioners, the taxpayer may have further avenues to appeal for a re-hearing to the Circuit Court, or to the High Court or Supreme Court on a point of law.

### 3809 Additional tax and penalties

Interest arises on underpaid tax at a daily rate of 0.0273%, which is 9.96% per annum.

Also in their Code of Practice, the Revenue have set out a 'penalty' grid, which shows the penalties charged for each of three categories of negligence on the part of the taxpayer. The least serious category of negligence is 'insufficient care' (with a 20% penalty) and the most serious is 'deliberate default' (with a 100% penalty). This grid is reproduced below:

| Category of tax default | Net tax-gearred penalty | Net penalty after mitigation where there is: |   |   |
|-------------------------|-------------------------|--|---|---|
|                         |                         | Co-operation only                            | Co-operation including prompted qualifying disclosure | Co-operation including unprompted qualifying disclosure |
| Deliberate default      | 100%                    | 75%  | 50%   | 10%   |
| Gross carelessness      | 40%                     | 30%  | 20%   | 5%  |
| Insufficient care       | 20%                     | 15%  | 10%   | 3%  |

The grid also shows that the penalty level can be reduced where:

- (1) the taxpayer co-operates during the audit with the Revenue (essentially this means the taxpayer complies with all reasonable requests made by the Revenue for records and assistance); and/or
- (2) the taxpayer makes a prompted qualifying disclosure (as a consequence of the notification letter received from the Revenue) or unprompted qualifying disclosure (no notification received from the Revenue that taxpayer has been selected for audit).

It remains to be seen how the Revenue will apply the Code of Practice and the categorisation of taxpayers among the different levels of negligence in the case of assessments raised due to transfer pricing adjustments.

### **3810 Resources available to the tax authorities**

The Revenue do not have a dedicated transfer pricing unit. Where transfer pricing issues arise, resources are drawn from international tax specialists or the 'Large Cases Division' in the Revenue.

### **3811 Use and availability of comparable information**

Should an Irish company not have internal comparable data to support the arm's length nature of its international related party transactions, it may be able to obtain data on the gross and net margins of comparable companies operating in Ireland by acquiring the annual returns of relevant companies from the Companies Registration Office.

All companies registered in Ireland are obliged to file an annual return with the Companies Registration Office, unless an exemption from filing applies. Depending upon the size of the company, financial statements may be required to be filed with the annual return.

### **3812 Risk transactions and industries**

There are not considered to be particular related party transactions or industry sectors that could be regarded as facing a higher than normal risk of a transfer pricing enquiry from the Revenue.

To some extent, Irish taxpayers could be considered (indirectly) to be at a higher risk of a transfer pricing review should overseas tax authorities, which have developed extensive transfer pricing regulations, focus their attention on transactions or industries that include overseas affiliates of an Irish taxpayer.

### **3813 Limitation of double taxation and competent authority proceedings**

Irish companies normally contemplate competent authority proceedings in respect of transfer pricing adjustments imposed by overseas tax authorities on international related parties that trade with the Irish company, rather than transfer pricing adjustments imposed by the Revenue.

Currently all of Ireland's tax treaties contain a mutual agreement procedure (MAP). The Revenue are willing to support requests for competent authority relief on

application by Irish taxpayers, subject to the facts and circumstances of the case coming within the provisions of the relevant double tax treaty.

It should also be noted that as a member of the European Union, Ireland is bound by the Code of Conduct to eliminate double taxation in the area of transfer pricing, approved by the EU Council of Finance and Economic Ministers on 7 December 2004. The Code of Conduct aims to ensure more effective and uniform application by EU Member States of the 1990 Arbitration Convention (90/436/EEC), which was designed to deal with double taxation issues faced by taxpayers arising from transfer pricing adjustments.

### **3814 Advance pricing agreements (APAs)**

Ireland does not have a formal APA procedure for Irish companies to agree prices for international related party transactions with the Revenue.

It should be noted however that the Revenue have, upon request, provided inward investors with advance rulings on key tax issues relevant to the decision to establish operations in Ireland. Until recently, these advance rulings were generally provided on a company's qualification for Ireland's manufacturing relief. Of late, the key tax issue upon which taxpayers are requesting advance rulings from the Revenue is whether income from a particular activity would be regarded as trading income (taxed at 12.5%) or passive income (taxed at 25%).

In May 2003, the Revenue Commissioners released a document entitled 'Guidance on Revenue opinions on classification of activities as trading'. This document was prepared in response to the growing number of advance opinions being requested of the Revenue on the appropriate classification of particular activities for taxation purposes. While its main purpose is to clarify the procedure for requesting an advance opinion, the Revenue document also provides a significant amount of practical guidance on Revenue attitudes to what constitutes a trading activity.

The practical guidance is found in a number of examples set out in the document. These examples are used by the Revenue to illustrate their thinking on three key issues discussed in the document:

- (1) the notion that trading presupposes activity;
- (2) the distinction between trading and investment; and
- (3) the importance of the role of the applicant company in a group structure. It should be noted that the Revenue Commissioners have chosen not to set threshold criteria (such as number of employees, value of tangible fixed assets, etc), which, once met or exceeded, would automatically deem an activity to be considered a trade.

### **3815 Anticipated developments in law and practice**

In recent years, rumours of an announcement on the introduction of a more widespread transfer pricing regime have preceded both the annual Budget Speech by the Minister for Finance in December and the consequent publication of the annual Finance Bill in February.

At the time of writing in May 2008, there have been no official announcements on when the Irish transfer pricing legislation may be expanded.



**3816 Liaison with customs authorities**

It is understood that there is no liaison between the income tax authorities and the customs authorities, even though they are both under the same Board of Management and are controlled by the Minister for Finance.

Nevertheless, there is a significant overlap between the methods applied by the Customs Service to value a transaction between related parties and the methods contained in the OECD Guidelines to assess compliance with the arm's length principle. Care must be taken to ensure that any transfer pricing policies implemented are also appropriate from a customs perspective and vice versa.

**3817 OECD issues**

Ireland is a member of the OECD, and the Revenue have publicly recognised that the OECD Guidelines are the internationally accepted standard for the allocation of profits among entities in an MNC. On this basis, the Revenue are likely to endorse the OECD Guidelines if and when new transfer pricing legislation is introduced in the future.

**3818 Joint investigations**

Under the terms of Ireland's tax treaties and the EU Mutual Assistance Directive, the Revenue can and do exchange information with treaty partners and fellow EU member states. Generally, Ireland's tax treaties also allow for communication between Ireland and the treaty partners for the purposes of implementing the provisions of the double tax treaty.

**3819 Thin capitalisation**

There are no specific thin capitalisation rules in Ireland but some provisions in the Irish tax legislation can deny a full deduction for interest payments in certain circumstances:

Interest payments to overseas affiliates may, depending upon the location of the recipient, be reclassified as distributions in certain situations, and therefore would not be tax deductible.

Other provisions apply to deny an interest deduction in circumstances where borrowings from a related party are used to acquire share capital (or lend to) a company which immediately before the loan was made was connected with the borrower.

The reader is urged to consult with an Irish tax adviser concerning the application of the deemed distribution and restriction on deductibility of interest rules.

**3820 Management services**

Ireland has no specific legislation on management services. Where an Irish company is paying for management services the general rules on deductible expenses will apply. Generally this means that a payment will be deductible for tax purposes where a company receives a benefit from the management services provided, once the payment is connected with the company's trade.

When a company is providing services, it should be seen to be generating income from the services provided in order to ensure a tax deduction is obtained for the costs it incurs in providing the services.

# 39 Israel

## 3901 Introduction

The Israeli transfer pricing regulations (the 'Israeli TP Rules') were introduced by the Israeli Parliament and became effective upon their publication on 29 November, 2006. The Israeli TP Rules generally follow the OECD Guidelines as well as section 482 of the U.S. Internal Revenue Code. The Israeli TP Rules require that all cross-border transactions carried out between related parties be consistent with the arm's length principle and are expected to be taxed accordingly.

## 3902 Statutory rules

### *Overview*

The Israeli TP Rules, promulgated under section 85A and 243 of the Israeli Tax Ordinance, were introduced by the Israeli Parliament and came into effect upon their publication on 29 November, 2006. These regulations incorporate the arm's length principle into Israeli tax law.

The Israeli TP Rules apply substantially to all types of cross-border transactions<sup>14</sup> in which a 'special relationship'<sup>15</sup> exists between the parties to the transaction. These transactions, including various types of services (such as research and development; manufacturing; marketing; sales and distribution), the use or transfer of tangible and intangible goods and financing transactions, are required to be carried out according to the arm's length principle. The recently approved Israeli TP Rules address topics such as determination of the arm's length principle, reporting and assessment procedures and transitory provisions.

On 29 October, 2007 the Israeli Tax Authorities issued a new transfer pricing form entitled "Declaration of International Transactions". The new form must be filled out for each and every cross-border transaction between related parties and attached to the annual income tax return. This form applies to the 2007 tax year and onwards. The transfer pricing form contains the following details:

- Transaction number;
- An indication whether this is a one-time transaction;
- Description (type of asset or service and field of activity);
- Details of the related party involved in this transaction;
- Place of residency of the related party; and
- Total amount of the transaction

---

<sup>14</sup> Upon approval by the tax assessing officer of the taxpayer, certain one-time transactions may be excluded from the scope of the regulations.

<sup>15</sup> According to the section 85A of the Israeli Tax Ordinance, 'special relationship' includes the association between an individual and his/her relative, the control of one party to the transaction over the other or the control of one individual over the other parties to the transaction, whether direct or indirect, singly or jointly with other individuals.

The taxpayer is required to include in the annual tax return the signed transfer pricing form, stating that “**I hereby declare that the transactions with foreign related parties are in accordance with the arm’s length principle, as defined in the Israeli transfer pricing regulations promulgated under Sections 85A of the Israeli Tax Ordinance and the relating regulations**”. (free translation from Hebrew)

#### *Application of the arm’s length principle under the Israeli TP rules*

Application of the arm’s length principle is generally based on a comparison of the conditions in a cross-border controlled transaction with the conditions surrounding similar transactions entered between independent enterprises (‘comparable companies’). In order to determine if a cross-border controlled transaction has been carried out in accordance with the arm’s length principle, the following steps would need to be taken:

- Identify the cross-border controlled transactions within the group;
- Identify the tested party for each respective transaction;
- Perform a functional analysis with special emphasis on comparability factors such as business activity, the characteristic of property or service, the contractual conditions of the cross-border transaction and the economic circumstances in which the taxpayer operates;
- Select the appropriate transfer pricing method(s);
- Select the comparable companies and establish an arm’s length range determined by the comparable companies; and
- Examine whether the tested party’s results fall within the arm’s length range.

#### *Transfer pricing methods*

In general, the Israeli TP Rules specify six hierarchical transfer pricing methods, which would need to be applied in the following order:

- **Comparable Uncontrolled Price (CUP) Method;** a method that compares the prices for property or services transferred or provided in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction under comparable circumstances.
- **Resale Price Method (RPM), Cost Plus (CP) Method or Comparable Profits Method (CPM);** methods that compare the profitability that a taxpayer realises from a controlled transaction to profit margins in comparable uncontrolled transactions.
- **Profit Split Method (PSM);** a method that compares the controlled transaction with an uncontrolled transaction according to the division of profits or losses between related parties, that reflects the contribution of each party to the transaction, including the exposure to risks and rights to the assets relating to the transaction.
- **Other Methods;** in cases where none of the above-mentioned methods can be used to derive the most reliable measure of an arm’s length result, the

taxpayer may apply any other method as the most appropriate method under the specific circumstances.

### *The arm's length range*

A cross-border controlled transaction is considered to be arm's length if, following the comparison to similar transactions, the result obtained does not deviate from the results of either the full range of values derived from comparable uncontrolled transactions when the CUP method is applied or the interquartile range (the values found between the 25<sup>th</sup> and 75<sup>th</sup> percentiles in the range of values) when applying other methods. Under a TP audit, if the results of the cross-border controlled transaction fall outside the relevant range (either the full range or the interquartile range depending on the method used), the transfer price will be set at the median of the comparable results.

### *Transitory provisions*

According to the Israeli TP Rules, if a transfer pricing study, which evaluates the arm's length character of the controlled transaction, has been performed according to OECD documentation requirements, or an OECD member country's documentation requirements, prior to the enactment of the Israeli TP Rules, this study will be regarded as if it has been performed under the Israeli TP Rules, for a period of two years from the enactment date of the Israeli TP Rules.

### *Advanced pricing agreements (APAs)*

A taxpayer that is a party to a cross-border controlled transaction may request an Advanced Pricing Agreement (APA) from the Israeli tax authorities for a particular transaction or for a series of transactions that have been set at arm's length levels. The request for such an agreement should include supporting documentation with respect to the transaction including documents that demonstrate how the transfer price was established, inter-company agreements, and opinions or any other supporting documentation that supports the arm's length compensation that has been established for the specific transaction.

The tax assessing officer will inform the taxpayer of his decision within 120 days (this period can be extended to 180 days). If the tax assessing officer does not respond during this period, the transfer price will be deemed to have been set at arm's length levels.

Currently, the Israeli tax authorities issue only unilateral APAs. At the conclusion of the APA procedure there is a 'binding agreement' between the taxpayer and the Israeli tax authorities.

### *Reporting procedures*

The Israeli TP Rules require all taxpayers engaging in cross-border controlled transactions to include in their annual tax return a statement detailing the nature of such transactions including reference to their price and other terms. Furthermore, the tax assessing officer may issue the taxpayer a formal letter of request, requiring the taxpayer to submit, within 60 days of the letter's request, all relevant documentation and other information related to the inter-company transactions. This information includes:

- Description of the principal cross-border controlled transactions and the parties involved in these transactions;
- Description of the business environment and the economic circumstances in which the parties operate;
- Functional analysis of the parties involved in the transactions (including functions, risks and resources employed);
- Selection of the pricing method and the reasons behind such selection; and
- Economic analysis (determination of arm's length prices).

In addition, the taxpayer should submit supporting documentation such as contracts, any disclosure made regarding the controlled transactions to any foreign tax authority, including any request for an advanced pricing agreement and any differences between the prices reported to the foreign tax authority and the prices reported in the Israeli tax returns. Furthermore, the taxpayer is required to disclose all transfer pricing studies conducted or an assessment prepared for purposes of filing to the Israeli or other foreign tax jurisdictions, as well as any opinion from an accountant or lawyer, if such were given.

### **3903 Burden of proof**

According to the Israeli TP Rules, the initial burden of proof lies with the taxpayer. The taxpayer is required to submit the appropriate documentation and relevant information of the inter-company transactions to the tax assessing officer within 60 days of the latter's request. Once the taxpayer has presented all relevant information as required, the burden of proof shifts to the assessing officer.

# 40 Italy

## 4001 Introduction

Transfer pricing has gained much attention in recent years in the Italian Tax environment.

The main reason is the on-going relocation of production to territories with low operating costs, developed infrastructure, tax incentives and a skilled labour force.

Secondly, highly centralised business models resulting from supply chain restructurings (i.e. change of the business model for distribution or manufacturing companies) and the concentration of services can play an important role within MNEs.

Notwithstanding this increasing interest on transfer pricing issues, statutory rules and tax authorities Circulars in Italy are yet to be reflective of this updated business environment.

## 4002 Statutory rules

Statutory rules on transfer pricing are included in Articles 9 and 110 of the Italian Income Tax Code.

*In particular:*

- Article 110, paragraph 7, states that components of the income of an enterprise derived from operations with non-resident corporations which directly or indirectly control the enterprise, are controlled by the enterprise or are controlled by the same corporation controlling the enterprise, have to be valued on the basis of the normal value of the goods transferred, services rendered and services and goods received, if an increase in taxable income derives there from. Possible reductions in taxable basis are allowed only on the basis of mutual agreement procedures or in light of the Arbitration Convention.
- Article 9, paragraph 3 states that normal value means the average price or consideration paid for goods and services of the same or similar type, carried on at free market conditions and at the same level of commerce, at the time and place in which the goods and services were purchased or performed. For the determination of the normal value reference should be made, to the extent possible, to the price list of the provider of goods or services, and, in their absence, to the price lists issued by the Chamber of Commerce and to professional tariffs, taking into account usual discounts.

## 4003 Other regulations

The translation of the statutory rules mentioned above into operating guidelines has been accomplished by the Ministry of Finance Instructions through Circular Letter No. 32/9/2267, dated 22 September 1980.

The above Circular provides principles and methods to be used in determining normal value. In particular, the Circular:

- Defines the scope for the application of transfer pricing rules;

- Details the “base methods” to be utilised to determine the normal value:
  - CUP (preferred method when applicable)
  - Resale price method
  - Cost plus method
- Details the “alternative methods” acceptable as check methods and when the “base methods” are not applicable:
  - Global profit split
  - Profit comparison
  - Return on invested capital
  - Gross margin comparison
- Provides specific guidelines for transactions relating to the sale of tangible assets, intangibles, interests and intra-group services.

The 1980 Circular Letter was released in light of the 1979 OECD Transfer Pricing Report. For the issues not covered by the Ministry Instructions, the same Circular Letter n. 32 specifically refers to the 1979 OECD Guidelines. Although a Ministerial Circular updated with recent OECD developments is still pending, it may become available in the future.

#### **4004 Legal cases**

In the last few years there have been various judicial decisions concerning transfer pricing issues. The most important cases are listed below, which provide general principles on different matters (i.e. concept of free competition, arm’s length definition, burden of proof and necessary documentation in order to deduct the inter-company charges).

In the following paragraphs:

- ITCO means the Italian Company whose behaviour was assessed
- ITA means Italian Tax Authorities

#### *Ruling No. 13233 of the Civil Cassation, fiscal division (October 2001)*

Ruling No. 13233 discussed the concept of “free competition”.

ITCO purchased goods from its foreign controlling company. The ITA adjusted the purchase price stating it was not arm’s length. ITCO appealed to the Court claiming that transfer pricing provisions were not applicable in that case due to the absence of free competition in that particular market: only another Italian company produced the same product under licence from its foreign parent company. The Judges stated that in order to speak of “free competition” it is sufficient that a similar product is sold in Italy, without any legal restriction in the price definition, without the need to have an “ideal” free competition. For this reason the Court rejected the appeal.

#### *Ruling No. 130 of the Tax Court of Toscana (January 2002)*

Ruling No. 130 discussed the “arm’s length value” definition.

The Tax Court stated that normal value can be determined with reference to industry average data and, in particular, to data provided by the Trade Association to which the

resident company belongs, confirmed also by financial statements' data from industry resident companies.

*Ruling No. 253 of the Tax Court of Ravenna (November 2002)*

Ruling No. 253 discussed a non-interest bearing loan made to a controlled non-resident company.

ITCO granted a non-interest bearing loan to a controlled company resident in Luxembourg. The ITA assessed interest income at "normal value" based on the A.B.I. (Italian Bankers' Association) prime rate. The ITCO was not able to justify why it granted a considerable non-interest bearing loan to its foreign affiliate, when ITCO itself suffered interest costs on its own debts. The Tax Court recognised the deemed profitability nature of the loan and the correctness of the interest expense amounts calculated by the Tax Authorities.

*Ruling No. 1070 of the Tax Court of Vicenza (February 2003)*

Ruling No. 1070 discussed inter-company sales performed without a mark-up.

An ITCO sold raw materials to a German related company at a price equal to purchase price without any mark-up. Based on financial statements data, the ITA derived the average mark-up on costs earned by ITCO on its other operating transactions (38%) and then applied this mark-up to the inter-company sale of raw materials.

The Tax Court stated that the assessment had to be cancelled since transfer pricing principles could not be applied for the following reasons:

- the operation was minimal compared with the volume of purchases and sales;
- the operation was not comparable with the usual inter-company transactions (ITCO business activity involved the trading of finished products);
- the transaction was carried out to finalise the production (by the German company) of a peculiar product that had to be sold to an important Italian client. The aim was an increase of the overall business.

*Ruling No. 13398 of the Civil Cassation, fiscal division (September 2003)*

Ruling No. 13398 relates to the burden of the proof.

ITCO (in a tax loss position) applied a 6% rebate on sales to its French parent company when a certain threshold of sales was exceeded. The ITA considered the rebate not justified by the costs and risks borne by the French company and consequently determined a positive adjustment. The ITCO should have demonstrated that the rebate was justified by the distribution costs and risks borne by the parent company, with the consequent savings for ITCO and that, considering the savings realised, the prices applied were in line with those applied to third parties.

The Court decided that, in the absence of the mentioned demonstration, the adjustment was correct.

*Ruling No. 158 of the Tax Court of Milan (June 2005)*

Ruling No. 158 concerned the documentation necessary in order to support the deductibility of inter-company services' costs.



An ITCO received charges from its foreign parent company under a “Multilateral Services Agreement”. The mentioned charges were considered not tax deductible by the ITA due to alleged lack of documentation, with the consequent application of additional taxes, penalties and interest.

The Milan Tax Court solved the dispute in favour of the ITCO since it presented adequate documentation to demonstrate the certainty and inherence of the costs sustained:

- written agreement describing the services provided;
- comfort letter issued by a large auditing firm, attesting that the cost allocation was correctly performed and that the attribution of costs to the various Group entities was made on the basis of the benefits received by the same entities;
- invoices containing a detailed description of the services performed;
- demonstration that the costs borne, with reference to the services received, were correctly recorded in the accounting books and included in the financial statements of the Italian company; and
- documentation describing, for each type of service, the contents of the activity performed and the benefits received by the Italian company.

*Ruling No. 22023 of the Civil Cassation, fiscal division (October 2006)*

Ruling No. 22023 stated the important principle according to which the non-fairness of transfer pricing in a multinational Group must be proved by the ITA, which should demonstrate that the company does not comply with the arm’s length principle.

ITCO, which used to purchase cars from foreign related companies, borne the repairing and maintenance costs on the new cars, without an adequate remuneration. The ITA supported that this way of operating would have caused a reduction in the tax basis in Italy and an increase of profit of related companies resident in low tax jurisdictions but did not give any real demonstration on this.

The Judges gave reason to ITCO since the ITA did not demonstrate the non-fairness of the transfer prices within the Group. In fact, they maintained that it is necessary to refer to the OECD Guidelines that expressly state that, if the local jurisdiction provides the Tax Authorities should demonstrate its own request, then the taxpayer is not obliged to prove the correctness of the transfer prices applied, unless the Tax Authorities have first demonstrated (at least prima facie) the non observance of the arm’s length principle.

*Ruling No. 1/30/2007 of the Tax Court of Piemonte (January 2007)*

Ruling No. 1/30/2007 provides interesting guidelines concerning inherence of costs and fair market value of services received.

In order to fulfil the contractual obligations with a new acquired Italian company, an ITCO in a start-up phase availed itself of the consulting services from a UK related company (UKCO). The consulting agreement between ITCO and UKCO provided for charges from the latter in proportion to ITCO turnover (5% during the first year of activity, lower percentages in the following years). The agreement provided that the fee to UKCO should not exceed its costs plus a 15% mark-up.

ITCO deducted the costs charged from UKCO for income tax purposes. The ITA

challenged the deduction due to the generic description of the invoices issued by UKCO, and from the failure to demonstrate the congruity of the charge taking into account quality and quantity of services received.

Against the above challenge, ITCO filed timely appeals, accepted by the Tax Court of First Instance. ITA appealed the First Instance judgments but the Tax Court of Second Instance of Piemonte, under discussion, confirmed the correctness of the ITCO position.

The reasons for the decision:

- the generic description of the invoices is overcome by the reference to the agreement with UKCO, from which it could be inferred a complex activity, having a constant and continuous nature, with a wide range of activities (thus rendering impossible an analytical description of the services in the invoice);
- the above consulting activity was necessary for ITCO, that was in a start-up phase and not having internally the resources and the skills required by its client;
- the lump-sum determination of the remuneration (percentage of turnover) compensating the service provider on the basis of the results achieved was not considered as tax avoidance, but in line with the provisions of Ministerial Circular 32/80 concerning transfer pricing;
- the proof of the inherence and of the congruity of the cost in relation to the business activity is up to the taxpayer, a proof that in this case has been provided;
- with reference to the transfer pricing issue, the tax commission noted that the agreement between UKCO and ITCO took into account, in conjunction with the basic mechanism (percentage of turnover) also UKCO costs, so that in no event the remuneration pertaining to UKCO could have exceeded the costs of the latter plus a 15% mark-up. Such agreement demonstrates – according to the Tax Court – that the consideration agreed was weighted with reference to the costs borne by the service provider.

#### *Ruling No. 52 of the Tax Court of Pisa (February 2007)*

Ruling No. 52 discussed the applicability of the CUP methodology.

The ITA issued a notice of assessment to an ITCO operating in the garden pumps market, with reference to fiscal year 2002, recognising as taxable the revenues not recorded deriving from the sales of products to a French related party at a price lower than normal value.

The ITA, comparing the same products sale price applied to third parties with those applied to the French related company, had noticed that the latter were about 10% lower. This difference was recognised as deemed taxable by the ITA. However, the Court agreed with the arguments of the taxpayer, which demonstrated that the price comparison made by the ITA was performed on the basis of uncomparable transactions, as regards to the stage of commercialisation, volumes and number of shipments. In the Tax Court opinion, the mentioned differences would have been sufficient to justify a 10% difference in the sales price and the ITA, in order to prove their reasons, should have carried out at least a careful analysis of the tax rates in

force in the two countries involved and of the comparable transactions.

#### **4005 Burden of proof**

The general principle states that the burden of proof lies with the Tax Authorities. However, taxpayers are expected to demonstrate the fairness of inter-company transactions in case of an assessment by the Tax Authorities. This general principle has been confirmed also by the above Civil Cassation's decision, dated October 2006 and by Ruling No. 52 of the Tax Court of Pisa, dated February 2007.

Particular rules apply in cross-border transactions involving counterparts (even third parties) resident in tax haven jurisdictions.

The Italian taxpayer, in order to deduct the relevant costs, must provide evidence:

- that the foreign party is a genuine commercial undertaking; or
- that the transactions were effected in connection with a real economic interest and that the relevant transactions actually took place.

The mentioned costs must be indicated in the annual tax return, otherwise penalties will apply.

#### **4006 Tax audit procedures**

##### *Selection of companies for audit*

The tax audit activity of the Italian Tax Authorities is now focused on major taxpayers and multinationals. Beginning on 2002, in fact, taxpayers with a business volume or turnover not lower than around EUR26 million are expected to be systematically audited at least once every two years. Starting on 2002, taxpayers with a business volume not lower than EUR5.2 million will be systematically audited at least once every four years. These audits may be complete and extensive or just focus on specific items such as on the basis of transfer pricing issues alone.

It is also worth highlighting that the Italian Tax Authorities are expected to increase the exchange of information with foreign tax authorities.

##### *The provision of information and duty of the taxpayer to co-operate with the tax authorities*

No specific documentation requirements concerning transfer pricing are provided by the Italian law.

Notwithstanding the above, transfer pricing documentation should adhere to the OECD Guidelines, in order to support the transfer pricing policy adopted.

General rules on tax documentation apply; accordingly all income and deduction items should be adequately substantiated.

Italian Tax Authorities may require taxpayers to produce or send deeds and documents (also in the form of questionnaires) concerning the assessment to which they are subject to. In this case, taxpayers are obliged to comply with Tax Authorities' requests. If a taxpayer fails in submitting documentation within 15 days after the Tax Authorities' request (term that can be extended at the Tax Authorities' discretion), they can make an income assessment based on their own evaluation.

#### 4007 The audit procedure

Tax audits in Italy are normally carried by accessing the taxpayer's premises. This visit may be preceded by a formal request for information by the Tax Authorities, but normally tax audits are not announced in advance. Apart from exceptional cases, the duration of a tax audit cannot exceed sixty days, calculated as the effective presence of the Tax Authorities at the company's premises. At the end of the audit, the Authorities release a Report with the exceptions raised.

Against the tax audit Report the company may file a defence brief to the relevant Tax Office within 60 days. Before then, the Tax Office cannot issue any tax assessment.

Tax issues, including transfer pricing issues, may be settled with Authorities before having a formal litigation procedure in front of a Tax Court. The relevant procedure was introduced by Decree 218/1997, the so-called '*accertamento con adesione*'. If an agreement is reached, an official motivated report has to be drawn up, showing the amount of taxes, interest and penalties due. In this case, penalties are reduced to one fourth of the minimum.

In case a litigation procedure was already started, but the company and the Tax Authorities still wish to settle the dispute, the procedure introduced by Article 48 of the Decree 546/1992, also called the '*Judicial Settlement Procedure*', is available. In this case, penalties are reduced to one third.

If the dispute is decided by the Tax Court, penalties are applied in full. There are three levels of Judgment (First Degree, Second Degree, and Supreme Court – *Corte di Cassazione*).

Unless a suspension is obtained, while the dispute is pending Tax Authorities are allowed to collect 50% of taxes assessed before the First Degree Judgment, 2/3 of taxes (and sanctions) resulting as due following the First degree judgment, and total taxes (and sanctions) resulting as due following the Second Degree judgment.

#### 4008 Additional tax and penalties

The Italian tax law provides for taxpayers the obligation to file tax returns, maintain tax books and records, withhold tax at source, etc. If the taxpayer does not fulfil these obligations, then administrative, or in certain cases criminal penalties may be imposed. Unlike other legislations, Italy does not have a special penalty regime for transfer pricing since the general penalty regime applies.

Administrative penalties may range from 100% to 240% of the amount of tax underpayment. Special rules apply in case of reiteration of similar violations in additional fiscal years.

Penalties may be reduced:

- to one fifth of minimum in case of spontaneous settlement (without any tax audit in place);
- to one fourth of minimum in case of *Accertamento con Adesione* (please see the precedent paragraph); and
- to one third in case of Judicial Settlement Procedure (please see the precedent paragraph).

The tax office has four years from the end of the year in which the return was filed to issue assessments for additional tax. This period is increased to five years if no

return was filed (Art. 43 DPR 600/1973), and is doubled if the taxpayer's act constitutes a criminal offense.

Based on the legislative decree n. 74 dated 10 March 2000, transfer pricing seems to be included within the hypotheses of tax fraud. The legislative decree, in fact, provides specific tax criminal penalties for "Valuation" acts. Even though it is not so evident if the word "valuation" also refers to transfer pricing business practices, the Italian Tax Authorities tend to notify the outcome of the transfer pricing assessment to the local public prosecutors when criminal thresholds are exceeded.

#### **4009 Resources available to the tax authorities**

Significant resources are being dedicated to transfer pricing and audits have increased in the last few years.

The Italian administrations have created task forces with the aim to monitor larger companies on all tax issues, with particular emphasis on transfer pricing and permanent establishment implications.

Over the past few years, the number of qualified personnel has significantly increased and preparation for transfer pricing cases has also improved.

#### **4010 Use and availability of comparable information**

##### *Use*

In order to support the transfer pricing policy adopted, best practices documentation includes a benchmark analysis, showing that the results earned by the tested entity fall within the arm's length range of results derived from uncontrolled comparable companies.

##### *Availability*

Companies are required by law to file their financial statements with the Chamber of Commerce. In this respect, it is possible to obtain meaningful data on the results of other companies. This information may be used when comparables are required. There are databases available to research comparable companies both at the European level and at the Italian level.

#### **4011 Risk transactions or industries**

The main areas of interest for the Italian Tax Authorities include the assessment of transfer pricing and permanent establishment issues. With reference to transfer pricing issues, the intra-group transactions analysed with more attention relate to supply chain conversions (e.g. from fully fledged distributor to agent), management fees received from group companies, and transfer of IP outside Italy.

#### **4012 Limitation of double taxation and competent authority proceedings**

The UE Convention (on the elimination of double taxation in connection with the adjustment of transfers of profits of associated enterprises) has not been frequently used in Italy. Furthermore, correlative adjustments are not very common in the Italian practice.

### **4013 Advance pricing agreements (APAs)**

On 23 July 2004 Italian Tax Authorities issued the official procedure concerning the so called "International Ruling", introduced by Article 8 of the Law Decree No. 269 of 30 September 2003.

The procedure involves companies engaged in "international activity", with reference to transfer pricing, dividends, royalties and interests; in particular:

- Any resident company complying with one, or more than one, of the following requirements:
- With reference to non-resident companies, it meets one or more than one of the conditions provided by Art. 110, paragraph 7 of the Italian Tax Consolidated Text (transfer pricing rules);
- Its assets, funds or capital, is participated by non-resident persons or it participates to the assets, funds or capital of non-resident persons;
- It has paid to or received from non-resident persons dividends, interests or royalties.
- Any non-resident company carrying on its activity in Italy by a permanent establishment.

The ruling must be submitted to one of the competent offices (i.e. the Milan or Rome office on the basis of companies' or permanent establishment tax residence).

The information to be included in the ruling, under penalty of no acceptance, is:

- general information concerning the company, such as the name, its registered office, and its tax and VAT identification numbers;
- documentation that proves the eligibility requirements;
- the scope of the application and the purpose of the ruling request; and
- the signatures of the legal representatives.

Within 30 days from receipt of the application or from the completion of the inquiry activity, the empowered local office of the Italian Revenue Agency may notify the taxpayer to appear in front of the tax inspector to verify the accuracy of the information provided, and to define the terms and conditions of the negotiation proceeding to be followed between the taxpayer and the Revenue Authorities.

The procedure must be completed within 180 days from the filing of the request.

Once the agreement has been reached, it remains in force for three years (the year in which the agreement is signed and the following two years).

Within 90 days before the expiration of the agreement's terms the taxpayer may ask for a renewal. The Revenue Office must give its approval or refusal to the renewal, at least 15 days before the agreement's deadline.

### **4014 Anticipated developments in law and practice**

As mentioned above (paragraph 2903) a new Circular concerning Transfer Pricing Documentation is expected to be issued shortly. According to available information, the ITA may officially endorse the Resolution of the Council and of the Representatives of the Governments of the Member States, meeting within the Council, on a Code of Conduct on transfer pricing documentation for associated enterprises in the European

Union (EU TPD) (2006/C 176/01).

Moreover, and confirming the increasing focus of transfer pricing issues, in January 2008 the ITA issued a Circular Letter (Circular Letter n. 6/E, dated 25 January 2008) stating the areas to be considered when identifying companies to be audited, including:

- the existence of inter-company transactions with non-resident related parties in order to verify the compliance with the provisions of the transfer pricing rules, included in Article 110, paragraph 7, of the Italian Income Tax Code; and
- the existence of inter-company transactions with resident companies when an internal transfer pricing issue could occur due to the presence of a favourable tax regime.

#### **4015 Liaison with customs authorities**

Administrative rules enable the exchange of information between tax and customs authorities, and recent experience suggests that such an exchange of information does occur (in particular as regards to the importation of goods from tax heaven jurisdictions).

#### **4016 OECD issues**

Italy is a member of the OECD and has approved the OECD Guidelines. In the absence of detailed and up to date local regulations, often reference is made to OECD Guidelines.

It is important to note, however, that through three identical decisions relating to a permanent establishment case, dated 25 January 2006 (no. 17206, deposited on 28 July 2006, no. 22849 and no. 22853, both deposited on 25 October 2006) the tax section of the Supreme Court expressed a position limiting the role of the OECD Commentary, stating that the latter does not have a legislative value and it represents, at the most, a recommendation to the OECD Member countries.

#### **4017 Joint investigations**

On 1 May 2006, Italy became the 12th Party to the joint OECD Council of Europe/OECD Convention on Mutual Assistance in Tax Matters. As a Party to the Convention, Italy enhances its ability to combat tax evasion and avoidance through exchange of information on a wide range of taxes. The other Parties to the Convention are Azerbaijan, Belgium, Denmark, Finland, France, Iceland, the Netherlands, Norway, Poland, Sweden and the United States. A key feature of the Convention is the ability to take part in simultaneous multilateral examinations.

Indeed, some joint investigations have already been carried out.

#### **4018 Interest payable deductibility**

The 2008 Finance Act (24 December 2007, no. 244 Law) replaced the previous interest deduction limitations (i.e., thin capitalisation and “pro-rata” rules).

The new general rule states that the interest payable and assimilated charges are deductible, in each fiscal year, to the extent of the interest receivable and assimilated revenues. In addition, it is stated that any excess of interest payable over interest receivable is deductible up to 30% of EBITDA. The non-deductible amount may be carried forward without any time-limit.

The new interest deduction limitation does not apply to certain taxpayers, including individual entrepreneurs, partnerships, banks, financial entities, insurance companies, and their holdings. It applies however to holdings of industrial and commercial groups. The rule applies both to interest due to related parties and to interest due to third parties.



# 41 Japan

## 4101 Introduction

Japan has had transfer pricing legislation since 1986 and was one of the first countries to pioneer advance pricing agreements (APAs) specifically to cover transfer pricing. Japan remains progressive and energetic in its approach to developing transfer pricing practice. The Japanese tax authorities now have enormous experience, and are increasingly committing resources to the policing of the transfer pricing regime. To date, many very significant tax assessments based on transfer pricing adjustments have received press publicity. Japan's transfer pricing environment is thus one that requires great care and attention by taxpayers.

## 4102 Statutory rules and other regulations

Japan enacted formal transfer pricing legislation in April 1986 in the form of Special Taxation Measures Law, Article 66-4, and since 2005, Article 68-88 for consolidated companies (collectively, STML Art. 66-4 and 68-88). In support of STML Art. 66-4 and 68-88, related cabinet and ministerial orders were issued via the Special Taxation Measures Law Enforcement Order, Article 39-12 (since 2005 Article 39-112 for consolidated companies; collectively Enf. Order Art. 39-12 and 39-112) and the Special Taxation Measures Law Ministerial Order, Article 22-10 (Enf. Order Art. 22-10). The National Tax Agency's (NTA) interpretation, and guidance for the application, of the transfer pricing legislation and rules are set out in the related Special Taxation Measures Law Basic Circulars, dated 8 September 2000 (the September 2000 Circular), 1 June 2001 (the 1 June 2001 Circular) and 25 June 2001 (the 25 June 2001 Circular) respectively.

Japan is a member of the OECD and actively participated in drafting the 1995 OECD Transfer Pricing Guidelines for multinational enterprises (MNEs). As such, the NTA advocates the theory and practices set out in the OECD Guidelines, as confirmed by the 1 June 2001 Circular. In practice the OECD Guidelines are interpreted and implemented under the framework of Japan's own transfer pricing legislation as well as Japan's unique political and economic context. This 'localisation' of OECD principles has created some significant differences in their implementation in Japan compared to other jurisdictions.

Nevertheless, Japan's transfer pricing legislation, consistent with the OECD Guidelines, is based on the arm's length principle. In summary, STML Art. 66-4 and 68-88 provide that a corporation (or other juridical person) that has conducted the sale or purchase of inventory, rendered services, or engaged in other transactions with a foreign related party, must do so at an arm's length price. In transactions where the Japanese tax authorities determine that arm's length principles have not been adhered to for the purposes of corporation tax, the price can be adjusted to approximate a third party transaction. In this situation, under the legislation, the Japanese tax authorities have broad powers to recalculate the transfer price.

### *Framework of the transfer pricing legislation*

In general terms, the legislation applies to international transactions between a 'juridical person' and an affiliated 'foreign juridical person'. As discussed below in more detail, two juridical persons are affiliated where a juridical person is engaged in a transaction with a foreign juridical person with which it has a 'special relationship.'

### *Applicability*

#### **Foreign transactions**

In general, the Japanese authorities do not believe that there is a threat of lost tax revenues in domestic transactions because any shifted income is ultimately taxed in Japan. Consequently, Japan's legislation applies only to foreign affiliated transactions. The rules apply between related corporations, irrespective of whether the non-Japanese company is the parent or the subsidiary. However, the rules do not apply to Japanese-source income of a non-Japanese affiliate where that income is taxable in Japan, due to such affiliate having a permanent establishment (PE) in Japan.

#### **Juridical persons**

The legislation applies to cross-border transactions between a juridical person and a foreign juridical person. Juridical persons include corporations, corporations in the public interest such as incorporated associations or foundations, and cooperative associations such as agricultural cooperative associations or small enterprise cooperative associations. The legislation therefore does not apply to partnerships, unincorporated joint ventures, unincorporated associations or individuals. A foreign juridical person is a juridical entity that is established under the laws of a foreign country and does not have its main office in Japan.

The legislation does not specifically refer to partnership transactions. While it is thought that the legislation does not treat corporate partners as related by reason of their partnership interests, it is believed that certain partnership transactions may be covered if the relationship test is met and the transaction is between Japanese and foreign taxpayers.

### *Definition of 'affiliated'*

Juridical persons will be deemed to be affiliated where a juridical person is engaged in a transaction with a foreign juridical person with which it has a 'special relationship'. A 'special relationship' will exist:

- if they have a 50% or greater common ownership (see '50% test' below); or
- if another 'special relationship' exists (see 'Other Special Relationship' below).

### *The 50% test*

The 50% test will be met if the taxpayer, which is a juridical person, directly or indirectly, owns 50% or more of:

- the total number of issued shares (voting and non-voting) in the other juridical person; or
- the total amount invested in the other juridical person.

Thus, the test will be satisfied in the typical case of a Japanese subsidiary of a foreign parent as well as in the case of a foreign subsidiary of a Japanese parent. Two corporations will be deemed to be affiliated where, in a brother-sister group, 50% or more of the issued shares (voting and non-voting) in each of the two corporations are owned by the same party. Under the indirect ownership rules, a corporation is deemed to own the stock held by another corporation if the first corporation owns 50% or more of the issued shares of the second corporation. This ownership can be through one corporation or through several corporations. There are no provisions in the Japanese tax law with respect to partnerships. Each partner, however, is generally deemed to personally hold the assets of the partnership. Accordingly, in the case of stock in a corporation, the number of shares deemed held by each partner is proportionate to the partner's ownership in the partnership. Family attribution rules would also apply to determine whether indirect ownership would meet the 50% test. Thus, in the case of a spouse, any holdings of the spouse are included and in certain cases, holdings of the spouse's family.

#### *Other special relationship*

A 'special relationship' will also exist in a number of situations where the 50% stock ownership test is not met. A 'special relationship' includes situations where:

- 50% or more of the officers of the company are or were employees or officers of the other company (to date no time limit has been specified);
- the representative director of the company is or was an employee or officer of the other company;
- a considerable proportion of a company's operating transactions are with the second company (operating transactions are those transactions that are generally related to the corporation's main source of revenue); or
- a considerable proportion of a company's outstanding loans, which are necessary to the company's operations, have been borrowed from or guaranteed by the second company.

#### *Transactions through unaffiliated parties*

The Japanese legislation will also apply to transactions entered into with unaffiliated persons in cases where the transactions with the foreign affiliates are conducted through an unaffiliated person (presumably acting as a conduit). The type of transaction that this rule is designed to deal with is one that takes place with an unrelated trading company. Trading companies in Japan play a vital role in facilitating the import and export of goods. They act as an intermediary between the seller and the purchaser of the goods in question. Some commentators believe that this provision was necessary because in Japan a substantial portion of the import/export business is conducted through trading companies.

#### *Types of transaction covered*

The legislation covers transactions involving the sale or purchase of tangible personal property and 'other transactions'. The legislation was deliberately left quite broad to give the NTA a greater degree of flexibility. The types of transaction falling within the 'other transactions' category include:

- rents from tangible assets;
- royalties for the use of and consideration for the sale or purchase of intangible assets; interest on loans or advances; and
- fees for inter-company services.

The legislation sets out detailed rules for transactions involving tangible personal property, and requires the use of 'equivalent methods' for 'other transactions'. It should be noted that the Japanese reporting form (Schedule 17(3) for taxpayers with fiscal years beginning on or after 1 April 2003, formerly Schedule 16-4), which is part of a corporation's annual tax return, includes requests for information regarding these 'other transactions' (see Section 4105 below).

#### *Methods of arm's length price determination*

The legislation provides that the affiliated juridical persons must conduct their transactions at an arm's length price. While the legislation does not specifically recognise either a range of arm's length prices or net profitability as a standard for establishing specific arm's length prices, both concepts are introduced by the 1 June 2001 Circular for the purposes of irregularity checks during audits. In addition, the 28 April 2005 amendment to the 1 June 2001 Circular provides that in determining the arm's length price of the tested transaction, where more than one comparable transaction has a high level of comparability, the average of those transactions may be used as the arm's length price/profitability.

#### *The sale or purchase of inventory*

The legislation provides specific methods for determining an appropriate arm's length price. It provides that the arm's length price is to be determined, in the case of the sale or purchase of inventory, under:

- the comparable uncontrolled price (CUP) method;
- the resale price method;
- the cost plus method; or
- if these methods cannot be used, either a reasonable method that is similar to the above methods, or 'other methods' prescribed by Enf. Order 39-12.

The Japanese legislation does not provide a priority for the application of the CUP, resale price or cost plus methods. In drafting STML Art. 66-4 and 68-88, the legislators are understood to have felt that the absence of a priority of methods would give companies greater flexibility to find the appropriate inter-company price to properly reflect an arm's length price within the particular industry or market. This tends to suggest that a priority has not been assigned to any of the various methods.

#### *The other methods*

Enf. Order Art. 39-12 and 39-112 in effect introduces the profit split method and, for fiscal years beginning on or after 1 April 2004, the transaction net margin method (TNMM), as 'other methods'. The profit split method requires profits to be allocated between enterprises on the basis of a key, with the following factors, either singly or

in combination, being used as an allocation key for calculating the profit split:

- (1) costs – if costs from the profit and loss account are the allocation key, then profits could be allocated on the basis of the relative proportion of an enterprise's:
  - (a) manufacturing plus operating costs; or
  - (b) staff costs plus costs for related facilities.
- (2) assets – if assets from the balance sheet are the allocation key, then profits could be allocated on the basis of the relative proportion of an enterprise's:
  - (a) operating assets; or
  - (b) capital employed.

It should be noted that Enf. Order Art. 39-12 and 39-112 do not exclusively require the use of the above approach. Other factors sufficient to presume the degree to which each party contributed to the realisation of income can also be considered, although in practice this might be less readily accepted by the NTA. The September 2000 Circular also allows the use of the comparable profit split method and the residual profit split method. The comparable profit split method distributes the profit to the parties by reference to the profit split ratio of a comparable transaction between unrelated parties where such information is available. The residual profit split method may be applied when either party to the controlled transaction owns significant intangible assets. In this method, routine profits are first distributed to the respective parties by reference to the information of the uncontrolled transaction without having significant intangible assets. The residual profit is then distributed to the respective parties in proportion to the value of the significant intangible assets that they own.

The TNMM as described in the Enf. Order Art.39-12 and 39-112 provides three ways by which arm's length pricing may be determined: TNMM by modified resale price (8(ii)) computes the transfer price in a transaction involving a controlled foreign entity as the taxpayer's resale price minus the sum of (i) the taxpayer's resale price multiplied by the operating margin of the comparable transaction, and (ii) the taxpayer's selling, general and administrative expenses. TNMM by full cost mark up, (8(iii)) computes the transfer price in a transaction involving a controlled foreign entity as the sum of (1) the taxpayer's total costs, being the sum of costs of goods sold and selling, general and administrative expenses, and (2) the taxpayer's total costs multiplied by the full cost mark up of the comparable transaction, i.e. the ratio of operating profit to total costs of the comparable transaction. Under 8(iv), the transfer price in a transaction involving a controlled foreign entity may be computed by reference to a method similar to those described under 8(ii) or 8(iii).

### *Other transactions*

For transactions other than the sale or purchase of inventory, such as rent for the use of tangible property, royalties for the use of or consideration for the sales or purchase of intangible property, fees for services rendered and interest on loans or advances, the legislation provides that methods similar to the CUP, resale price and cost plus methods can be used. If these cannot be used in a given situation, a fourth or 'other' method can be used. This 'other method' is to be a reasonable method as described in the above discussion.

Moreover, for inter-company service fees, the 1 June 2001 Circular was updated on

20 June 2002 (new paragraph 2-10) to include specific reference to the treatment of intra-group services, largely as a reiteration of the OECD commentary on intra-group services (Chapter VII, OECD Guidelines). Payment for such services is deductible by the recipient company if the recipient would need to acquire the services from an unrelated party, or perform them itself, if they were not provided by the related party. However, services provided by a parent company in its capacity as shareholder are not treated as services performed for consideration and are not deductible. Paragraph 2-10 applies equally to both Japanese parent and foreign parent multinational companies.

The 1 June 2001 Circular was also updated on 20 March 2006 and 25 June 2007 to include new guidance on the appropriate treatment of Cost Contribution Arrangements (CCAs) and transactions involving intangible property.

### **4103 Legal cases**

In December 2007, judgment was delivered in the first court case on the transfer pricing legislation. The decision related to the NTA's use of secret comparables, which the court upheld (see Section 4110 below).

Details of some of the adjustments that have been made by the tax authorities, and related issues regarding disputes with the authorities, have also been published from time to time. In recent years the number of cases and value of assessments by the Regional Tax Bureaus (RTB) has increased significantly. For example, for the administrative year ended 30 June 2007 (2006), transfer pricing assessments were issued for income adjustments totalling Yen105.1 billion, while the number of assessments was 101 in total. Set out below are the most recent examples of some of the matters publicised. Note that the cases described herein are initial assessments only and that the assessment amounts may be reduced as a result of a taxpayer's recourse options (see Section 4107 below).

#### *2005 – Merrill Lynch*

Income from derivatives transactions between taxpayer's affiliates in the US and Europe, and its three branch offices in Tokyo, was allegedly not recognised in Japan. An income adjustment in the amount of Yen60 billion was made.

#### *2006 – TDK*

TDK received a notice of assessment from the Tokyo RTB for the five year period through the fiscal year ended March 2003 for electronic parts transactions with foreign affiliates in Hong Kong and the Philippines. The adjustment to income was Yen21.3 billion.

#### *2006 – Mitsubishi Corporation*

Mitsubishi received an assessment from the Tokyo RTB for the year ended March 2000 which resulted in additional tax liability of Yen5 billion for the company's transactions with a subsidiary and an affiliate of the company's Energy Business Group in Australia. The Tokyo RTB also plans to assess later fiscal years (six years ending in March 2005) but issued the assessment for the year ended March 2000 first due to the impending expiry of the statute of limitations period. Mitsubishi has

recorded provisions for expected income adjustments of Yen23.4 billion for all six years.

*2006 – Takeda Pharmaceutical Co., Ltd.*

Takeda received a notice of assessment from the Osaka RTB in relation to the six fiscal years through March 2005 in connection with transferring its earnings to TAP Pharmaceutical Products Inc., a 50-50 joint venture between Takeda and Abbot Laboratories, by setting an unreasonably low profit margin for the Prefaced peptic ulcer drug that the joint venture sells in the US. The adjustment to income was Yen122.3 billion.

*2006 – Sony Corporation (Sony) and Sony Computer Entertainment Inc (SCEI).*

Sony and SCEI received a notice of assessment from the Tokyo RTB for the six fiscal years through March 2005 for transactions between SCEI and its subsidiary Sony Entertainment America Inc. (SCEA), and Sony for fiscal years ended March 2004 and 2005 for transactions related to CD and DVD disc manufacturing operations with a number of overseas subsidiaries. The adjustment to income was Yen74.4 billion.

*2008 – Honda Motor Co., Ltd.*

Honda received a notice of assessment from the Tokyo RTB for the five fiscal years through March 2006 for profit earned by its subsidiary in China. The Tokyo RTB said that royalties paid by the Chinese subsidiary to Honda for production technologies were insufficient. The adjustment to income was Yen140 billion.

#### **4104 Burden of proof**

The Japanese legal system places the burden of proof in all taxation matters with the government. Transfer pricing examiners consider that this requires them to obtain detailed information regarding comparable transactions, although they also believe that generally such information cannot be disclosed to a taxpayer, as this is prohibited by taxpayer confidentiality requirements. This situation gives rise to the issue of so-called 'secret comparables'. In practice in any audit, the taxpayer has a clear burden under the legislation to provide information and in any case, as a matter of examination management strategy, it would be potentially disadvantageous to seek to withhold information.

#### **4105 Tax audit procedures**

Companies are required to complete and return an annual corporation tax return. As part of that return, Schedule 17(3) must be completed; this gives details of the taxpayer's foreign affiliated parties and any transactions with those foreign related parties, including disclosure of the transfer pricing methodology adopted for each transaction. A review of this form, in conjunction with the company's financial statements and a review of the company's results may lead the tax authorities to select a company for audit.

Within the context of this review the NTA are likely to be alerted to the possibility of transfer pricing issues in cases where:

- (1) the volume of transactions with affiliated foreign companies is notably large;
- (2) inter-company prices, commission paid and royalty rates charged are set but later changed, so that related foreign parties receive advantages or benefits;
- (3) a company's profit does not increase in proportion to expansion in the market for its principal product or is not in proportion to the taxable income of comparable companies;
- (4) losses are made on the sale of products purchased from affiliated foreign companies;
- (5) affiliated foreign companies are making profits that do not reflect the functions they perform;
- (6) the functions performed by affiliated foreign companies are not clearly identified;
- (7) the basis on which royalty rates have been calculated are not identified; and
- (8) the basis on which income is allocated between the company and affiliated foreign parties appears to be unreasonable.

A transfer pricing audit is equally likely for domestic or for foreign-owned companies.

#### **4106 The audit procedure**

Once a transfer pricing issue has been identified, specialist examiners from the appropriate RTB visit the taxpayer's premises to conduct an investigation.

The tax authorities are entitled to request any information they consider necessary to determine the appropriate transfer prices. The 1 June 2001 Circular sets out in detail examples of the kinds of documents that may be requested by the examiners. These include the books of account, records and other documents, not only of the taxpayer but also of the foreign affiliate. As to requests for overseas information, the taxpayer is required to endeavour to meet such requests. If a taxpayer fails to present, or submit, within a reasonable period of time information including overseas information that is recognised to be necessary to determine an arm's length price, the authorities may impute taxable income to the Japanese company on the cross-border transactions with a foreign affiliate by applying one of the prescribed methods. The prescribed methods include either the resale price method, the cost plus method, or a profit split method using a high level global profit split; i.e., based on an allocation of the total consolidated operating margin of the entire group to which the taxpayer belongs, as disclosed in the group's annual report (assuming that a segmented consolidated operating margin including the transactions under audit is not provided in the annual report). In calculating the additional taxable income, the tax authorities are to use businesses comparable in terms of type, size and other characteristics to the Japanese taxpayer. The imputed method is a last resort and it is reportedly said that there has been one case only where it has been applied by the tax authorities to date.

#### **4107 Recourse options**

There are three domestic methods and one bilateral method of recourse for tax relief available to taxpayers upon receiving a notice of assessment, namely:

- (1) Domestic Recourse



- (a) Request for Reinvestigation to the applicable RTB;
  - (b) Application for Review to the National Tax Tribunal;
  - (c) Litigation; and
- (2) Bilateral Recourse under the Japan/Treaty Partner Nation Tax Convention (competent authority negotiations).

#### **4108 Additional tax and penalties**

Interest is charged on unpaid tax at the lower of 7.3% per annum or the sum of the Official Discount Rate as of 30 November of the previous year (0.75% as of 30 November 2007) plus 4% (i.e. total of 4.75% for interest accruing in 2008) for one year after the due date for filing, and for the period from the issuance of the notice of assessment until the date on which the additional tax is actually paid. The interest rate increases to 14.6% if unpaid tax is not subsequently paid within three months of the date that a notice of assessment is issued. This is statutory interest and is not deductible for corporation tax purposes.

There is an automatic penalty of 10% of additionally assessed taxes, plus 5% of additionally assessed taxes exceeding the amount higher of taxes originally reported or Yen500,000. However, a 35% penalty is imposed on understatements where deliberate tax evasion is judged to have taken place. These penalties are not deductible for corporation tax purposes.

Effective 1 April 2007 in the event that a taxpayer files a request for mutual agreement procedures following a transfer pricing assessment, payment of national tax and penalties pertaining to the assessment can be deferred until the completion of mutual agreement procedures (one month after the day following the date of reassessment based on mutual agreement, or, should agreement not be reached, one month from the day following the notification of this fact to the taxpayer), if requested by the taxpayer. The taxpayer, however, needs to provide collateral for the amount of taxes to be deferred. In addition, the taxpayer is exempted from delinquent tax for the deferral period. The deferral provision was extended to local taxes in 2008.

#### **4109 Resources available to the tax authorities**

Tokyo, Osaka and several other RTBs each have a team of specialist transfer pricing examiners who conduct investigations. Over the last several years, the NTA has stepped up its transfer pricing enforcement by monitoring and expanding the scope of its examinations. The NTA has been increasing the number of examiner positions and the number of offices to be used to investigate transfer pricing strategies in order to handle the increase in the number of transfer pricing cases and APA (see Section 4112) requests. Additionally, the NTA is educating its staff to identify 'red-flag' issues to consider when auditing corporations that are operating in Japan. As a result of the NTA becoming progressively tougher, more experienced and sophisticated in transfer pricing, it has made some spectacular assessments against a number of companies in various industries, including the pharmaceutical and medical equipment industries.

#### **4110 Use and availability of comparable information**

The Japanese tax authorities' very strict compliance with the legislation leads the

auditors to review transfer pricing on an individual transaction basis (or product line basis or business segment basis), focusing on the gross margin and not the operating margin. While the 1 June 2001 Circular issued by the NTA refers to the operating profit margin in the context of an irregularity check, the NTA's and RTBs' historical preference for profit split analyses remains unchanged where such is used either as a transfer pricing methodology itself or as a reasonableness check of the method used by the taxpayer, depending on the situation. Also, where a profit split analysis is not able to be conducted due to lack of financial data about the foreign affiliate, the practice followed by the examiners of relying on gross profit margins in establishing arm's length prices for foreign-owned distributors remains essentially unchanged.

Given the tax authorities' practice of reviewing transfer prices on an individual transaction basis, they place heavy reliance on comparable transactions. In many of the cases, these are external uncontrolled comparable transactions obtained by reverse audit of the taxpayer's competitors. The 1 June 2001 Circular requires examiners to provide the taxpayer with an explanation of conditions of selection of the secret comparable, the content of the comparable transaction and the method of adjustment for any differences between it and the taxpayer. The scope of such explanation is, however, restricted by a confidentiality requirement levied on examiners, and thus the identity of the secret comparable remains undisclosed and can create major difficulties at audit. Indeed, this issue of 'secret comparables' is currently one of the most contentious issues in the Japanese transfer pricing environment. As noted above (see Section 4103), a recent decision of the Tokyo District Court upheld the tax authorities' right to use secret comparables in making a transfer pricing adjustment. That decision is currently under appeal.

#### **4111 Limitation of double taxation and competent authority negotiations**

All tax treaties concluded by Japan contain a provision for competent authority negotiations. The Commissioner's Secretariat of the NTA and the Deputy Commissioner for International Affairs, who head the NTA's Office of International Operations and Office of Mutual Agreement Procedures, are in charge of competent authority negotiations.

If competent authority negotiations result in the Japanese authorities having to cancel a portion of a proposed transfer pricing adjustment, the RTB will reduce the amount of tax due accordingly, i.e. the taxpayer does not need to file for a reassessment of tax. Such reductions will have a corresponding effect on the amount of local taxes due, since municipal and prefectural taxes are based on the amount of corporation tax paid.

As of 30 June 2007, there were 250 ongoing cases under competent authority negotiation (for both transfer pricing assessment and APA cases) and it is anticipated that the number of cases will continue to increase. One of the major reasons for the difficulties in the competent authority negotiations is the difference in tax policies relating to the methodology that should be used in determining an appropriate arm's length price. For example, as was evident in the bilateral US-Japan APA reported as obtained by Komatsu (see Section 4112 below), it is understood the Inland Revenue Service (IRS) preferred to use the comparable profits method (CPM) while the NTA preferred to use a profit split method. As a result of the increase in the number of

transfer pricing assessment cases that are left unresolved at the competent authority level, the NTA is encouraging taxpayers to apply for APAs.

#### **4112 Advance pricing agreements (APAs)**

The original Japanese APA system was called the 'pre-confirmation system' (PCS) and was instituted in April 1987, immediately following the introduction of transfer pricing legislation. Japan was one of the first countries to introduce such a system solely for transfer pricing purposes.

A significant body of APA experience has developed since then, and in October 1999 the NTA issued a formal Circular on APA procedures, which in large measure brought existing practice onto a more formal basis. That Circular has since been integrated into the 25 June 2001 Circular.

Under the 25 June 2001 Circular, there is a strong expectation that an APA will be bilateral. Under an APA, a taxpayer submits its transfer pricing methodology to be used to determine the arm's length price and its specific content (together, the 'TPM') to the relevant RTB. The RTB will evaluate the TPM and, if appropriate, confirm it or suggest changes. As part of this process, if the APA is bilateral, co-ordination through the NTA's Office of Mutual Agreement Procedure will take place to arrive at competent authority agreement. Once a TPM is agreed upon, so long as tax returns comply with the agreed TPM, pricing is regarded by the RTB as arm's length. In principle, the period to be covered by an APA is three to five years.

The 25 June 2001 Circular recognises pre-filing conferences as an important part of the process. The formal filing requires a body of detailed supporting documentation, including a functional analysis, details of the transfer pricing methodology applied for, stand-alone financial statements of the taxpayer as well as its foreign affiliate that is party to the transaction subject to the APA application, and an explanation of the material business and economic conditions assumed. An amendment (effective 25 June 2007) to the 1 June 2001 Circular also strengthened the wording of the application requirements. As a result, the inclusion of the stand-alone financial statement of the foreign affiliate into the APA application is a strict requirement to be adhered by the taxpayer, and non-submission may result in the RTB's refusal to process the APA application. Moreover, the same amendment also provides that an APA application may not be processed if it results in profit in Japan being reduced without reasonable economic grounds.

An APA application will not stop an ongoing transfer pricing examination, although there is specific clarification that 'roll-back' – the use of an agreed TPM for periods prior to an APA being in force – may be acceptable for bilateral or multilateral APAs. There is also guidance relating to post year-end adjustments to conform to a TPM.

Between 1987 and 1992, few PCS cases were filed and only a handful of these were approved. Since 1992, however, transfer pricing legislation around the world (particularly in the US) has developed considerably. In response to this, the NTA has taken an even more proactive attitude towards the bilateral APA procedures. By 30 June 2007 some 598 bilateral APA applications had been filed, with over 407 bilateral or multilateral APAs completed up to that date. In addition, in 2007 the number of APA examiners at the Tokyo RTB alone was doubled, from 27 to 52. Examples of reported APAs are summarised below.

Apple Computer Japan, Inc. was the first foreign parent company to obtain a

bilateral APA with the NTA and IRS. It was reported that the profits ratios from domestic sales of Apple's personal computers were to be based on ratios that were mutually agreed to by the NTA and the IRS.

Matsushita Electric Industrial Co became the first Japanese-parent taxpayer to obtain an APA that was mutually agreed by the NTA and IRS.

Komatsu Ltd became the second Japanese-parent company to complete a bilateral Japan-US APA. This APA was based on a 'hybrid' method, which combines the attributes of the CPM and the profit split, which are the methods most preferred by the IRS and the NTA, respectively. It is now thought that this approach was a 'one-off' rather than a precedent for wide subsequent use.

Coca-Cola (Japan) is also known as having obtained a bilateral Japan-US APA following the transfer pricing assessment on its royalty payment.

In 2005, the first bilateral APA between Japan and China was completed.

### **4113 OECD issues**

Japan is a member of the OECD.

# 42 Kazakhstan

## 4201 Introduction

Kazakhstan, unlike other Central Asian countries and Russia, adopted a separate law on state control over the application of transfer pricing with effect from 1 January 2001 (Transfer Pricing Law). Currently, Kazakhstan's transfer pricing legislation is regarded as the most detailed within the CIS (Commonwealth of Independent States) region.

This law has become the subject of much attention from both local and foreign companies operating in Kazakhstan. This attention stems mainly from the fact that the Transfer Pricing Law, in certain aspects, significantly departs from the key principles outlined in the OECD Guidelines. Thus, the Transfer Pricing Law and corresponding Transfer Pricing Instruction contain a number of unusual concepts, some of which have the effect of widening the scope of the application of transfer pricing by the auditing authorities.

Furthermore, the Transfer Pricing Law and the Transfer Pricing Instruction contain a number of ambiguous provisions, which in turn impact the practice of how the authorities apply the law.

## 4202 Statutory rules

### *Scope*

While the Transfer Pricing Law focuses on cross-border transactions, it remains extremely broad in scope primarily due to the fact that transfer pricing control extends to certain transactions involving unrelated parties. Thus, the relevant state authorities (i.e. tax and customs) are empowered to control transfer prices in cross-border transactions of the following types:

- 1) between related parties;
- 2) barter transactions;
- 3) involving counter-claims and reducing claims;
- 4) with parties registered or resident in, or having a bank account in tax havens;
- 5) with legal entities that have taxation privileges;
- 6) with legal entities that have reported losses in their tax returns for the two tax years preceding the transaction;
- 7) transactions not listed under items one through five, if the transaction price deviates by more than 10% in any direction from the market price;
- 8) transactions carried out in Kazakhstan, which fall under items five and six above, if such transactions are connected with cross-border transactions.

### *Related parties*

The Transfer Pricing Law generally defines related parties as individuals or legal

entities whose special mutual relations may allow the economic results of the transactions to be influenced. The Transfer Pricing Law further sets out a comprehensive list of parties (14 scenarios in total) that should be regarded as related for the purpose of the Transfer Pricing Law.

#### *Pricing methods*

The tax authorities should determine the market price based on three methods: Comparable Uncontrolled Price method, and Cost Plus method or Resale Price method if Comparable Uncontrolled Price method may not be applied. Thus, the legislation attaches a clear priority on the use of the Comparable Uncontrolled Price method.

The Transfer Pricing Instruction provides details and examples of how the tax authorities should make tax assessments based on the above-mentioned pricing methods.

#### *Documentation requirements*

Kazakhstan does not currently have formal transfer pricing documentation requirements.

However, the Transfer Pricing Instruction establishes the list of official sources of information on market prices, and taxpayers whose transaction prices conform to prices from the official sources appear to be safeguarded from transfer pricing adjustments in practice.

### **4203 Other regulations**

N/A

### **4204 Legal cases**

The most significant legal cases on transfer pricing matters involved appeals of subsurface users working in Kazakhstan on the tax authorities' transfer pricing adjustments in relation to the export of oil and other commodities. A few other cases have taken place in the financial sector related to interest rate levels.

### **4205 Burden of proof**

Generally, the transaction price is deemed to be the market price unless proven otherwise by the tax authorities. However, in practice, it is often the case that the burden of proof is shifted to the taxpayer to demonstrate that the applied price was at market level.

### **4206 Tax audit procedures**

The tax and customs authorities are responsible for controlling, monitoring and evaluating cross-border transactions for transfer pricing purposes.

The tax authorities are generally responsible for monitoring transactions on certain exported goods and services, maintaining an information database on market prices for goods (works, services), conducting tax audits as well as assessing and collecting taxes and penalties as a result of price adjustments.

The customs authorities are generally responsible for monitoring transactions on certain imported goods, maintaining an information database on customs

declarations, providing information to the tax authorities on the monitored goods, participating with the tax authorities in tax audits as well as assessing and collecting customs payments and penalties as a result of price adjustments.

Transfer pricing audits are normally carried out within the scope of regular tax audits. In practice, transfer pricing audits may last from 30 working days to as long as one year.

#### **4207 Revised assessments and the appeals procedure**

Taxpayers have the right to appeal the transfer pricing adjustments at the higher level tax authority, up to the Tax Committee of the Kazakhstan Ministry of Finance. Should the outcome of the appeal with the tax authorities be unsatisfactory, taxpayers can further appeal the assessments in Kazakhstan courts (taxpayers have the right to appeal directly to courts as well). Certain foreign subsurface users operating in Kazakhstan have the right to appeal through international arbitration (e.g. UNCITRAL).

#### **4208 Additional tax and penalties**

As a result of the application of the Transfer Pricing Law, the tax authorities can make adjustments to prices leading to the additional assessment of taxes, including corporate income tax, value added tax, excise, royalty and excess profits tax for subsurface users, and customs payments.

The Kazakhstan Code of Administrative Violations does not provide for specific fines for the violation of transfer pricing legislation. Generally, as a result of transfer pricing adjustments, the taxpayers are penalised based on the provision for underreporting taxes in tax returns, which is calculated at 50% of the additionally assessed tax.

Interest penalties also apply at the annual rate of 27.5% (currently) for each day of delay of the tax payment.

#### **4209 Resources available to the tax authorities**

The tax and customs authorities carry out the transfer pricing control using the following tools:

- Monitoring of certain transactions (i.e. gathering detailed information on the sale/purchase of certain goods and services);
- Carrying out transfer pricing audits;
- Enquiries to the parties of the transaction, any third parties directly or indirectly involved in the transaction as well as the competent authorities of the other jurisdictions involved.

The tax and customs authorities are also maintaining databases on export/import prices of goods and services. However, these are not available for public use.

#### **4210 Use and availability of comparable information**

The Transfer Pricing Instruction establishes the list of official sources of information on market prices, and taxpayers whose transaction prices conform to prices from the official sources appear to be safeguarded from transfer pricing adjustments in practice.

However, these information sources mostly quote commodities' prices. With respect to other goods and services (including intangibles), the availability of comparable information is very limited or of a low quality.

#### **4211 Risk transactions or industries**

Based on practical experience, the most risk-intense types of transactions from a transfer pricing perspective involve subsurface use operations (i.e. export of oil and other commodities) and the financial sector.

#### **4212 Limitation of double taxation and competent authority proceedings**

Although the majority of double tax treaties concluded by Kazakhstan contain provisions on competent authority proceedings, the Kazakhstan tax authorities have not applied them regularly in practice. In part, this is due to the fact that Kazakhstan transfer pricing legislation in many areas contradicts OECD transfer pricing Guidelines, thus making the competent authority proceedings difficult to achieve with the majority of Kazakhstan trading countries.

#### **4213 Advance pricing agreements (APAs)**

Kazakhstan transfer pricing legislation does not contain OECD equivalent APA procedures. Instead, according to the Transfer Pricing Law, Kazakhstan taxpayers have the right to provide the tax and customs authorities with the economic substantiation of the applied price/pricing formula in advance. Such economic substantiation would need to be supported by relevant documentation. Further, based on the Transfer Pricing Instruction, the authorities within one month should send the taxpayer an official response letter regarding the presence/absence of price deviations from the market price.

However, in practice, APAs are not being pursued by taxpayers for the simple reason that they are not binding under the transfer pricing legislation.

#### **4214 Anticipated developments in law and practice**

After six years of reform efforts made by the investment community, it appears that the government is demonstrating a willingness to consider substantive amendments. As a result, a completely new draft Transfer Pricing Law is currently under consideration by the deputies of the Kazakhstan Parliament.

Although the outcome is unclear, there appears to be growing acceptance among certain deputies that the existing transfer pricing legislation requires a substantive revision in accordance with the OECD principles, rather than the cosmetic changes contained in the previous draft Transfer Pricing Law proposed by the Government earlier in 2006.

Notable changes suggested in the new draft law developed with the assistance of PricewaterhouseCoopers include:

- Introduction of the arm's length concept;
- Limitation of the transfer pricing control by the authorities to transactions between related parties and transactions with companies registered in jurisdictions with privileged taxation;



- Reference to the OECD Guidelines on transfer pricing where the law is silent or unclear;
- Introduction of an effective APA mechanism (i.e., no price adjustments in case of an APA, procedures for conclusion of an APA, terms of an APA, etc.);
- Use of a range of market prices versus a single (average) market price;

#### **4215 Liaison with customs authorities**

Although both tax and customs authorities are assigned as competent authorities under the Transfer Pricing Law, they do not appear to effectively co-ordinated with each other on transfer pricing matters in practice. This often results in assessments of a different taxable base for customs and tax purposes (i.e. higher taxable base for purposes of calculating customs payments and lower base for purposes of corporate income tax deductibility).

#### **4216 OECD issues**

Kazakhstan is not a member of the OECD and Kazakhstan tax and customs authorities are not bound by the OECD Guidelines on transfer pricing. However, due to the limited transfer pricing provisions in the domestic legislation, the tax authorities might refer to the OECD Guidelines for guidance or alternative solutions (unofficially).

#### **4217 Joint investigations**

The Kazakhstan tax authorities may conduct joint investigations on transfer pricing matters within the Eurasian Economic Community (EEC) along with Russia, Kyrgyzstan, Tajikistan and Belarus.

The Kazakhstan tax authorities may also request information on transfer pricing from the competent authorities of other states with which Kazakhstan has signed double tax treaties (currently 37 states).

Otherwise, the information on joint investigations is limited and not publicly available.

#### **4218 Thin capitalisation**

Kazakhstan tax authorities do pay attention to the interest rate levels deducted for Kazakhstan corporate income tax purposes. Transfer pricing control is used in addition to the debt to equity ratio limitations established in the Kazakhstan tax legislation.

In practice, the tax authorities were able to successfully challenge the interest rate levels deducted by one of Kazakhstan's largest banks in a well publicised transfer pricing court case.

#### **4219 Management services**

In practice, management services are subject to scrutiny by the tax authorities. However, we have not seen large transfer pricing adjustments in respect of management services. This is likely because the Kazakhstan tax authorities are not yet very experienced in evaluating the pricing of services and intangibles.

# 43 Korea

## 4301 Introduction

Since the introduction of the Korean transfer pricing regulations, transfer pricing has become one of the most important international tax issues concerning taxpayers engaged in cross-border inter-company transactions. The Korean transfer pricing regulations are based on the arm's length standard and are generally consistent with the OECD Guidelines. The Korean transfer pricing regulations prescribe transfer pricing methods, impose transfer pricing documentation requirements and contain provisions for advance pricing agreements (APAs) and mutual agreement procedures (MAPs).

There have been numerous amendments made to the transfer pricing regulations over the years. Significant revisions have included expansion in the definition of special relations (i.e. scope of related parties), introduction of the concept of an arm's length range and changes to provide taxpayers with increased flexibility on tax appeals, APAs and MAPs. The most recent amendments include:

- introduction of formal regulations on cost contribution arrangements, transfers of intangible assets and intra-group services;
- simplification of secondary adjustments on transfer pricing adjustments made on transactions between a resident and foreign affiliate;
- revision of rules for MAPs; and
- recognition of the Berry ratio as a transfer pricing method.

In recent years, the Korean National Tax Service (NTS) has made the enforcement of transfer pricing compliance a high priority. Field examiners have undergone training to enhance their transfer pricing examination and audit capabilities. Transfer pricing has become a routine part of a tax audit.

## 4302 Statutory rules

The Korean transfer pricing regulations are contained in the Law for the Coordination of International Tax Affairs (LCITA), which was enacted on 1 January 1996. The LCITA stipulates that transfer prices should be consistent with arm's length prices.

The transfer pricing methods specified in the LCITA and underlying Presidential Enforcement Decree are listed in order of priority below:

- comparable uncontrolled price method, resale price method or cost plus method;
- profit split method, transactional net margin method or Berry ratio method; and
- other unspecified methods.

Transfer prices should be supported by the most reasonable transfer pricing method while giving consideration to the order of method priority.

The regulations also contain transfer pricing documentation requirements. There are primary documentation requirements and secondary documentation requirements.

Primary documentation requirements relate to transfer pricing documentation that taxpayers are required to submit each year as part of their corporate tax return. Primary documentation includes:

- (1) Declaration of transfer pricing method;
- (2) Summary of international transactions; and
- (3) Summary of income statements of overseas affiliates.

The 'Declaration of Transfer Pricing Method' form requires the taxpayer to report the transfer pricing method or methods used to set or determine its transfer prices. In addition, the taxpayer is also required to provide an explanation of why that particular method was selected. The transfer pricing method should be the most reliable method among those available and should justify the arm's length nature of the taxpayer's transfer prices.

The 'Summary of International Transactions' form provides the NTS with a summary of the taxpayer's inter-company transactions, according to transaction counterparty and type of transaction. Taxpayers are required to report the following: (a) the name of each overseas related party with which the taxpayer engages in transactions; (b) the relationship between the taxpayer and the overseas related party; (c) a description of the nature of the transaction; and (d) the amount of the transaction.

Effective from 1 June 1998, the 'Summary of Income Statements of Overseas Affiliates' requires a taxpayer to submit the income statement of each overseas affiliate with which it engages in transactions. The overseas affiliate income statements should be submitted for the most recent tax year and should be prepared to the profit before tax level. In addition, the taxpayer should indicate the primary business activities of the overseas related parties and the taxpayer.

Taxpayers are also required to provide the NTS upon request with other documentation that supports the arm's length nature of their transfer prices. Secondary documentation include inter-company agreements, corporate transfer pricing policies, organisational charts, financial statements segmented by business, product line or function, description of business, selection and application of the transfer pricing method, and any other documents that may be useful to evaluate the arm's length nature of a taxpayer's transfer prices.

Taxpayers are required to submit transfer pricing documentation to the NTS within 60 days of the request, although, a one-time 60 day extension is allowed upon the application. During a tax audit, however, secondary documentation, as well as any other supporting documentation, must be promptly provided since the duration of tax audits are often very short, and the auditors want to resolve all issues within the short timeframe.

In addition to transfer pricing, the LCITA also covers:

- interest paid to a controlling overseas shareholder;
- corporate income retained in a tax haven;
- offshore gifts; and
- international cooperation by the tax administration.

### **4303 Other regulations**

The LCITA supersedes all previous domestic corporation tax laws and transfer pricing

guidelines published by the NTS.

On 15 June 2004, the NTS issued basic tax rulings under the LCITA, which are intended to provide guidelines for interpretation of the LCITA in accordance with internationally accepted rules and standards for taxation. These basic tax rulings consist of 31 sections and are the first to be applicable to the LCITA since its enactment. The key highlights of the basic tax rulings include sections on deductibility of management service fees, factors when selecting comparable transactions, applying the comparable uncontrolled price method or the resale price method, situations for applying the Berry ratio method, and secondary adjustments on unrepatriated transfer pricing adjustments. These basic tax rulings are effective from 15 June 2004.

In addition, the NTS issues official rulings upon request by taxpayers. Although these rulings are interpretations of the law for a specific case and are not legally binding, they are usually applied to other similar cases. The rulings, therefore, provide useful practical guidelines and are very influential.

#### **4304 Legal cases**

There have been a handful of legal cases involving transfer pricing and very little information on these cases is publicly available. Some cases have been settled out of court, some cases are currently pending in domestic appeals and other cases have proceeded to competent authority.

#### **4305 Burden of proof**

Korean tax law does not clearly specify where the burden of proof lies with regard to supporting or challenging transfer prices. By law, however, a taxpayer is required to report and justify the transfer pricing method(s) used to set or evaluate its transfer prices each year, at the time of filing its tax return. If the taxpayer has submitted proper documentation, the NTS must demonstrate why the taxpayer's transfer prices are not at arm's length and propose a transfer pricing adjustment in order to challenge the transfer prices of a taxpayer. Once the NTS has proposed an alternative transfer pricing method and adjustment, it is then up to the taxpayer to defend the arm's length nature of its transfer prices.

In the event that a taxpayer does not provide the NTS with proper transfer pricing documentation at the time of filing its tax return, the burden of proof will fall on the taxpayer to demonstrate the arm's length nature of its transfer prices.

#### **4306 Tax audit procedures**

##### *Selection of companies for audit*

In general, the NTS reviews tax returns, including transfer pricing related documentation, to identify taxpayers that demonstrate a high likelihood that they are not in transfer pricing compliance. The NTS will then request further information from these identified taxpayers for review. The failure to submit transfer pricing related data required by the LCITA will increase the likelihood of selection for audit. Taxpayers are also generally subject to audit every five years based on the tax statute of limitations.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Tax authorities can request any relevant information for their audit, e.g. contracts, price lists, cost data of manufactured goods, accounting principles used, organisation charts, mutual investment agreements, etc.

Since it is likely that the attitude of the taxpayer will affect both the outcome of the audit and/or the size of any adjustment, it is important during the negotiation process that taxpayers do not offend the tax authorities by being uncooperative. Thus, taxpayers are effectively obligated to provide the requested information in order to avoid any possible adverse consequences, which could otherwise arise.

### *Secondary adjustments*

A uniquely problematic aspect of the Korean transfer pricing regulations is the concept of secondary adjustments. Secondary adjustments are additional tax treatments that occur if a transfer pricing adjustment is not repatriated back to Korea. Most secondary adjustments is treated as deemed dividend subject to withholding taxes at the rate specified in either the corporate tax law or applicable treaty.

### *Transfer pricing review committee*

On 30 June 2005, the NTS announced the establishment of a Transfer Pricing Review Committee (TPRC) to review proposed transfer pricing adjustments prior to finalisation of the tax audit. Under the auspices of the Assistant Commissioner for International Taxation, the TPRC is intended to help ensure that taxpayers are treated fairly and consistently with respect to transfer pricing assessments. The TPRC is responsible for reviewing proposed adjustments that are in excess of KRW1 billion or disputed by a taxpayer. The TPRC may also review proposed transfer pricing adjustments arising in other situations on a case by case basis.

## **4307 Domestic tax appeals procedure and MAPs**

There are a variety of domestic appeal options available to taxpayers including Pre-Assessment Notice Protest to district, regional or head office of the NTS, Request for Investigation to the NTS, Request for Adjudication to the National Tax Tribunal (NTT) or Appeal to the Board of Audit and Inspection (BOAI). The most common forum for domestic tax appeals is the NTT. Taxpayers may only pursue court litigation after an appeal to the NTS, NTT or BOAI.

Most transfer pricing disputes go the MAPs. There are several reasons for this. First taxpayers initiating MAPs may apply for a suspension of the payment of a tax assessment. This option is not available to taxpayers pursuing domestic tax appeals, except in very limited circumstances. Second, pursuing MAPs increases the likelihood of obtaining relief from double taxation and waiver of underreporting penalties. Finally, MAPs are generally more compelled to rely on generally accepted rules and standards.

## **4308 Additional tax and penalties**

The tax law provides for penalties where there is an understatement of the tax base and an underpayment of tax. These rules also apply in the case of transfer pricing. However, the LCITA provides that the penalty for understatement will not apply in situations where a taxpayer has taken due care, and that care is proven or verified during MAPs.

The following penalties may be imposed depending on the type of taxpayers' obligations under related tax laws, which the taxpayer failed to fulfil.

#### *Failure to file tax returns or to keep books of account*

If the taxpayer does not file tax returns within the time limit prescribed by the Corporate Income Tax Law (CITL), or the obligation to maintain or keep books of account has not been performed, the taxpayer will be subject to the following penalties:

- (1) In cases of intentional failure to file corporate tax returns, the penalties shall be the larger of:
  - (a) 40% of the computed corporate income tax amount determined by the government; or
  - (b) 0.14% of the revenue.
- (2) In cases other than (1) in the above, the penalties shall be the larger of:
  - (a) 20% of the computed corporate income tax amount determined by the government; or
  - (b) 0.07% of the revenue.

#### *Under-reporting of the tax base*

Penalty tax on the under-reported tax base is imposed on the difference between the correct tax base, which should have been reported under the CITL, and the tax base actually reported at the time of filing the tax return. The amount of penalty to be imposed shall be as follows:

- (1) In cases where the total reported tax base has been intentionally reduced, the penalties shall be the larger of:
  - (a) 40% of the corporate income tax corresponding to the total under-reported tax base; or
  - (b) 0.14% of the total under-reported tax base.
- (2) In cases other than (1) in the above, the penalties to be imposed shall be 10% of the taxes on the under-reported tax base. If there is no tax calculated, however, no penalties will be imposed.

#### *Penalty for non-payment or insufficient payment*

If a taxpayer fails to pay tax or makes an underpayment of taxes due, the taxpayer will be subject to penalties as determined by applying the interest rate prescribed by the CTL, which is determined in consideration of the default interest rate of financial institutions and number of days that the taxes have not been paid. The current applicable interest rate is 10.95% per annum (18.25% before 2003).

#### *Penalty on non-compliance with the request for submission of information*

The LCITA stipulates penalties for the failure to comply with a request for submission of information.

If a taxpayer is requested to submit transfer pricing related information but fails to do so, the NTS will deny the submission of this information at a later time, i.e. when

filing a tax appeal or in the course of the MAPs.

In addition, if a taxpayer is requested to submit transfer pricing related information but fails to do so within the due date without any justifiable reason or submits false information, the taxpayer is subject to a penalty for negligence up to KRW30 million for each instance of failure.

#### *Penalties in practice*

Under the CITL, the government automatically imposes related penalties when taxpayers fail to meet specified obligations. There are generally no exceptions, i.e. there will be little chance of negotiating penalties between taxpayers and the government. Under the LCITA, however, it is more likely that the NTS will consider the taxpayers' situation and sincerity when imposing penalties.

#### **4309 Resources available to the tax authorities**

The Division of International Taxation is an office of the NTS, which provides support to the regional tax offices on transfer pricing matters. Investigations are conducted with the assistance of the relevant department experts.

#### **4310 Use and availability of comparable information**

Taxpayers may use various forms of comparable information to support their transfer pricing policies, including internal as well as third party data. There are several company directories and electronic databases available in Korea, which contain detailed information and data on Korean companies.

#### **4311 Risk transactions or industries**

The LCITA states that any transaction with an overseas affiliate may be subject to a transfer pricing adjustment. Recently, the NTS has aggressively challenged royalty payments and management service fees. The NTS will also closely scrutinise transactions with affiliates located in tax haven countries. The NTS has also conducted industry-wide tax audits (pharmaceutical, tobacco, newspaper, private equity, etc). Certain situations will also draw the attention of the tax authorities, such as distributors incurring operating losses or changes in transfer pricing policy which reduce the amount of taxes paid.

#### **4312 Limitation of double taxation and MAPs**

The LCITA contains detailed mutual agreement procedures. Taxpayers may use these procedures to seek relief from double taxation.

#### **4313 Advance pricing agreements (APAs)**

The Korean APA program was launched on 1 January 1997. Taxpayers may apply for unilateral or bilateral APAs. There is no limitation on the number of years that can be covered by an APA but most applications cover a five year period. For taxpayers seeking a bilateral APA, it may also be possible to roll-back the results of the APA to open tax years.

An application for an APA needs to be made prior to the taxable year for which the APA is being sought.

In order to apply for an APA, a taxpayer must complete and submit a formal application that describes the transactions for which the APA is being requested, the overseas affiliates involved, the transfer pricing method to be applied and the period requested to be subject to the APA. In addition, the taxpayer will need to provide a description of its business activities and organisation structure as well as the financial statements and tax returns for the parties to the transactions for the most recent three years. It may be possible to avoid the submission of some information if it can be clearly demonstrated that the information is irrelevant.

It should be noted that after the terms of the APA have been finalised, the results are legally binding on the NTS but not the taxpayer. In other words, if the taxpayer's transfer prices are determined to be within the range previously agreed to with the NTS, the NTS cannot make an adjustment. The taxpayer, however, is not required or bound to meet the conditions of the APA.

The taxpayer has the right to withdraw or modify his or her request for the APA at any time prior to obtaining the NTS' final approval. In the event that a taxpayer decides to withdraw his or her application for the APA, all submitted data will be returned to the taxpayer without further consequences.

Advance pricing agreement requests are completely confidential and data submitted to the NTS will only be used for the purposes of reviewing APA requests and performing follow-up management.

As in other countries, APAs allow Korean taxpayers to obtain certainty on the acceptability of transfer prices, eliminating the risk of penalties and double taxation. Additional benefits of applying for APAs include the possibility of obtaining the assistance of foreign tax authorities to help persuade the NTS of the reasonableness of the request, and the opportunity to negotiate with high level NTS staff rather than regional tax office personnel (as in the case of an audit). In addition, the NTS is much more willing to negotiate during a request for an APA than during a tax audit or MAP. The number of APA requests is anticipated to increase significantly over the next several years. Advance pricing agreements are actively promoted by the NTS.

#### **4314 Anticipated developments in law and practice**

Each year, the NTS releases revisions or updates to the LCITA, based on feedback it receives from taxpayers and tax agencies.

#### **4315 Liaison with customs authorities**

While the NTS and Korea Customs Service both fall under the jurisdiction of the Ministry of Finance and Economy, there is no formal connection between the two agencies. As such, transfer prices are evaluated by the Korean tax and customs authorities, independently of each other. Both authorities, however, have expressed a strong willingness to work together for consistency and reconcile differences.

#### **4316 OECD issues**

Korea is the 29th member of the OECD. The Korean transfer pricing regulations are largely based on the OECD Guidelines.



**4317 Joint investigations**

It does not appear that the NTS has teamed up with other tax authorities for the purposes of undertaking a joint investigation into transfer prices.

**4318 Thin capitalisation**

As noted above, the LCITA also covers the payment of interest to a controlling overseas shareholder.

# 44 Latvia

## 4401 Introduction

The adoption of the Latvian Corporate Income Tax (CIT) Act in 1995 established a requirement that transactions with related parties comply with the arm's length principle. Since then the development of transfer pricing (TP) law has been relatively slow. However, recently the Latvian State Revenue Service (SRS) has started to tackle the TP issue actively by developing a set of supporting regulations. Accordingly, the Latvian TP legislation and practice are currently at a developmental stage.

## 4402 Statutory rules

The TP area in Latvia is governed by the following legislation:

- the Taxes and Duties Act (Section 23)<sup>2</sup>;
- the CIT Act (Section 12);
- the Commercial Code (Section 182); and
- the Cabinet of Ministers' 4 July 2006 Rule 556, 'Application of the CIT Act' (CIT Rule).

### *Transactions*

Latvian law requires that foreign related party transactions meet the arm's length standard. Furthermore, the CIT Act requires TP adjustments for a non compliant transaction between two Latvian companies that belong to the same group (i.e., direct or indirect ownership of at least 90% is required).

Taxable income specifically for CIT purposes must be adjusted if the price applied to any of the following related party transactions differs from its arm's length value:

- fixed assets, goods or services sold at prices below market prices; and
- fixed assets, goods or services bought at prices above market prices.

The Taxes and Duties Act states in determining the market price or value of a transaction that any discounts and mark ups applied to transactions between unrelated parties should be taken into account, as well as any pricing changes driven by the following factors:

- demand fluctuations due to seasonality or other factors;
- differences in the quality or characteristics of goods or services;
- expiry of the sell buy date;
- marketing policy on placing new products in the market or placing products in a new market; and
- sales of samples and demo versions to attract customers.

The Taxes and Duties Act provides for a wider application of the arm's length principle than only between foreign related parties. A tax audit may examine and adjust the

price of the following transactions:

- transactions between related parties;
- barters and set offs;
- price deviations exceeding 20% of prices that a taxpayer had applied to similar goods or services over a short period; and
- exports and imports.

#### **4403 Other regulations**

##### *Calculating an arm's length price*

The CIT Rule prescribes five TP calculation methods that are consistent with the OECD Guidelines:

- (1) traditional transaction-based TP methods:
  - (a) the comparable uncontrolled price method;
  - (b) the resale price method; and
  - (c) the cost plus method;
- (2) transactional net profit methods:
  - (a) the transactional net margin method; and
  - (b) the profit split method.

Along with the OECD Guidelines, the CIT Rule gives a preference to the three traditional transaction-based methods, whereas the transactional profit methods are to be used only when all of the traditional transaction-based methods are inadequate or inapplicable.

##### *TP documentation requirements*

Latvian law currently does not require Latvian companies to have appropriate TP documentation in place that provides a reasonable calculation of prices applied to related party transactions.

It was expected that the specific documentation rules would be adopted some time in early 2008; however, these are still in preparation and the prospective adoption of the documentation rules is unknown.

##### *Reporting related party transactions*

Latvian taxpayers are required to report transactions with related parties on a special form as an attachment to their annual CIT return.

#### **4404 Legal cases**

Latvia has no established TP practice as the Latvian tax authorities are still experiencing a learning curve in this field. The SRS has made several TP adjustments, but there are no legal cases on TP issues yet.

#### **4405 Burden of proof**

The Tax and Duties Act places the burden of proof in tax matters, including TP, firmly on the taxpayer. A tax decision issued by the SRS has to state only the basis for adjusting tax payment and calculating penalties. The taxpayer then has to provide proof to challenge the decision.

#### **4406 Tax audit procedures**

In Latvia, TP is audited as part of a regular tax audit, which generally may cover up to three previous tax years. The SRS generally tends to challenge TP with taxpayers showing low profits.

The SRS must give a taxpayer ten days written notice of a decision to conduct a tax audit. The notice must state the commencement date and duration of a tax audit, as well as taxes and duties and tax periods subject to the tax audit.

A tax audit cannot take longer than 90 days, unless the SRS Director General sanctions an extension. The duration of a tax audit may be extended by 30 days if additional information is required and by 60 days if such additional information has to be requested from foreign tax authorities or foreign companies. Any period between the date an information request is made and the date it is received will be excluded from the extension.

These temporal limitations do not apply to simultaneous tax audits in which the SRS liaises with the tax authorities of a foreign country in which the related party of a Latvian entity is registered as a taxpayer.

Upon completion of a tax audit, the SRS must provide the taxpayer with an audit report that sets out the results of the audit. If any tax offence is identified, the SRS will prepare a decision about increasing the tax liability to include additional taxes and penalty.

#### **4407 Revised assessments and the appeals procedure**

If a tax audit has resulted in an additional liability, the taxpayer must pay it, together with any penalty, within 30 days of receiving a tax decision, or the taxpayer may challenge the decision by appealing to the superior official. If the taxpayer does not agree with a decision of the SRS Director General, the highest tax official, then the decision may be taken to court.

#### **4408 Additional tax and penalties**

From 1 January 2007, a new tax penalty system has been established by the Taxes and Duties Act and from 4 March 2008 tax penalties have been slightly reduced prescribing the following penalty levels:

- (1) If the tax charge for the period under review has been understated by:
  - (a) up to 15% of the tax charge, there is a possible penalty of 30% of the total tax liability that should have been reported; or
  - (b) more than 15% of the tax charge, there is a possible penalty of 50% of the total tax liability that should have been reported.

- (2) If the revenue authorities find that the taxpayer has previously understated a tax charge (a repeat offence), there is a possible penalty of 70% of the total tax liability that should have been reported.
- (3) If a taxpayer who has already committed a repeat offence commits one or more similar offences within three years, there is a possible penalty of 100% of the tax that should have been reported for each of these subsequent offences.

The SRS Director General may decide to reduce the penalty if the taxpayer admits an offence and pays the unreported tax and penalty of 15% of the total tax liability that should have been reported within 30 days of receiving the SRS decision on the tax audit results.

#### **4409 Resources available to the tax authorities**

The SRS has established a separate central team specialising in TP issues. If regional tax auditors face a difficult TP issue or if their decision is appealed, then they may seek assistance from the central TP team.

#### **4410 Use and availability of comparable information**

The SRS has acquired the Van Dijk Bureau database '*Analyse Major Databases from European Sources*' (AMADEUS) to be able to perform independent benchmarking.

The Taxes and Duties Act also provides that if the price of a transaction is not at arm's length, then the tax authorities may determine during a tax audit the market price of the transaction, relying on the following methods and information sources:

- internal comparables of the taxpayer;
- prices and values that independent companies have applied in similar transactions;
- calculating the costs of the transaction and adding a mark-up calculated in line with the industry average financial results derived from either the Latvian Central Statistical Office database or the tax authorities' own databases;
- using the average price of similar goods as provided by the Central Statistical Office; and/or
- engaging an independent valuation expert.

#### **4411 Risk transactions or industries**

- In the absence of developed TP auditing practices, there is no particular industry or transaction having any larger TP risk than others, qualifying for exemption, or governed by stricter rules than others.
- However, transactions involving a related provider of services, especially management services, or intellectual property are more likely to be scrutinised. These transactions are typically challenged on the grounds that the underlying contracts or other supporting documents are inadequately formalised.
- Recent cases show that tax authorities tend to challenge the TP adjustments of tax payers even if the TP documentation is in place.

#### **4412 Limitation of double taxation and competent authority proceedings**

- Almost all double tax treaties contain a clause relating to competent authority proceedings, (i.e., mutual agreement procedures). However, there is no information about the SRS involvement with competent authority proceedings, because no such information is published.

#### **4413 Advance pricing agreements (APAs)**

There are no provisions enabling taxpayers to enter into APAs with the SRS. However, the Cabinet of Ministers has drafted a rule that prescribes an APA application procedure.

The Administrative Proceedings Act entitles a person to seek an advance ruling regarding the exercise of his rights in specific legal circumstances, including the application of TP law.

In practice, however, this procedure is more likely to be used to substantiate the application of a particular TP method or provision of law, rather than negotiating advance approval for a specific TP situation.

An advance ruling is not binding on the requesting party, but it is binding on the issuing government agency, which may not change its position to one that is less favourable for a taxpayer, even if the legal opinion contained in the ruling is subsequently shown to have been incorrect.

#### **4414 Anticipated developments in law and practice**

As stated above, the Cabinet of Ministers has two draft rules in preparation, one of which prescribes an APA application procedure and the other governs TP documentation requirements.

#### **4415 Liaison with customs authorities**

The State Revenue Service is the main body for tax administration and customs authority. Thus, there are no obstacles to co-operation and information exchange between tax authorities and customs authorities.

#### **4416 OECD issues**

Latvia is not yet an OECD member, but has committed itself to joining the OECD by 2010.

Given that the arm's length principle and Latvian TP rules are borrowed from the OECD Guidelines, the SRS has expressed its willingness to adopt the principles set out in the guidelines. As a result, the CIT rule that came into force on 1 July 2006 contains a paragraph stating that the OECD Guidelines may be used in selecting and applying methods for determining the arm's length price or value.

#### **4417 Joint investigations**

The SRS practices information exchange with foreign tax authorities in line with Latvia's double tax treaties. However, there is no publicly available information about the results of joint investigations that took place as a result of information exchange.

**4418 Thin capitalisation**

Latvian thin capitalisation rules are contained in the CIT Act to prevent companies from being highly leveraged and distributing profits through interest payments to shareholders and third parties. A taxpayer must comply with the following restrictions on interest deductions:

- Taxable income should be adjusted for interest payments exceeding the amount of interest calculated by applying to the interest bearing liability 1.2 times the average short-term interest rate of credit institutions as determined by the Central Statistical Office for the last month of the tax year; and
- Taxable income should be adjusted for the amount of interest in proportion to the excess of the average interest bearing liability over an amount equal to four times shareholders' equity at the beginning of the tax year, less any revaluation reserve. If the shareholder's equity is negative, for calculation purposes it is assumed to be zero.

If taxable income must be adjusted under both criteria, the larger of the two adjustment amounts would apply.

These rules are neither applied to banks and insurance companies, nor to payments of interest on loans or financial lease services acquired from EU-registered credit companies, the State Treasury, the World Bank, the Nordic Investment Bank or Latvian residents.

**4419 Management services**

When auditing intra-group services, tax auditors will analyse two key questions, namely (1) whether an intra-group service has in fact been provided and, if so, (2) what charge for that service is consistent with the arm's length principle.

To prove the existence of a management services transaction, a contract and/or an invoice might be insufficient. The taxpayer should also prepare a memorandum of delivery and acceptance explaining the nature and amount of service and confirming that the services have been acquired and approved by both parties. Also, it is useful to retain other documents, such as meeting notes or reports prepared during or as a result of consultation.

# 45 Lithuania

## 4501 Introduction

The arm's length principle was only introduced in Lithuania by the Corporate Tax Act of 20 December 2001. Little attention was paid to transfer pricing before this time. The OECD Transfer Pricing Guidelines have been carried over into Lithuania's domestic transfer pricing legislation, although in a more condensed form, and with a somewhat clearer stance on a number of questions.

## 4502 Statutory rules

The definition of related parties includes, inter alia, a) members of a group consisting of a parent and one or more of its 25% or greater subsidiaries, b) two entities if one of them directly or indirectly controls over 25% of the shares in the other entity, or has the right to over 25% of voting rights of the other entity, or has an obligation to coordinate its business decisions with that entity, or is under an obligation to third parties for the obligations the entity c) two entities where one has the right to make decisions that bind the other. The term 'associated parties' to which transfer pricing rules also apply, covers all entities which may influence each other as a result of which conditions in transactions between them differ from those which would occur if each entity were acting to maximise its own profit (i.e. there is no requirement to have shareholding or voting ties).

## 4503 Other regulations

In 2007, the Tax Authorities issued official recommendations on transfer pricing "For tax payers about transfer pricing". These recommendations are based on the OECD Transfer Pricing Guidelines.

## 4504 Legal cases

There are no prior court cases relating to transfer pricing.

## 4505 Burden of proof

By law, the tax authority needs to make a case for an adjustment. In practice, however, it is often the case that a comparatively simple opening argument results in the taxpayer having to make substantial effort to build a defensive case.

## 4506 Tax audit procedures

Tax audits are more likely following a refund claim, a tip-off or liquidation. There are two types of procedures – limited and full. Either procedure can cover either a specific tax or the whole range of taxes. There is a standard 90 day time limit on the duration of any investigation, although this can be extended. There is a five year statute of limitations.



**4507 Revised assessments and the appeals procedure**

The appeals process is firstly to the officer conducting the investigation, then to a more senior person at the tax office, followed by the commission for tax disputes and finally the courts. In practice, however, most disputes over reasonably grounded differences in interpretation are settled in comprise without litigation.

**4508 Additional tax and penalties**

There is a misdeclaration penalty of between 10% and 50% of the tax, the exact amount being discretionary. A penalty may be limited if there is no overall loss to the state budget, for example through a corresponding adjustment. In addition, there would be penalty interest calculated as 0.04% of the unpaid tax per day.

**4509 Resources available to the tax authorities**

There are only three persons specialising solely in transfer pricing within the tax authorities. This indicates that the authorities are not as experienced as many other EU tax authorities. There have been comparatively few public statements, or high profile investigations to date. However, recently they have started requesting the companies to submit the transfer pricing documentations for review within a 30 days (statutory) period.

**4510 Use and availability of comparable information**

The authorities already have direct access to the Amadeus database. They focus on adjustments to internal comparable uncontrolled prices, including analysis of margins and mark-ups on transactions between the taxpayer and unrelated parties. However, they are already reviewing the benchmarking studies as well. Lithuania is not an OECD member and local rules allow the use of secret comparables in certain cases.

**4511 Risk transactions or industries**

At present the most notable risk transactions are those involving various types of services or management fees. There are a number of benefit tests and emphasis placed on demonstrating the actual performance of a service.

**4512 Limitation of double taxation and competent authority proceedings**

Competent authority proceedings have not yet been frequently requested by taxpayers.

**4513 Advance pricing agreements (APAs)**

There is a tax ruling procedure which can be used to avoid penalties, and the system is in general sufficiently flexible to cover many aspects of transfer pricing. Currently the tax rulings are not binding and the tax authorities usually try not to provide detailed answers to the questions. However work continues at the level of the Ministry to set up the framework for a more formal APA system.

**4514 Anticipated developments in law and practice**

At present there are no penalties for failure to comply with documentation rules, but

it is possible that this may change. Furthermore, the appendix to the corporate tax return in which related party balances should be disclosed is expected to become clearer. At present there is uncertainty over precisely what information is being requested.

#### **4515 Liaison with customs authorities**

There is minimal interaction between inspectors responsible for direct tax and their colleagues in customs.

#### **4516 OECD issues**

Lithuania is not an OECD member but follows the organisation's guidelines closely with respect to interpretation of double tax treaties. However for transfer pricing, local rules take precedent, in the event of conflict with the OECD Guidelines. One example is the use of secret comparables, which is permitted by local legislation in certain cases.

#### **4517 Joint investigations**

At present, the Lithuanian authorities are not making extensive use of exchange of information opportunities.

#### **4518 Thin capitalisation**

Very broadly, interest on debt exceeding a 4:1 debt-equity ratio is disallowed (unless it can be proven that an unrelated party would have lent at higher gearing). Debt from persons who on their own or together with related parties own directly or indirectly 50% of the payer is considered. For the purposes of the calculation, year-end balances are used (unless the tax authorities deem these unrepresentative), and the definition of equity is the balance on the last day of the tax period, excluding the financial result of the period and certain revaluation reserves. Interest from unrelated banks is not subject to thin capitalisation restrictions, unless an associated enterprise guarantees the debt.

#### **4519 Management services**

Management services fall under particular scrutiny as historically, over the past 15 years, they have been seen by investors as simply a repatriation tool which does not require the legal procedures of a dividend and also offers a tax deduction. Tax authorities lacked the resources and commitment to challenge this practice effectively. For this reason, shared service centres and headquarters are facing increased documentation burdens and Lithuanian finance personnel are increasingly reluctant to take responsibility for the effects of any such charge, sometimes even adding it back for tax purposes regardless of substance.

The law specifically states that taxpayers should demonstrate that services were actually rendered, normally meaning objective tangible evidence such as reports or travel documents. There is also a benefit test, which appears to be an either/or rather than a cost to benefit comparison. Duplication of services is not permitted, which may inadvertently lead to difficulties in services which support or build on existing resources. Also of note is the non-deductibility of costs related to services which are

deemed to arise from merely being a participant in a group, possibly referring to the benefits of centralised purchasing and similar functions, although there is yet little practical experience of how this rule will be applied.

# 46 Luxembourg

## 4601 Introduction

Luxembourg has enacted tax legislation that addresses transfer pricing but has been little used to date.

## 4602 Statutory rules, other guidelines and legal cases

The statutory rule on transfer pricing is found in Article 56 of the Luxembourg Income Tax Code. This provides that where there is a transfer of profit rendered possible by the fact that a Luxembourg taxpayer has a special economic relationship with a non-resident, then the tax authorities may estimate the financial result. It is to be assumed that this provision would only be applied in a situation where the transfer of profit was away from Luxembourg. For example, this might be the case if a Luxembourg company paid heavily in excess of the market rate for a service provided to it.

Furthermore, if a shareholder receives an advantage from a company that the shareholder would not have received if there had not been a shareholding relationship, then this could be characterised under the Luxembourg Income Tax Code as a hidden distribution. Again, this might occur in a case where a shareholder charged a Luxembourg company heavily in excess of the market rate for a service provided by the shareholder. Such a hidden distribution would result in an add-back to the taxable profits of the Luxembourg company, and also possibly an obligation to account for withholding tax on the deemed distribution. The rate of withholding tax on a hidden distribution of dividends is 15% of the gross amount received (thus 17.65% of the net amount), unless reduced under the application of a double tax treaty or the EC Parent-Subsidiary Directive.

A further situation where intra-group pricing arrangements might be of concern to the Luxembourg tax authorities is where an advance agreement is to be sought from the tax authorities and such agreement is based on an assertion that one or more intra-group transaction flows will be undertaken at 'arm's length'.

The Luxembourg legislation does not give further guidance on how any transfer of profit or advantage to a shareholder is to be quantified, or what constitutes an 'arm's length' arrangement. Nor is there any case law on these issues.

However, it can reasonably be assumed that in any situation where the non-resident entity or shareholder is located in another OECD member country, then the Luxembourg legislation should be construed in conformity with the 'associated enterprises' Article of the relevant double tax treaty. Where the wording of such an 'associated enterprises' Article follows closely Article 9(1) of the OECD Model Tax Convention (which would normally be the case in double tax treaties concluded by Luxembourg), then further guidance given by the OECD on the use and interpretation of this Article can be assumed to have authority, and hence the OECD Guidelines should be regarded as giving important guidance in the Luxembourg environment in the case of any dispute.

**4603 Tax audits and resources available to the tax authorities**

Due to the relatively low profile of transfer pricing in Luxembourg, the tax authorities have no specialist resources for dealing with any transfer pricing issues. If any transfer pricing issues do arise, then they will be dealt with by the tax bureau that normally handles the taxpayer's affairs. However, the transfer pricing of all transactions and all industries is open to challenge, and in the event that the tax authorities seek to adjust a taxpayer's tax return, then the burden of proving that the adjustment is not valid lies with the taxpayer.

**4604 Availability of comparable information**

Luxembourg companies are required to make their annual accounts publicly available by filing a copy with the local court. However, the accounts do not necessarily provide much information on potentially comparable transactions or operations, since they do not normally contain much detailed financial information.

**4605 Advance pricing agreements (APAs)**

While there is no procedure for obtaining a formal APA, the tax authorities are quite flexible in this area, and advance agreements in writing are regularly obtained on an individual basis. Administrative circulars on the calculation of the cost plus tax basis for coordination centres, and on group finance companies, have been withdrawn. It is however possible to agree on a case by case basis with the tax authorities, an acceptable arm's length result for a spread on financing operations, or for other financing-related transfer pricing issues, if necessary, prior to the completion of a transaction. Similarly, advance agreements on royalty rates and other aspects of the structuring of intellectual property holdings are also possible. In discussing any advance agreement, it should be recognised that while the tax authorities have few resources at their disposal, their awareness of the commercial environment is very strongly developed. Hence in presenting any proposals for negotiation, well thought through but succinct documentation, supporting the reasonableness of the desired result, is always going to be of benefit.

It is not clear whether the Luxembourg tax authorities would be prepared to negotiate a bilateral APA. No such APAs have yet been negotiated.

# 47 Malaysia

## 4701 Introduction

With the rapid development in transfer pricing legislation globally and regionally, the Malaysian Inland Revenue Board (MIRB) introduced the Malaysian Transfer Pricing Guidelines (Transfer Pricing Guidelines) in July 2003. The Transfer Pricing Guidelines provide further guidance to taxpayers on the application of the arm's length principle espoused in the anti-avoidance provisions within the Malaysian Income Tax Act, 1967 (MITA). Consequently, taxpayers have a clearer direction in terms of acceptable transfer pricing arrangements as well as the extent of documentation required to be maintained.

The introduction of the Transfer Pricing Guidelines was followed by the setting up of a specialist group within the MIRB to deal with transfer pricing issues. Given the above focus by the MIRB, Multinational Companies (MNCs) should ensure that their transfer pricing policy with regard to their Malaysian entities meet the arm's length standard and appropriate documentation maintained as outlined in the Transfer Pricing Guidelines.

## 4702 Statutory rules

The legislative reference to transfer pricing in Malaysia can be found in the anti-avoidance provisions in Section 140 of the MITA which deals with the concept of 'dealing with one another at arm's length'. These provisions provide sufficient basis in ensuring that transfer prices between related parties are at arm's length.

The key implications of Section 140 in relation to transfer pricing can be summarised as follows:

- The Section is extremely wide and open for application by the MIRB in a multitude of situations involving both local and cross-border transactions;
- Section 140(6) is a deeming section, and consequently, if the MIRB can demonstrate that a transaction falls within the ambit of this Section, the anti-avoidance provisions in Section 140(1) can be automatically invoked;
- Although the burden of proof is on the MIRB, it can easily be shifted to the taxpayer; and
- There is no definition of the term 'arm's length' in the MITA.

Section 140 of the Malaysian income tax legislation will be used by the Malaysian tax authorities in adjusting any transfer pricing abuses. Section 140 allows the Director General to disregard transactions believed not to be conducted at arm's length and make the necessary adjustments to revise or impose tax liability on the persons concerned.

The tax authorities have indicated that since the issuance of the Transfer Pricing Guidelines, they would expect companies to have proper transfer pricing documentation to support their transfer pricing position upon enquiry. Otherwise, penalties would be imposed in addition to any additional taxes assessed as a result

of transfer pricing adjustments.

### *Arm's length principle*

As there is no definition in the MITA of what is meant by 'arm's length', the Transfer Pricing Guidelines provides clarity on both the concept and its application. The Transfer Pricing Guidelines acknowledges the arm's length principle as the preferred basis to be adopted in related party transactions and this is consistent with the internationally accepted arm's length principle advocated in the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (OECD Guidelines).

### *Meaning of 'control' and 'associated persons'*

To trigger any form of transfer pricing attention, the transactions under scrutiny need to be between associated persons or colloquially referred to as related parties. Generally, the relationship entails one party having control over the other, either directly or indirectly. There is no centric focus in the Transfer Pricing Guidelines on defining terms, however, paragraph 4.3 of the Transfer Pricing Guidelines refers to the definition of 'control' in the MITA.

The definition of 'control' lies in Section 139 which relates to persons who are associated with each other to an extent that 'control' can be imputed.

For the purposes of Section 2 of the MITA (Interpretation Section), a 'controlled company' is one having not more than 50 members and controlled, in the manner described by Section 139, by not more than five members.

The Transfer Pricing Guidelines offers a wider meaning to the term 'associated enterprise' than the MITA. Under the Transfer Pricing Guidelines, 'two enterprises are associated enterprises with respect to each other if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise; or the same persons participate directly or indirectly in the management, control or capital of both enterprises'.<sup>16</sup>

Based on the above, to be considered an associated enterprise or to infer control appears to be fairly easily caught within the lattice of the MITA or Transfer Pricing Guidelines.

### *Scope of the Transfer Pricing Guidelines*

The scope of the Transfer Pricing Guidelines clearly states that they are applicable to 'transactions between associated enterprises within a multinational where one enterprise is subjected to tax in Malaysia and the other enterprise is located overseas'.<sup>17</sup> The Transfer Pricing Guidelines also states that the scope covers 'transactions between a permanent establishment (PE) and its head office or its other related branches, as for purposes of the Malaysian Guidelines the PE will be treated hypothetically as a distinct and separate enterprise from its head office or its other related branches'.<sup>18</sup> However, in practice transfer pricing transcends to all entities that have transactions with another related entity, irrespective of geographic location. This would include transactions between two related entities within Malaysia, especially

<sup>16</sup> Paragraph 4.3.2 of the Transfer Pricing Guidelines.

<sup>17</sup> Paragraph 3.1 of the Transfer Pricing Guidelines.

<sup>18</sup> Paragraph 3.2 of the Transfer Pricing Guidelines.

in instances where the two entities have different tax attributes (e.g. tax losses, incentives). It should also be noted although the Transfer Pricing Guidelines do not carry the legislative authority, the disclosure in Form C as discussed below implicitly requires taxpayers to follow the principles set out in the Transfer Pricing Guidelines to meet the arm's length standard as stipulated in Section 140(6).

#### **4703 Legal cases**

No legal cases concerning transfer pricing have been decided by the courts to date. Thus far, any cases involving disputes on transfer pricing issues have been settled out of court and the details have not been published. In order to set examples, it is anticipated that the Malaysian tax authorities could bring cases involving abuses of transfer pricing to the courts in the future.

#### **4704 Burden of proof**

Under the Self Assessment System, the burden of proof lies with the taxpayer to clear any tax avoidance allegation and/or alleged transfer pricing abuse. The intention of the Transfer Pricing Guidelines is to assist the taxpayer in their efforts to determine arm's length transfer prices and at the same time comply with the local tax laws and the administrative requirements of the MIRB.

In this connection, upon a tax audit or enquiry, the relevant taxpayers with related party transactions must be able to substantiate with documents, and to the MIRB's satisfaction, that its transfer prices have been determined in accordance with the arm's length principle and that there has not been any abuse of the transfer prices resulting in an alteration of the incidence of tax in Malaysia.

#### **4705 Tax audit procedures**

##### *Form C*

In submitting their annual tax returns (i.e. Form C for companies), all taxpayers that have transactions with their related parties are required to complete Section N to declare their related party transactions for the year in the following categories:

- Total sales to related companies in Malaysia;
- Total sales to related companies outside Malaysia;
- Total purchases from related companies in Malaysia;
- Total purchases from related companies outside Malaysia;
- Other payments to related companies in Malaysia;
- Other payments to related companies outside Malaysia;
- Loans to related companies in Malaysia;
- Loans to related companies outside Malaysia;
- Borrowings from related companies in Malaysia;
- Borrowings from related companies outside Malaysia;
- Receipts from related companies in Malaysia; and
- Receipts from related companies outside Malaysia.



In addition, if the taxpayer is a controlled company, it will need to disclose the details of its five main shareholders in Part P of the Form C. The information provided will be used as one of the resources by the Malaysian tax authorities in selecting whether the company is a potential for a transfer pricing audit or tax audit. As the disclosure of related party transactions is part of the taxpayer's income tax return, failure to properly disclose information on its related party transactions could result in an incorrect tax return.

#### *Selection of companies for audit*

Upon issuance of the Transfer Pricing Guidelines, the Malaysian tax authorities have set up a special transfer pricing team that will principally focus on transfer pricing audits. It is the understanding that this team will be responsible for the selection of taxpayers for a possible transfer pricing audit.

Transfer pricing/tax audits can be triggered by a number of different factors, including:

- information disclosed in the Form C;
- outstanding tax enquiries;
- sustained losses;
- use of tax havens;
- comparison of various financial ratios achieved by a similar company within the same trade or industry;
- desk audit referrals;
- company's past compliance record;
- third party information;
- company is in a specific industry currently targeted by tax authorities;
- company is in the process of liquidation; or
- company has not been tax audited in the last six years.

Other relevant information from public sources, such as newspaper reports, can also trigger audits.

#### *The provision of information and duty of the taxpayer to co-operate with the tax authorities*

Pursuant to the MITA, the taxpayer must keep and retain in safe custody, sufficient records for a period of seven years from the end of the year to which any income from that business is related to, to enable that income from that business for each year of assessment or the adjusted loss from that business for the basis period for any year of assessment to be readily ascertained by the Malaysian tax authorities.

The Malaysian tax authorities have the right of full and free access to all buildings, places, books, documents and other papers for the purposes of the MITA. The Malaysian tax authorities may make requests for information with which the taxpayer must comply within a negotiated time frame. The company's level of co-operation in an audit is likely to influence the level of penalties imposed should a transfer pricing adjustment be made.

### *Documentation requirements*

Whilst there are no specific transfer pricing documentation requirements in the MITA, the general provision in the MITA (specifically Section 82) requires taxpayers to maintain appropriate documentation to support their transactions. Such records must be retained for a period of seven years.

The Transfer Pricing Guidelines have clearly stated the list of documents required for purposes of supporting and explaining the company's transfer prices.

However, the list is not meant to be exhaustive and the Malaysian tax authorities could request more documents, depending on the specific circumstances of the taxpayer. In that event, the taxpayer is advised to be prepared to provide relevant additional information or documents from what is already listed in the Transfer Pricing Guidelines.

Briefly, the list of documents stated in pages 30 to 31 of the Transfer Pricing Guidelines is divided as follows:

- Company details – ownership structure, company organisational chart, and operational aspects of the business;
- Transaction details – summary of the related party transactions, pricing policy, price breakdown, terms of the transactions, economic conditions at that time of the transactions, and any independent comparable transactions; and
- Determination of arm's length price – selection of pricing methodology, functional analysis and comparability analysis.

Although the Transfer Pricing Guidelines do not specify when such documents need to be prepared, under the Self Assessment System, taxpayers are generally expected to have appropriate and sufficient documentation when they submit their tax return (usually within seven months from their year-end). The transfer pricing documentation does not have to be submitted together with the tax returns but will have to be made available to the MIRB upon request. Such requests are usually a precursor to a desk audit or field audit to review the company's transfer prices.

In addition to the above documentation, the MIRB will usually request for additional supporting documents such as agreements, samples of transaction documents (invoices, purchase orders, shipping documents) as well as any other information relating to a specific transaction.

The Malaysian tax authorities have also noted that, in the context of a transfer pricing audit or tax audit, the Malaysian tax authorities may seek information from a treaty partner under an 'Exchange of information' Article where this facilitates the process of reviewing a taxpayer's compliance with the arm's length principle.

### **4706 The audit procedure**

As part of the Self Assessment System, the MIRB is expected to carry out tax audits, including transfer pricing audits, on taxpayers. One distinguishing factor under the Malaysian regime is that the transfer pricing review process tends to be carried out in conjunction with a field audit whereby there is greater scrutiny of transactions as opposed to the practice in other established countries where documentation review is generally carried out via a desk audit.

*Desk audit*

The transfer pricing audit process is generally initiated by a request for financial and management information such as the Statutory Accounts, Tax Computation, Management Accounts and Transfer Pricing Documentation, amongst other things. Based on the information provided, the MIRB will carry out a review of these documents and decide if a more detailed review is required.

In straightforward cases, the MIRB will either correspond with the taxpayer or request for a meeting to discuss any issues and work towards a closure of the case.

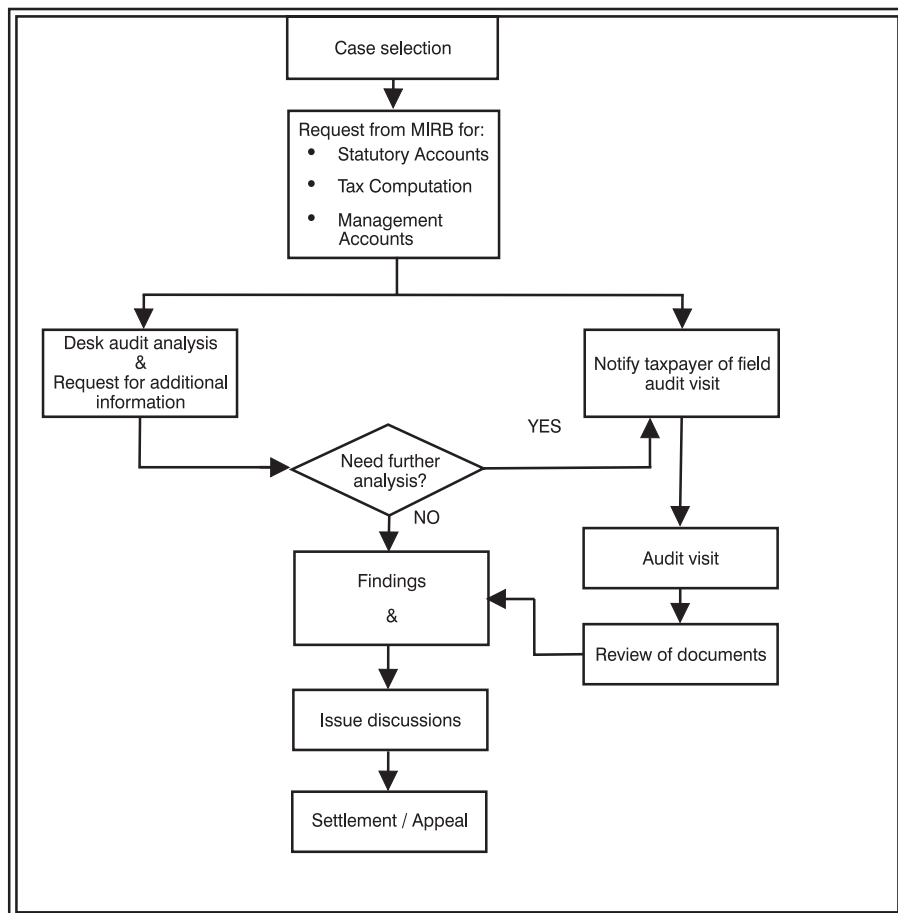
*Field audit*

If the MIRB's initial findings from the desk audit review warrants a field visit, the MIRB will inform the taxpayer accordingly of the purpose of their visit, the officers who will be carrying out the audit process, the duration of the visit and the documents that need to be made available for their review. Generally, field audit visits are carried out by four to six tax officers over a one week period. The officers will examine any financial documents, supporting documents and agreements that are linked to a taxpayer's business operations. As part of the field visit, the officers will also conduct interviews with the key personnel of the taxpayer's business to have a better understanding of the functional profile of the company and the pricing basis adopted. At the end of the field audit, the MIRB will summarise their initial findings and arrange for a follow up meeting at their offices to discuss the case.

The process is fairly structured with reasonable timeframe provided for the submission of documents and information as the MIRB is cognisant of taxpayers' concurrent business obligations. Furthermore, with the increasing number of audits carried out nationwide on a yearly basis, the review process is becoming routine for the MIRB even though the concept may still be novel to many taxpayers.

The diagram below depicts a typical audit process although there may be exceptions to the process depending on the taxpayer's circumstances.

## Audit Process



### Learning points from audits

Some common areas of focus and issues that emerge during audits include:

#### Losses

Where a taxpayer has genuinely made losses or a low profit due to special circumstances such as production problems, unavailability of resources or lower than expected throughput, documentary evidence relating to such circumstances should be compiled to support the transfer pricing documentation. Without such documentary evidence, it may be difficult to justify any results attributable to such special circumstances.

#### Use of year on year data

In the absence of specific guidance in the Transfer Pricing Guidelines on how the

comparables data is to be applied, taxpayers have a number of options such as using weighted average results of the comparables over a period of time to be compared against the taxpayers' weighted average results for a similar period. In practice, this may not be acceptable as the MIRB would prefer to test the results of the taxpayer for each year rather than the weighted average for a given period.

### *Management fees*

One transaction that is always scrutinised is the payment of management fees or head office charges to parent companies or affiliates. In order to justify the charge is at arm's length, taxpayers are expected to have agreements detailing the type of services, and the basis of charge. Additionally, details of how the charge is calculated or provided costs are allocated together with evidence of the services received during each period and how these services benefited the local entity will also be required. As such, in addition to a charging policy which is robust and meets the arm's length standard, it is equally important to retain evidence of actual services received and how those services benefit the local entity. Such evidence could take the form of emails, notes of meetings, visit details, etc.

As more Malaysian companies are venturing abroad, management fees are also charged out of Malaysia. In such situations, similar supporting documentation needs to be maintained to ensure that costs relating to services provided for the affiliates are charged out accordingly.

### **4707 Revised assessments and the appeals procedure**

If a taxpayer is not satisfied with a transfer pricing adjustment or assessment, the available avenues of appeal mirror the normal tax appeal procedures. To appeal, the taxpayer must file an appeal with the MIRB within 30 days of receiving the Notice of Assessment. This culminates in the MIRB either agreeing to the appeal or routing the matter to the Special Commissioners. Failing at that level, the ultimate decision resides in the High Court (or Court of Appeal), if the taxpayer or MIRB so desire to proceed to such authority.

Before proceeding with the appeals process, the taxpayer is required to pay the assessed tax and penalties.

An alternative avenue available to taxpayers via the double taxation treaties is the Mutual Agreement Procedure (MAP) which is a mechanism that caters for equitable tax treatment on transactions that involve multiple tax administrations. In some instances MNCs recognise the need for the use of this type of dispute resolution procedures to ensure the elimination of double taxation. Currently, Malaysia has concluded 68 double tax agreements globally.

### **4708 Additional tax and penalties**

Currently, there are no specific provisions for non-compliance with the Transfer Pricing Guidelines or not having prepared Transfer Pricing Documentation. However, if a transfer pricing adjustment is made, any additional taxes resulting from such an adjustment will usually be subject to the normal penalties imposed under the Self Assessment System. The table below summarises the relevant penalty rates:

**Penalty structure**

|  | Period           | Penalty rates |
|--|------------------|---------------|
| Voluntary disclosure before case is selected for audit                                       | < one year       | 15%           |
|  | one -three years | 20%           |
|  | > three years    | 30%           |
| Voluntary disclosure after being informed of case selection but before commencement of audit | 35%              |               |
| Findings during audit visit (First offence)  | 45%              |               |

Given that transfer pricing can be subjective and the conclusion of what is arm's length by the taxpayer may differ from that of the MIRB, the rate of penalty imposed on transfer pricing adjustments may be reduced if the taxpayer is able to demonstrate that their transfer prices were arrived at using a reasonable basis of support with the necessary documentation.

**4709 Resources available to the tax authorities**

Since the Transfer Pricing Guidelines were issued in Malaysia in July 2003, the MIRB has set up a team at its head office which specialises in transfer pricing audits. To date, this has been further enhanced with the setting up of separate transfer pricing teams in the various tax audit assessment branches of the MIRB across the country.

With the additional disclosure information requested in Parts N and P of the Form C, the tax authorities have information to make a reasonable selection of companies for a tax or transfer pricing audit. Additionally, the tax authorities digitises the information disclosed by companies in their tax returns. This electronic database of information allows the tax authorities to effectively identify companies for audit, conduct trend analyses of a company's results as well as benchmark the company's performance against its industry.

The majority of the tax officers have previous experience handling tax investigations and tax audits. The officers are continuously updating their knowledge through dialogues with other tax administrations in the region, in addition to attending and participating in training conducted by foreign and international tax authorities/bodies such as the OECD.

**4710 Use and availability of comparable information**

In order to demonstrate that the pricing outcomes being examined are arm's length, a company will need to demonstrate, through adequate documentation, that the transfer prices meet the arm's length test for Malaysian tax and transfer pricing purposes.

*Tax authorities*

The tax authorities will usually obtain comparable information within their internal database. Each year, companies are required to submit their tax returns, and other

associated work papers to the tax authorities. This forms part of the internal comparable information available to the tax authorities as well as information obtained from other tax audits performed.

### *Taxpayers*

As a starting point the taxpayer should determine whether internal comparable information can be found within the company. In the event internal comparable information is unavailable, the tax authorities would expect companies to have carried out an external comparable study using local comparables. Only in the event local comparables cannot be found, the tax authorities are willing to consider overseas comparables on a case by case basis.

In carrying out the search for local comparable studies, public directories and databases are used. Most Malaysian companies (private and public) except for exempt private companies must prepare audited accounts, which can then be obtained from the Companies Commission of Malaysia. The process of retrieval of such information is done manually and is therefore time-consuming.

In deciding the arm's length price, the Transfer Pricing Guidelines do not specify a preference for a single figure or a range of figures to be used. Therefore the tax authorities have the flexibility to decide if a single figure or use of a range of figures is appropriate in determining whether the arm's length position has been adhered to by the taxpayer.

### **4711 Risk transactions or industries**

No particular industry is more at risk of receiving a tax audit than another. Past experiences indicate that once the tax authorities have had substantial success in a particular company or industry, other companies in the same industry have been targeted.

The tax authorities are beginning to focus on the following related party transactions as part of their audit selection:

- sales and purchases of goods, assets and services;
- transfer and use of know-how, copyrights and trademarks;
- loan and interest payments;
- cost sharing arrangements;
- management and administrative fees;
- unusual economic transactions and arrangements;
- research and development expense allocation; and
- sale, purchase and other commission payments.

Other issues that may alert the tax authorities include:

- reduction of profits in a post tax holiday period;
- losses made on the sale of products or assets to related companies;
- physical delivery of goods and invoicing to customers are performed by different group companies located in different tax jurisdictions;

- consistent losses or very low profits compared to other independent comparables;
- significant differences in sales or purchase prices on transactions between related companies and independent third parties; and
- frequent changes in prices on transactions between related companies.

As the Malaysian tax authorities get more experienced in transfer pricing matters, the taxpayers will need to be better prepared to defend their transfer pricing position with adequate documentation.

#### **4712 Limitation of double taxation and competent authority proceedings**

In addition to the limited agreements dealing with the taxation of international traffic of ships and aircraft, Malaysia has a fairly extensive network of comprehensive double tax agreements modelled on the OECD convention.

An increasing number of Malaysia's treaties contain an 'Associated Enterprises' Article, which permits the respective tax authorities to adjust the profits of an entity where the transaction did not occur at an arm's length price. Treaties that have been negotiated with Malaysia in recent years contain the accompanying relieving provisions in the Article that effectively requires one country to reduce the amount of tax charged to offset the increased tax liability imposed by the other country as a result of reflecting the transaction at arm's length. It must be noted, however, that the adjustment is not automatic.

Most of Malaysia's treaties contain a 'Mutual Agreement Procedure' (MAP) Article.

#### **4713 Advance pricing agreements (APAs)**

The move towards setting up an APA programme in Malaysia needs to be initiated by a request from a taxpayer for either a unilateral APA or a bilateral APA.

The tax authorities are now encouraging taxpayers to apply for an APA. In this regard, if any taxpayer is interested in applying for an APA, they can initiate discussions with the tax authorities.

#### **4714 Liaison with customs authorities**

Information obtained by the income tax authorities is confidential and cannot be exchanged with the customs authorities. However, import/export documents on the taxpayer's business premises can be taken by the income tax authorities in the course of a tax audit.

#### **4715 OECD issues**

Malaysia is not a member of the OECD. However, the tax authorities have generally adopted the arm's length principle and use the transfer pricing methodologies endorsed by the OECD Guidelines. Preference is given to the traditional transaction methods, namely comparable uncontrolled price (CUP), resale price method and cost plus method. Transactional net margin method (TNMM) is usually only accepted as a last resort.



**4716 Joint investigations**

Malaysia would partake in a joint investigation of a multinational group with another country, if both countries would benefit from the investigation. Joint investigations involving the Malaysian authorities have taken place in the past.

**4717 Thin capitalisation**

Currently, Malaysia has no thin capitalisation transfer pricing legislation.

# 48 Mexico

## 4801 Introduction

Mexican transfer pricing legislation did not comply with international standards until 1997. However, in December 1996, the Mexican Congress enacted significant tax reform introducing transfer pricing rules consistent with guidelines issued by the Organisation for Economic Co-operation and Development (OECD), controlled foreign company legislation, and other anti-avoidance measures. These changes represented a critical stride in bringing Mexico's tax rules closer to the international regimes of more developed countries. To date, several minor reforms regarding transfer pricing have been enacted, although the bulk of the Mexican rules are mainly incorporated by reference in the Mexican Income Tax Law (MITL) which requires the application of the OECD Transfer Pricing Guidelines to the extent consistent with the MITL and any applicable treaty. In addition, the Mexican transfer pricing tax authorities have become relatively sophisticated in a short period of time.

## 4802 Statutory rules

Most of the transfer pricing rules are included in Articles 86 (Sections XII, XIII and XV), 215, 216 and 216-BIS of the MITL. Under these rules, taxpayers are required to produce and maintain documentation demonstrating that gross receipts and allowable deductions for each fiscal year (FY), arising from international inter-company transactions are consistent with the amounts that would have resulted had these transactions taken place with unrelated parties under similar conditions. Moreover, documentation of inter-company transactions should be based on a transactional basis.

The documentation requirements in Article 86 section XII of the MITL include the following elements:

- (1) General information such as the name of the company, address, taxpayer identification number, name of the related parties and a description of the taxpayer's ownership structure covering all related parties engaged in transactions of potential relevance;
- (2) An overview of the taxpayer's business, including an analysis of the economic factors that affect the pricing of its products or services, such as a description of the functions performed, assets employed and risks borne by the taxpayer for each type of transaction;
- (3) A description of the controlled transactions and the amount of the transactions (including the terms of sale) for each related party, and on a transactional basis according to Article 215 of the MITL; and
- (4) A description of the selected methodology applied as established in Article 216 of the MITL, including information and documentation of inter-company transactions for each type of transaction.

All inter-company transactions between related parties must be reported at arm's length prices for income tax purposes. This general rule makes the arm's length principle the cornerstone of the income tax system since it covers transfers of tangible and intangible property, services, domestic and cross-border transactions, transfers of shares whether publicly traded or not, entered into by individual and corporate taxpayers.

The Mexican transfer pricing documentation requirements are consistent with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the OECD (OECD Guidelines).

This documentation requirement applies to all corporations and to all taxpayers engaged in business activities with annual gross receipts exceeding Mexican Pesos (MXN) MXN13 million (approximately USD1.25 million) during the previous fiscal year. In the case of taxpayers providing professional services, the documentation requirement applies unless the gross receipts from those services does not exceed MXN3 million (approximately USD290,000).

Given that the income tax is determined annually, and since the statute makes reference to the gross receipts and the allowable deductions are considered in determining the income tax liability, the documentation must test the arm's length character of the inter-company transactions of the taxpayer for each and every year.

Taxpayers are required to determine tax obligations and report on a calendar year basis for income tax purposes. There is no specific deadline for preparing transfer pricing studies. Nevertheless, a recent Supreme Court case decision in 2007 held that the deadline to comply with the transfer pricing documentation requirement is the date the corporation files its income tax return (normally no later than March 31st of the following applicable calendar year), and failure to do so would result in the disallowance of deductions pertaining to payments to related parties. There are no sizeable immediate penalties in case of failure to prepare the documentation. Compliance with this obligation may only be reviewed by the tax authorities for full taxable years, and thus, the tax authorities may not request the documentation before the taxable year-ends.

Moreover, the Federal Tax Code obliges most taxpayers to have their financial statements audited by a Certified Public Accountant (CPA) in Mexico. The CPA must file the audited financial statements with the tax authorities along with a tax report that includes an opinion as to whether the taxpayer has complied with its federal tax obligations (*dictamen fiscal*), which is usually required to be filed by June following the end of the calendar year. If the transfer pricing documentation has not been prepared, such failure must be disclosed in the *dictamen fiscal*.

The Tax Administration Service (TAS) may request the documentation as early as January of the following the year, but in practice the documentation is not likely to be requested before the tax return is filed or even before the date of the issuance of the *dictamen fiscal*. We are aware of situations in which the TAS has actually requested the transfer pricing documentation after the tax return was filed and before the *dictamen fiscal* is due although this is unusual.

The transfer pricing documentation is considered to be part of the accounting records of the taxpayer. The MITL imposes the obligation to maintain the documentation as part of the accounting records and to identify related party transactions with non-residents. As in the past, the transfer pricing documentation must be kept at the tax domicile of the taxpayer.

It should be noted that the transfer pricing documentation is not filed with the tax authorities. Rather, it must be prepared and maintained by the company, in general, for a five-year period. In the course of a tax audit the taxpayer must make the transfer pricing documentation available upon request.

The MITL does not explicitly require taxpayers to produce documentation regarding 'domestic' related party transactions, but these transactions must be reported on an arm's length basis. Furthermore, at the beginning of fiscal year 2002 the law stated that the transactions must be determined based on the arm's length principle (i.e., comparable transactions between unrelated parties) and the international transfer pricing methods must be used for this purpose. Consequently, it is generally considered that taxpayers must create transfer pricing documentation to establish comparability and the propriety of the domestic related party transfer pricing methods for purposes of satisfying the requirements of an independent CPA who would provide the *dictamen fiscal*. Additionally, the Article 86, section XIII establishes an obligation of filing jointly with the return for the fiscal year, on the official form approved for the purpose by the tax authorities, information on all operations performed in the next preceding fiscal year with parties in a relationship residing abroad (referred to as the "DIM" for its acronym in Spanish).

Taxpayers are specifically required to report the amounts they would have accrued according to the arm's length principle for income tax filing purposes, notwithstanding the prices actually used in transactions between related parties might be different.

The law broadly defines related parties as parties that are directly or indirectly managed, controlled or owned by the same party or group of parties. A Permanent Establishment (PE) and its home office, other establishments and their related parties as well as their PEs are deemed to be related parties.

Unrelated taxpayers entering into a special contractual joint venture agreement known as an '*Asociación en Participación*' are also considered to be related parties for transfer pricing purposes in Mexico.

The tax authorities are entitled to make an adjustment if a taxpayer fails to comply with the obligation to report arm's length amounts in the income tax return.

Article 216 of the MITL specifies the following six Transfer Pricing Methods (TPM):

- (1) Comparable uncontrolled price method (CUP);
- (2) Resale price method (RPM);
- (3) Cost plus method (CP);
- (4) Profit split method (PSM);
- (5) Residual profit split method (RPSM); and
- (6) Transactional net margin method (TNMM).

In addition to the obligation to pay income tax in accordance with the arm's length principle, taxpayers have three important transfer pricing-related obligations: to prepare and maintain transfer pricing documentation, to file an information return on transactions with non-resident related parties with the timely filing of their income tax return for the previous fiscal year, as Appendix 9 of the Multiple Information Return ('information return'), and the transfer of shares and quotas in Mexican companies between related parties is subject to special reporting requirements.

Both traditional transactional methods (one through three) and profit-based methods (four through six) as described in the OECD Transfer Pricing Guidelines are acceptable in Mexico.

In 2007, the best method rule was included in the MITL and applies for all transactions developed between related parties. For this purpose, taxpayers are first required to use the CUP method and can only apply the other methods if the CUP method is not appropriate. This effectively places the burden on the taxpayer to prove and document the reasons for not applying this method. The law also provides a second preference to apply the RPM and/or the CP methods, implicitly imposing the burden of documenting why these methods were not appropriate if a profit based method is used. The law also clarifies that the RPM, CP and TNMM methods shall be considered as being met when it is established that both the revenues and costs are separately shown to be arm's length.

All inter-company transactions (domestic and cross-border) should also be disclosed in an appendix of the *dictamen fiscal*.

#### *Dictamen fiscal*

The following taxpayers must file a *dictamen fiscal*:

- (1) Companies that obtained gross receipts in excess of MXN30,470,980 during the prior fiscal year (approximately USD2.9 million);
- (2) Companies or groups of companies whose net worth (calculated pursuant to the Mexican Assets Tax Act) during the prior fiscal year exceeded MXN60,941,970 (approximately USD5.9 million);
- (3) Companies with at least 300 employees in each and every month of the prior fiscal year (1 January – 31 December);
- (4) PEs that fall in any of the above scenarios described under (1), (2) or (3).
- (5) Companies involved in or arising from a corporate division or a merger during the year of the transaction and during the subsequent year;
- (6) Entities authorised to receive deductible charitable contributions; and
- (7) Companies in the liquidation period if they had the obligation during the prior fiscal year.

As mentioned, the deadline for filing the *dictamen fiscal* with the TAS according to the Federal Tax Code is regularly June, with company-specific dates depending on the first letter of the tax ID number, except in the case of holding companies of groups that consolidate for tax purposes, whose deadline is normally in July. However, in some years, these deadlines have been extended.

#### *Information return*

All corporations and all individuals engaged in business activities are required to file an information return on transactions with non-resident related parties. This information return is due on the same day of the tax return filing date; within the three-month period following the end of the calendar year for corporations, and by the end of April for individuals. Taxpayers that file a *dictamen fiscal* may file their tax return along with the *dictamen fiscal*.

The information return must contain the amount of the transaction, the type of transaction, the gross or operating margin for each transaction, the transfer pricing method used, the taxpayer ID number of the related party, fiscal domicile of the related party and its country of residence.

Unlike the obligation to prepare transfer pricing documentation, all corporate taxpayers and all individuals engaged in business activities must file this information return irrespective of the amount of gross receipts. Maquiladora (see section 3403 – The maquiladora industry) companies with a valid Advance Pricing Agreement (APA) ruling from TAS and those that comply with Article 216-BIS of the MITL are not obligated to comply with such filing but only for its maquiladora operations.

Failure to comply with this filing can result in fines and in the disallowance of the deduction of all payments made to non-resident related parties. Additionally, failure to file the information return must be disclosed in the *dictamen fiscal*. The fines range from MXN42,944 to MXN85,887 (approximately USD4,153 to USD8,306), and these penalties are additional to the ones that could apply in case of a tax deficiency.

Since compliance is a requirement for the deduction of payments to non-residents, and since payments to resident related parties are not subject to this requirement, it might be possible to argue that the disallowance of the deduction is inconsistent with the non-discrimination provisions of Mexico's tax treaties (Mexico's tax treaties include a provision such as that in paragraph four of Article 24 of the OECD's Model Tax Convention on Income and on Capital). Nevertheless, it should be noted that the obligation to file remains in any case.

Both the *dictamen fiscal* and the information return, are probably used by the TAS in scheduling transfer pricing audits.

### *Transfer of stock*

Mexican law imposes income tax on income derived by non-residents from the sale of stock or quotas in Mexican resident companies. In this case a special *dictamen fiscal* prepared by a Mexican independent public accountant must be filed certifying compliance with tax obligations on the share or quota transfer unless the transaction is exempt under a tax treaty. This obligation applies even if the transaction qualifies as a tax-deferred reorganisation under domestic law.

The special *dictamen fiscal* on the alienation of shares must include a report on the value of the shares and the CPA must state which valuation methods were taken into account, and why, for example:

- (1) Inflation adjusted capital of the entity;
- (2) Present value of future cash flows (income approach), and
- (3) The last quote in case of publicly traded stock.

In the first case, the information must include details on the amount of the historical capital and the corresponding adjustments. In the second case the regulations under MITL require detailed information on the name or names of the methods used for the discounted value of the cash flows, discount rates, the existence of residual values, the number of projected time periods and the economic sector of the company whose stock was alienated. In any case, the CPA is required to explain in the report the reasons for the selection of one of these three alternatives. Compliance with these provisions effectively requires a complete appraisal of the company and it should be

noted that there is not a *de minimis* rule for small transactions or small companies.

### **4803 Other regulations**

#### *In general*

The statutory rules have not been extensively regulated. There are some rules dealing with some technical issues such as the documentation that must be attached to an application for an APA. These requirements are discussed in detail in Section 4714 below.

The regulations under the MITL require the use of the interquartile range for the resale minus, cost plus and TNMM methods and state that inter-company transactions will be deemed to be in compliance with the arm's length standard if they are within that range, but if the taxpayer's price, amount of compensation or profit margin is out of the interquartile range, the median of said range shall be deemed the price or amount of compensation that would have been used by independent parties.

These regulations require the use of a specific point within the range if the available information allows a more specific determination. According to the regulations, other statistical methodologies may be used under competent authority or if they are authorised under general rules issued by the TAS.

#### *The maquiladora industry*

Maquiladoras are companies that assemble or manufacture using temporarily imported raw materials and components on consignment for subsequent export. Typically, a maquiladora uses machinery and equipment consigned by the non-resident using its services. The term 'maquiladora' originally referred to a particular customs regime facilitating temporary imports and reducing costs for such imports such as customs fees, value added taxes, etc. However, this customs regime was combined with another similar regime (PITEX) in 2006 and the customs regime applicable to both is now termed the IMMEX program.

Prior to 1995 maquiladoras were regarded as cost centres and were not required to report significant profits. However, since 1995 the government has required maquiladoras either to report arm's length profits or to meet a safe harbour. These alternatives were regulated by administrative rules subject to annual renewal.

Failure to comply could result in a transfer pricing adjustment and the application of PE rules to the non-resident company providing detailed instructions to, and exercising general control of, the maquiladora.

One of the most important aspects of these rules is that they also provided a reduction on the asset tax liability imposed on non-residents that provide maquiladoras with inventory and equipment. The reduction was granted by limiting the asset tax base to the proportion of total production for the domestic market. This reduction in the asset tax was also available if the maquiladora obtained an APA.

The tax reform for 2003 brought some significant changes to the special transfer pricing rules for maquiladoras. Transfer pricing options for maquiladora companies are now provided under Article 216-BIS of the MITL.

The MITL establishes that foreign companies operating through a maquiladora will not be deemed as having a PE in Mexico, provided that they are residents of a

country that has a tax treaty in place with Mexico, that all the terms and requirements of the treaty are satisfied and, eventually, that the mutual agreements that Mexico and its applicable treaty partner may have are observed. This provision only applies if maquiladoras comply with any of the following options:

- (1) Prepares and maintains transfer pricing documentation determining an arm's length level of profitability for the maquiladora, and adding to the result of this analysis a 1% on the net book value of the machinery and equipment (M&E) owned by the foreign related company that is used by the maquiladora in its activities.
- (2) Reports taxable income of at least, the higher of the following values (safe harbour):
  - 6.9% of assets used in the maquiladora activity (including the inventories and fixed assets owned by the foreign related party). Such value must be determined under the principles of the Asset Tax Act that requires inflation adjustments and takes into account the statutory depreciation rates. All the assets used in the maquiladora operation during the fiscal year must be taken into account for the calculation. The only assets that may be excluded from the calculation are those leased at arm's length to the maquiladora by a Mexican resident or a non-resident related party, except if they were previously owned by the maquiladora. Property leased at arm's length from related parties that used to be property of the maquiladora may be excluded only if the maquiladora disposed of the property at an arm's length price. The value of assets used for maquila and non-maquila operations may be taken into account rateably only with an authorisation from the TAS.
  - 6.5% on operating costs and expenses of the maquiladora. The costs must be determined under Mexican Generally Accepted Accounting Principles except for the following items:
    - (a) the total amount of purchases is used instead of the cost of goods sold;
    - (b) tax depreciation is used instead of accounting depreciation;
    - (c) extraordinary or non-recurring expenses (under Mexican Generally Accepted Accounting Principles);
    - (d) inflation adjustments; and
    - (e) financial charges.

Both calculations are subject to a number of exemptions and special rules. The end result of those special rules might differ significantly from the numbers in the books of the company.

- (3) Prepares and maintains transfer pricing documentation considering a return on the net book value of M&E owned by the foreign related company that is used by the maquiladora in its activities. In this case the corresponding return must be adjusted to recognise that the financial activities (and associated risks) for the procurement of such M&E are not carried out by the maquiladora.

As of 2003, APAs for maquiladoras are elective. The benefits of the special transfer pricing rules may be secured by following one of the three alternatives described



above but no APA filing is necessary in any case.

Additionally, on 30 October 2003, a Presidential Decree was published in the Mexican Official Gazette, by which various benefits for taxpayers are provided. Specifically, Articles Tenth, Eleventh and Fourth Transitory, provide important tax benefits applicable for the maquiladora industry with the main purpose of promoting its competitiveness.

The Decree establishes that maquiladora companies are entitled to apply a partial income tax exemption. Such exemption will be calculated based on the difference in income tax resulting from the application of the percentages established in Section II of Article 216-BIS of the MITL (the higher between the 6.9% on assets and 6.5% on operating costs and expenses, 'safe harbour'), and 3% on the corresponding assets or costs. For purposes of calculating the aforementioned benefit, maquiladora entities may exclude the value of inventories used in their manufacturing operations. This benefit would be applicable for all maquiladoras as long as the rest of the requirements established under Article 216-BIS are complied with.

The new Mexican Flat Tax (referred to as the 'IETU' for its acronym in Spanish), which was enacted on 1 October 2007 and which became effective on 1 January 2008, has triggered some degree of concern in the marketplace due to its anticipated impact on Mexican business.

In an effort to address some of these concerns, the Mexican Executive Branch issued a Decree on 5 November 2007 (effective 1 January 2008). The Decree grants relief to specific categories of taxpayers, such as those that operate in the Maquiladora industry, those with significant inventory on hand, and real estate developers.

The decree provides that the maquiladoras will be entitled to an additional credit against the IETU which, in principle, should yield an effective tax rate of 17.5% (16.5% in 2008 and 17% in 2009 respectively) on the taxable income as determined under any of the existing transfer pricing methodologies of the MITL relative to maquiladoras.

Taxpayers desiring to use the cost plus self assessment option to determine the taxable income floor for purposes of arriving at the credit would need to adjust the return on foreign owned assets to 1.5% in order to compute this credit under this option.

This maquiladora tax credit will be available from 2008 to 2011.

#### **4804 Legal cases**

As a result of the firsts transfer pricing audits a few petitions have been filed before the courts. The Federal Court of Administrative and Fiscal Justice has recently ruled that the tax examiners outside the *Administración General de Grandes Contribuyentes*, the office in charge of the largest taxpayers of the country, are now entitled to make transfer pricing assessments. Please note that more court rulings can be expected in the future.

As part of the Ministry of Finance fiscal policy, in 2007 the TAS issued a special decree, which involved an amnesty scheme, by which those taxpayers with tax credits in place, could obtain important discounts in the penalties and surcharges, if they agreed to self correct its tax credits.

In case of liabilities for year prior to 2003, the Mexican tax authorities authorised to disregard 80% of the tax liability, and allowed to abate 100% of the related surcharges and penalties, as long as the agreed-upon amount is paid in one instalment. From

2003 through 2005, the tax liability may not be abated. However, the Mexican tax authorities are able to abate 100% of any surcharges and penalties for those years, as long as the agreed-upon amount is paid in one instalment.

Through the amnesty scheme, taxpayers in Mexico found interesting settlement alternatives for important tax audits, especially in corporate restructurings involving possible exit payments for the migration of intangible assets.

#### **4805 Burden of proof**

Assuming the taxpayer prepares and submits the transfer pricing study to the tax authorities upon request, in the case of a transfer pricing audit, taxpayers do not bear the burden of proof except in the case of transactions with tax havens, which are discussed below. If the TAS determines an adjustment is in order, it is required to demonstrate that the taxpayer failed to comply with its obligation to report arm's length amounts in the income tax return. It should be noted that any notice of deficiency must state the facts on which it is based, the applicable law, and must include an explanation of how the law was applied to the facts. Failure to comply with these requirements will result in an invalid notice of deficiency.

In the context of litigation relating to a transfer pricing assessment when the taxpayer submitted the transfer pricing study during the tax audit, the tax authorities have the burden of proving that the taxpayer's transfer pricing study was incorrect. On the other hand, the burden is shifted to the taxpayer when no study is presented. As a general rule, an assessment not challenged within the 45 working-day period becomes final. Under the competent authority procedure there is an exception to this time limit (see explanation below).

Any transaction with an entity resident or located in a low tax jurisdiction will automatically be presumed to be a transaction with a related party and will also be considered not to take place at arm's length. In these cases, the taxpayer has the burden of proof and it will be necessary to demonstrate that the transaction was entered into with an unrelated party, or that the transaction was entered into with a related party but took place at an arm's length price.

#### **4806 Tax audit procedures**

There is no extensive history on tax audits involving transfer pricing issues since, for practical purposes, transfer pricing only became relevant as from 1997. Therefore, there is no reliable information on specific industries targeted or on the criteria that will be used to select companies for examination. Transfer pricing may be reviewed as part of a tax audit or a specific transfer pricing audit can be performed. Some of the recently initiated examinations are specific transfer pricing audits.

The tax audit review begins when the tax authorities summon the company's CPA for specific information. If the authorities are satisfied with the information provided, the procedure stops there and the formal audit procedure is never initiated. But, if the authorities are not satisfied, they will require the information directly to the company and this is the formal beginning of the audit procedure.

The provision of information and duty of the taxpayer to cooperate with the tax authorities.

During an on-site examination, the taxpayer is under obligation to provide all the information that demonstrates compliance with tax obligations, including transfer

pricing documentation. Failure to comply with a request might trigger the disallowance of deductions, the imposition of fines or in more grave circumstances, the imprisonment of the representatives of the company. However, it should be noted that during an on-site examination taxpayers are merely under obligation to allow the examination to take place and to provide the books and records. Taxpayers are not required to produce special reports for the tax authorities, or to actively participate in the proceedings.

A taxpayer opposing a tax audit might be subject to a presumptive assessment of its income and the value of its assets and activities. The tax authorities are also entitled to search the company's premises and seize the required information.

Outside the scope of the specific requests of information and the on-site tax audits, the tax authorities have a broad power to obtain information from alternative sources, including as one of the most effective ones, the exchange of information with countries with whom Mexico has signed Tax treaties.

If a taxpayer does not comply with an information request during an audit, the TAS may impose fines that range from approximately MXN9,626 (approximately USD875) to MXN28,879 (approximately USD2,600) and take other measures to secure the information.

The attorney-client privilege does not exist in Mexico. Although professional service providers are required by law to maintain confidentiality with respect to client information, this duty to maintain confidentiality does not apply when the law (under statutory authority) imposes the obligation to produce a report. In tax audits, the law states that the tax authorities may request all kinds of documents pertaining to the audit from the taxpayer or third parties (including lawyers and accountants). In these situations the general obligation to maintain confidentiality is overridden by a request made by the tax authorities.

Documents prepared in anticipation of litigation are not protected but taxpayers and their advisers may refuse to provide documents that are not relevant to the tax audit.

#### **4807 The audit procedure**

In theory, transfer pricing may be reviewed using regular procedures, under this scenario the tax authorities would initiate the procedure through a summon the company's CPA, and if the information provided is not sufficient, they would be able to apply any verification procedure established by the Mexican Fiscal Code, including specific requests of information, on-site verifications, etc. The TAS has a specialised group (*Administración Central de Fiscalización de Precios de Transferencia*) that performs the transfer pricing examinations, and the specific faculties for this team to review transfer pricing issues, were published on 22 October 2007 in the Mexican Official Gazette. This group is part of the *Administración General de Grandes Contribuyentes*, a division of the TAS that deals with the largest taxpayers.

During the examination, the tax authorities may request information and must be allowed access to the accounting records of the company. All findings must be documented in writing and witnesses are required. In the course of the examination the taxpayer is not entitled to request information but the audit cannot be completed without providing to the taxpayer a written statement of findings. Upon receipt of this document, the taxpayer is entitled to furnish proof and reasoning that must be taken

into account for the final determination. The document where the taxpayer furnishes proof and reasoning is known as '*escrito de inconformidad*' and is similar to a protest. If a taxpayer does not provide any information to the TAS, in accordance with Supreme Court rulings, it is still entitled to prove that there is no deficiency during litigation.

It is legally possible to obtain and use information from foreign authorities without the permission of the taxpayer or without giving notice of such actions.

In transfer pricing cases, a three-month period must be allowed between the last partial written record (*última acta parcial*), which is the first document of the examination made available to the taxpayer, and the final determination. A two-month extension is available upon request.

As a general rule tax examinations must be completed within twelve months. This limit does not apply to certain audits, including transfer pricing cases which provides a two-year rule, but the Supreme Court of Justice has declared this exception to be unconstitutional. The statute of limitations on assessment is generally five years for all federal tax matters, including transfer pricing cases. The running of the period is suspended during an on-site audit (no suspension applies in the case of other types of examination) and if the taxpayer files a petition before the Federal Court of Administrative and Fiscal Justice (*Tribunal Federal de Justicia Fiscal y Administrativa*).

#### **4808 Revised assessments and the appeals procedure**

A transfer pricing adjustment may be appealed before the tax administration (*recurso de revocación*) or a lawsuit may be filed before the Federal Court of Administrative and Fiscal Justice. It is not necessary to use the appeals procedure within the administration before going to the Federal Court of Administrative and Fiscal Justice. In either case, the taxpayer has a 45-working day term to appeal the determination by the TAS.

In some cases, the administrative appeal is not filed since the TAS usually does not change its determination. Both the administrative appeal and the lawsuit require the taxpayer to provide a guaranty (bond, deposit, and/or mortgage) for the amount of the deficiency and an estimate of the additions to the tax of one year.

The Federal Court of Administrative and Fiscal Justice is an autonomous administrative court of original jurisdiction. It is divided into sections that hear cases within its territory. One of its divisions (*Sala Superior*) is higher within the hierarchy and is in charge of important cases, regardless of territorial considerations. In any case, the Federal Court of Administrative and Fiscal Justice can only decide whether a determination by the tax authorities was made according to the law and therefore, it cannot change the amount of the adjustment made by the tax authorities or determine that a third alternative must be followed. The Federal Court of Administrative and Fiscal Justice will only affirm or reverse the assessment made by the tax authorities. The Federal Courts may review judgments made by the Federal Court of Administrative and Fiscal Justice. The Federal Courts are vested with the authority to review legal and constitutional issues.

Determinations made by the courts are not binding except for the parties involved in the litigation. A holding by a court of law may only become mandatory precedent under limited circumstances (involving a reiterated position of the court) and even in such cases, it is mandatory only for lower tier courts and not for the TAS. Individual court determinations may only be treated as persuasive authority to those that were

not involved in the case.

Within the Federal Court of Administrative and Fiscal Justice there is no subject matter specialisation and therefore, in principle, any division of the court may hear a transfer pricing case. Nevertheless, the Sala Superior may decide to hear any case involving an amount of at least MXN100 million (approximately USD9.09 million). It has also been pre-established that the *Sala Superior* will hear any transfer pricing case where the statute is construed for the first time.

#### **4809 Additional tax and penalties**

Several consequences follow a transfer pricing adjustment. At the outset, an adjustment is made by making an assessment of the gross receipts and deductions that would have arisen in uncontrolled transactions. In cases where two or more comparables are found, a range will be used. The range must be adjusted using statistical methods, and the adjustment is made to the median of such a range. It should be noted that an adjustment by the tax authorities is only possible if the prices used by the taxpayer or the margin in the controlled transaction are outside such a range.

As a consequence of the assessment many tax attributes may need to be adjusted. For instance: if the adjustment turns losses into profits, the amount of net operating losses will decrease; if the price of an inter-company transfer of a fixed asset changes, the depreciable basis in such property will change. Also, the foreign tax credit limitation may increase if the taxable income increases as a consequence of an adjustment to an international operation, and the amount of the net after tax earnings account (known as 'CUFIN') will increase as a consequence of any increase to the taxable income. Withholding taxes and estimated payments may also require an adjustment.

In addition to the aforementioned changes, the amount of the adjustment to the taxable income is itself treated as a constructive dividend.

Constructive dividends may be subject to a corporate level tax triggered in case the distribution does not arise from the CUFIN account. The tax is calculated by applying the corporate tax rate to the amount of the transfer pricing adjustment grossed-up by 1.4286 in 2005, 1.4085 for 2006, and 1.3889 for subsequent years.

There are no separate penalties applicable to transfer pricing tax adjustments. Instead, the regular penalties for failure to pay are imposed. These penalties range from 55-75% of the inflation adjusted amount of the assessment. The penalty is 50% if the payment is made during the audit and prior to the notice of deficiency. Where the amount of a loss is reduced, the penalty ranges from 30-40% on the difference between the reported and the actual loss, to the extent a portion of the misstated loss is utilised. Besides the penalties and the inflation adjustment, late payment interest (termed 'surcharges') is also imposed.

A 50% reduction in penalties is applicable if a Mexican taxpayer meets the documentation requirement. There are no rules designed to determine the degree of compliance with the documentation requirements.

#### **4810 Resources available to tax authorities**

The Mexican government has also implemented important institutional changes aimed to improve the efficiency of law enforcement. A specialised group performs transfer pricing examinations.

Taxpayers must submit several information returns that provide the TAS with useful information in planning and conducting their examinations. These information returns include the information return on payments to non-residents, the information return on main suppliers and clients, and the information return on international transactions between related parties.

Mexico is actively exchanging tax information with its treaty partners, especially with the US. The exchange of information may be automatic, at specific request or more spontaneous in nature.

#### **4811 Use and availability of comparable information**

Comparable information is required in order to determine arm's length prices and should be included in the taxpayer's transfer pricing documentation. However, there is little reliable financial information publicly available on Mexican companies. Therefore, reliance is often placed on foreign comparables with a proper evaluation of market adjustments.

The tax authorities have the power to use confidential information of third parties. The taxpayer has limited access to this data through two designated representatives who must agree to be personally liable to criminal prosecution if the data is disclosed.

#### **4812 Risk transactions or industries**

Starting in 2007, the International Tax Division and the Transfer Pricing Central Administration, established important audit programs addressed to two main tax issues: (a) intangible assets migration derived from corporate restructures and (b) debt push down arrangements.

From an industry stand point, no substantial basis exists for identifying any particular industry as being especially at risk.

#### **4813 Limitation of double taxation and competent authority proceedings**

Double taxation relief is granted by corresponding adjustments under tax treaties. Mexican law requires approval of the adjustment in order to allow the Mexican taxpayer to file an amended tax return. Should these conditions be met, a tax refund may be obtained. Under most tax treaties entered into by Mexico, the corresponding adjustment may be denied in case of fraud, gross negligence or wilful default. Mexico has not implemented this rule.

The corresponding adjustment for domestic transfer pricing cases is not regulated. This means that taxpayers may elect to report the adjustment through an amended tax return for the year in question. However, it should be noted that there are certain restrictions on the filing of amended tax returns.

The competent authority procedure is available prior to the domestic law remedies and it is still available even if there is a final judgment against the taxpayer. The competent procedure is also available if the taxpayer did not meet the 45-working day term. The only limitation to the use of the competent authority procedure is that it is not possible to pursue both routes at the same time (competent authority procedure and domestic law remedies). A competent authority determination subsequent to an unfavourable ruling by court of law will only affect the tax assessment and not the ruling itself.

Should the taxpayer elect to appeal before the tax administration, it will be possible to challenge the final decision of such procedure before the Federal Court of Administrative and Fiscal Justice.

Most tax treaties entered into by Mexico contain time limits for notice of a competent authority procedure (i.e. four and a half years), and a ten-year period for the implementation of any agreement is usually included. In all cases it will be important to take into consideration the specific time limit included in the applicable Tax Treaty.

As a final step in the dispute resolution process between competent authorities of tax treaty countries, there is the arbitration procedure, than even though is not mandatory for the countries to enter into, it is a valid resource that should be evaluated.

#### **4814 Advance pricing agreements (APAs)**

APAs have been included in the law as a legal possibility since 1997. APAs are not agreements between the administration and the taxpayer. They are issued as unilateral 'rulings' under domestic law or as determinations under the competent authority procedure. APAs approve a methodology and not a specific result. Pre-filing meetings on a no-name basis are possible.

As of 2000, APAs covered up to five fiscal years: the current fiscal year, the three subsequent fiscal years and a one-year roll-back.

Bilateral APAs are also possible under the competent authority procedure, and in these cases tax authorities are entitled to waive late-payment interest. Bilateral APAs may be issued for more than five years since they are not subject to the limitations described above. Unlike rulings on international tax issues, the TAS is not required to publish APAs.

The law provides that APAs should be resolved in a maximum of eight months. In practice, most APAs take much longer.

The office in charge of APAs is the *Administración Central de Auditoría de Precios de Transferencia*. This is the same office that performs international examinations and therefore, the use of roll-back APAs to settle an audit is not practical.

As anticipated above, under general rules issued by the TAS, the information and documentation requirements for an APA application are substantial:

- (1) Power of Attorney of the legal representative;
- (2) Name of the company, tax domicile, tax identification number and country of residence of the taxpayer, and the person or persons with equity interest in the taxpayer;
- (3) Certified copy of the corporate book of the taxpayer where the shareholders are registered;
- (4) The names of the related parties in Mexico or elsewhere, which have a contractual or business relationship with the taxpayer;
- (5) A description of the principal activities, including the place where the activities are undertaken, describing the transactions between the taxpayer and its related parties;
- (6) Organisational chart of the group. The shareholding percentages must be included in the chart;

- (7) Balance and income statement as well as a breakdown of costs and expenses incurred by the taxpayer for the three prior years to the period to be covered by the APA. Where the taxpayer is under the obligation to file a *dictamen fiscal*, the audited financial statements with the report issued by the registered CPA is filed instead;
- (8) Tax returns of the taxpayer including amended returns for the last three years;
- (9) Copy in Spanish of all the contracts and agreements between the taxpayer and its related parties (resident and non-resident related parties);
- (10) Beginning and closing date of the fiscal years of the related non-resident entities with which a contractual or business relationship exists, or the indication that they use a calendar year;
- (11) Currency used in the main transactions;
- (12) The transactions to be covered by the APA;
- (13) Detailed description of activities undertaken by the company and its related parties, which have a contractual or business relationship with it, including a description of the assets and risks assumed by such person;
- (14) The method or methods proposed to determine the price or amount of consideration in transactions undertaken with related residents and non-residents, including criteria and other elements for considering that the method applies to the mentioned transaction or company;
- (15) Information on comparable transactions or companies, the adjustments made to the comparables and the explanation of rejected comparables and adjustments;
- (16) Financial and tax information corresponding to the fiscal years for which the ruling is requested, applying the method or methods proposed. This requirement is basically a forecast of the financial statements and tax returns; and
- (17) It is necessary to disclose whether the non-resident related parties are involved in a transfer pricing examination elsewhere. It is also necessary to disclose whether the taxpayer's related parties have filed a legal remedy regarding a transfer pricing case, or if they have been involved in transfer pricing litigation. In case there is a final determination, the main points of the holding must be explained.

The fee for an APA is MXN8,040 (approximately USD730). Once the APA is issued, an annual report must be filed with the TAS. The fee for the APA's annual review is MXN1,608 (approximately USD145). Should the critical assumptions change, the APA may be ended.

Recently, a number of important tax rulings have been conditioned to an APA.

#### **4815 Anticipated developments in law and practice**

##### *In law*

As part of the Tax reform undertaken by the Mexican Government, in 2007 the Ministry of Finance created a new tax regime defined as IETU for its acronym in Spanish which



could be considered as a flat tax or alternative minimum tax. The new Flat Tax law was effective since 1 January 2008 and replaces the Asset Tax law. Taxpayers will continue to be liable for regular income tax base on existing legislation and may also pay the supplemental Flat Tax. The Flat Tax is calculated by applying a 17.5% rate (please consider a transitional Flat Tax rate of 16.5% for FY 2008 and 17% for FY 2009) on cash basis taxable amounts, which consists of the difference between authorised cash deductions and certain taxable income actually collected.

Under the Flat Tax Law, entities residing in Mexico and foreign residents with a PE in Mexico engaged in: i) the sale or disposition of property, ii) rendering independent services, and iii) granting of the temporary use of enjoyment of assets, are subject to that tax .

According to Flat Tax Law, the payments effectively made for, among others: i) the acquisition of goods, ii) the receipt of independent services should be deductible for Flat Tax purposes to the extent are related to the generating income activity of the taxpayer. In this regard, taxpayers are required to fulfil the deductibility requirements established in the Income Tax Law, in order to deduct those payments for Flat Tax purposes.

Taken into account the prior considerations we could conclude, from a transfer pricing perspective, that the Mexican companies which carry out transactions with related parties resident in Mexico or abroad, must comply with the same transfer pricing regulations already established in the current Income Tax Law, including the arm's length standard and the documentation requirements.

### *In practice*

The TAS has been carrying out transfer pricing investigations outside the maquiladora industry. Starting in 2007, the International Tax Division and the Transfer Pricing Central Administration, established important audit programs addressed to two main tax issues: (a) intangible assets migration derived from corporate restructures and (b) tax planning through debt push downs arrangements. This kind of audit programs are likely to increase in the future. Some of the issues that will probably be included in the new programs could include fees for technical services, commission payments, royalty payments, and imputed permanent establishments. Controversial issues will probably include the use of multi-year averages for the tested party, the use of secret comparables and the protection of confidential information during court proceedings.

The TAS stated that a consequence of failure to meet the transfer pricing documentation requirements upon tax audit will result in the non-deductibility of all payments to non-resident related parties. This position may not have legal weaknesses and might be against the non-discrimination provisions in Mexican tax treaties.

In regard to the expected effects in Mexico, derived from the (new) Proposed and Temporary Services Regulations issued by the Internal Revenue Service in the US, from a Mexican stand point, we could conclude that there are no major inconsistencies between the Mexican Transfer Pricing Regulations and the (new) Proposed and Temporary Services Regulations that will be effective for tax years beginning after 31 December 2006. However some new, important issues are raised when documenting non-routine services, in particular, the eligibility to employ the profit split method

(which is also provisioned within the Mexican Transfer Pricing Regulations and has not been modified). Specifically, Treas. Reg. §1.482-9T(g)(1) now states that the profit split method is “ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers.” References to ‘high value’ and ‘highly integrated transactions’ have been eliminated; however, the preamble emphasises that “routine” transactions do not necessarily signify transactions with a low value.

There is continued uncertainty regarding the determination of an arm’s length return for “non-routine” services. While the imposition of the profit split has been de-emphasised in certain instances, there still appears to be a broad potential for application of the profit split method. This issue can be mitigated somewhat, however, through carefully developed and adhered to legal contracts and agreements.

For qualifying services that are charged at cost without a mark-up, a Mexican entity can still employ the provisions of Chapter VII of the OECD Transfer Pricing Guidelines for intra-group services as the Proposed and Temporary Services Regulations feature a new version of the “cost safe harbour.” This new version of the “cost safe harbour,” the services cost method (SCM) evaluates whether the price for covered services is arm’s length by reference to the total costs incurred in providing these services (without a mark-up).

While there are no major inconsistencies between the Proposed and Temporary Services Regulations and the Mexican Transfer Pricing Regulations, there may be some issues in connection with the application of the IRS’ positions on “high value” services and “non-routine” contribution for U.S. and Mexican cases by both taxpayers and the TAS. The profit split method is not intended to be the default method for evaluating high value services in the U.S. Economic substance (which has to be consistent with the inter-company agreements in place) is taking a more important role in the Proposed and Temporary Services Regulations.

#### **4816 Liaison with customs authorities**

The TAS is in charge of the enforcement of both tax and customs law. General tax examinations undertaken by the TAS include all federal taxes including income tax, value added tax, assets tax and customs duties. Therefore, values used for the purposes of payment of customs duties and other customs information are available for tax purposes. Similarly, any information submitted for tax purposes is also available for customs purposes. During an on-site audit all aspects of taxation are usually reviewed by the same team (including customs duties).

#### **4817 OECD issues**

Mexico is a member of the OECD and has accepted the Revised Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises. In general, the Mexican transfer pricing rules are consistent with the OECD Guidelines.

Under a reservation made on Article 9 of the Model Tax Convention on Income and Capital, Mexico reserves the right not to insert paragraph two (corresponding adjustment) in its tax conventions. However, most Mexican tax treaties provide for a corresponding adjustment if the adjustment made by the other state is arm’s length.

Under the MITL that became effective from January 2002, the OECD Guidelines are a mandatory interpretative source of the transfer pricing provisions of the Income Tax

Act to the extent they are consistent with the MITL and tax treaties.

#### **4818 Joint investigations**

The TAS is vested with the authority to participate in simultaneous tax examinations with another country under the exchange of information provisions included in tax treaties.

#### **4819 Thin capitalisation**

As of 1 January 2005, section XXVI is incorporated to Article 32 of the MITL, which establishes the procedure to be followed in determining the interest portion corresponding to loans that shall not be deductible.

In 2007 thin capitalisation rules were modified. For purposes of determining the annual average liabilities, all liabilities are now considered. The new rules clarify that the disallowance only applies to interest on debts with related parties resident abroad. The definition of related parties stated in Article 215 of the MITL is applicable. Moreover, the taxpayer can compare the liabilities multiplied by three, to either the i) equity (following Mexican generally accepted accounting principles), or ii) the sum of the tax basis equity accounts (Account of Contributed Capital "CUCA" for its acronym in Spanish, plus the CUFIN balances').

When the debt of Mexican taxpayers exceeds three times its shareholder's equity, the interest generated by excess debt will not be deductible. In calculating the debt to equity ratio mentioned above, the total amount of the related and unrelated party loans contracted by the company must be considered, with the exception of certain mortgages.

The thin capitalisation rules are not applicable to companies belonging to the financial sector, which comply with the capitalisation rules pertaining to their sector. Furthermore, Mexican entities that have an excessive debt to equity ratio due to loans with related parties can apply for an APA ruling from the TAS on the arm's length nature of the loan in order to maintain the excessive ratio. An authorisation is also possible for excesses attributable to unrelated party loans, if the arm's length nature of the taxpayer's operations with its related parties is also reviewed by the tax authorities.

These formalities to have the non-deductible excess interest waived will require the certification of an independent accountant.

A five year transitory rule was enacted to allow taxpayers to reduce their debts proportionately, in equal parts, in each of those years, until they achieve the reduction of their debts to meet the 3:1 ratio required. If at the end of the five year term, the ratio of liabilities continues to be higher than the allowed amount, the interest paid as from 1 January 2005 arising from debts exceeding three times the book equity will not be deductible.

Although this is a first step for thin capitalisation legislation, there are some rules pending for publication together with clarification on some issues in the actual provisions.

# 49 The Netherlands

## 4901 Introduction

Transfer pricing legislation has existed in the Netherlands since 1 January 2002. In addition to providing specific transfer pricing rules, the implementation of transfer pricing documentation requirements was meant to shift the burden of proof from the Dutch tax authorities to the taxpayer. This legislation is based largely on the OECD Guidelines with some modifications to reflect Dutch business practices. In the past, transfer pricing disputes have usually been dealt with informally and resolved by negotiation between the tax authorities and the taxpayer. Consequently, there is currently little relevant case law. Multinationals are experiencing an increase in the number of transfer pricing queries, which will force those companies to focus more on transfer pricing.

## 4902 Statutory rules

Prior to 1 January 2002, Dutch tax legislation did not contain any specific provisions on transfer pricing. However, the arm's length principle was recognised through the application of the general rules of profit determination included in the Personal Income Tax Act and the Corporate Income Tax Act. The relevant Article of the Personal Income Tax Act (under the new 2001 Act Article 3.8), which also applies to companies, implies that income and expenses will be eliminated from the taxable profit reported by the Dutch taxpayer to the extent these arise from transactions that are not at a fair market price.

Since 1 January 2002, specific transfer pricing provisions have been included in Article 8b of the Dutch Corporate Income Tax Act. This Article is largely drafted in accordance with Article 9 of the OECD's Model Tax Convention.

The basic features of the transfer pricing legislation are as follows:

- Codification of the arm's length principle;
- A widening of the scope of the transfer pricing legislation through a broader concept of 'control' between affiliated businesses, i.e. directly or indirectly, participating in the capital, management, or supervision of another company, provided that there is sufficient influence on the prices charged between the companies involved. The level of control and influence is not quantified in the law. This legislation applies to transactions where one party controls the other, or both parties are under common control; and
- A requirement to maintain data in the administration that demonstrates the arm's length nature of the transfer prices and how these prices have been derived.

A strict interpretation of the documentation requirements implies that taxpayers should prepare the relevant documentary evidence when the intra-group transactions take place. Although this is a prudent approach, the tax authorities effectively allow taxpayers four weeks to respond to any request to provide transfer pricing

documentation, or three months where particularly complex transactions are involved.

Where there is an understatement of the taxable income reported by a Dutch group company because of non-arm's length related party transactions, the tax authorities will make an upward adjustment to the taxable income of that company. Under certain conditions, the understatement may also be treated as a hidden dividend distribution, attracting the appropriate withholding tax. Any surplus profit reported by a Dutch group company because of non-arm's length related party transactions, may be treated as an informal capital contribution by the parent company. The Dutch group company can claim a notional deduction for the amount of the informal capital contribution, for Dutch corporate income tax purposes.

### *Patent box and group interest box*

With the changes to the Corporate Income Tax Act in January 2007, a new so-called special patent box and group interest box have been introduced.

#### *Patent box*

When a taxpayer has opted to apply the patent box regime, profits generated from patents can be taxed at an effective tax rate of 10%.

The patent box can be applied on request by the taxpayer when all following requirements have been met:

- (1) The taxpayer has an intangible asset;
- (2) The intangible asset has been developed by the taxpayer;
- (3) A patent has been granted to the taxpayer in regards to the intangible asset; and
- (4) The patent relates to an intangible asset which has been included on the balance sheet after 31 December 2006, to the extent that it has been developed after 31 December 2006.

Furthermore, the new regime requires that the expected income generated from the intangible asset should relate to a significant amount (30%), to the patent or patents granted to the taxpayer.

The patent box can only be applied for assets which qualify as an intangible asset. The patent box does not apply to brands, images, and other similar assets developed by the taxpayer. However, the patent will be applicable for cultivation rights on newly developed plant varieties.

The profits taxed in the patent box are limited to four times the total relevant development costs.

The patent box entered into force as of 1 January 2007. The European Committee has recently announced that generic measures to improve innovation do not encounter objection with regard to European legislation.

#### *Group interest box*

Companies can opt for the group interest box since 1 January 2007. In this group interest box, the net interest received and paid within a group will be effectively taxed at a rate of approximately 5%. To qualify as a group company, companies must be affiliated based on a financial interest of more than 50%. The positive net group

interest is limited to a percentage of the average fiscal equity of the taxpayer. This percentage is related to the official tax levy interest rate of the last quarter of the year concerned.

In addition to group interest mentioned above, income arising from short term investments that are earmarked for financing of future acquisitions can also be included in the group interest box.

The application of the group interest box is optional. The decision to opt in or out should be made on a uniform basis across the entire Dutch group and will apply for at least three years per taxpayer.

The European Commission is currently investigating to what extent the group interest box might constitute state aid. Therefore, further local tax advice is needed for the latest developments and the actual application of the rules in the situation of the taxpayer.

### **4903 Other regulations**

Other regulations have been issued to cover certain specific circumstances; some of these concern transfer pricing issues, and these are detailed below.

#### *Decrees and resolutions*

The Decrees and Resolutions issued by the Ministry of Finance provide guidance on the interpretation and application of Dutch tax law in certain specific situations. They are intended to ensure a consistent application of the tax laws, and consequently the tax authorities are bound by them. A taxpayer, however, has the right to appeal to the courts on any provision in the Decrees or Resolutions.

Details of the relevant Decrees, which were issued in 2001 and amended in 2004, as well as of one Resolution, are set out below.

#### *Transfer Pricing Decree (IFZ2001/295M)*

This Decree of 30 March 2001 on 'Transfer prices, the application of the arm's length principle and the OECD Guidelines provides guidance on the Dutch tax authorities' interpretation of the OECD Guidelines and clarifies how certain issues should be approached in practice.

The issues dealt with in this Decree include, among others, the following:

- Application of the arm's length principle in practice: the taxpayer should demonstrate that its transfer prices meet the arm's length standard;
- Application of various transfer pricing methods (TPMs): particular attention is given to the cost plus method and the practical implications;
- Administrative approach for avoiding and resolving disputes regarding transfer pricing: insight is given to the policies and procedures applied by the Dutch government in relation to mutual agreement and arbitration procedures;
- Arm's length fee for financial services; and
- Allocation of profit to headquarters and permanent establishments (PEs): the arm's length principle is also applicable in determining the tax base of foreign taxpayers.

*Amendments to the Transfer Pricing Decree (IFZ2004/680M)*

This Decree of 21 August 2004 is intended as a clarification of the 30 March 2001 Decree with respect to the following subjects:

*Inter-company services/head office expenses*

Some clarification is given on the activities that are considered shareholder activities. Furthermore, the Decree provides guidance on the determination of an arm's length fee for services. It allows a fee based on cost for support services that meet certain criteria, thus providing a practical approach for common, low-value added services.

*Contract research and development (R&D)*

In the Decree of March 2001, the tax authorities explicitly referred to performing contract R&D from a Dutch tax perspective. In addition, a guideline now defines the manner in which these activities should be remunerated. The Decree indicates that if ultimate decision making related to the R&D, the costs and risks of these activities and the economic ownership of the developed assets lie with the principal, then the cost plus method is an appropriate method for remunerating the contract R&D activities.

*Cost contribution arrangements (CCA)*

To terminate further discussions as to whether the cost contribution paragraph in the March 2001 Decree was completely in accordance with the arm's length principle, this paragraph has been revoked, and it is explicitly stated in the amendments that the OECD Guidelines apply.

*Valuation of intangible assets*

According to the Ministry of Finance, there are circumstances under which non-related parties would not agree on a fixed price for a transfer of an intangible asset but would include a price adjustment clause indicating, for example, that the price of the intangible asset depends on future income. In the August 2004 Decree, it is stated that an agreement on the transfer of an intangible asset is assumed to include a price adjustment clause, if such a clause would have been agreed on between independent parties operating under similar conditions.

*Withholding taxes*

The Decree recognises that some countries levy withholding taxes on service fees, even if this is not allowed under the tax treaty between that country and the Netherlands. This is especially true for mixed contracts, i.e. contracts consisting of a service and a royalty component. For payments under these contracts, withholding tax might be levied on the entire fee, even though only withholding tax on the royalty component is allowed under the tax treaty. The Decree states that withholding taxes cannot be credited against Dutch corporate income tax if these taxes conflict with the applicable treaty clause.

*Advance pricing agreement (APA) Decree (IFZ2004/124M)*

On 11 August 2004, the Ministry of Finance published a Decree (this Decree is an update of the original Decree IFZ2001/292M) entitled: 'Procedure for dealing with

requests for upfront certainty on transfer prices to be used in cross-border transactions (Advance Pricing Agreements)<sup>1</sup>. The Decree provides guidance on how the OECD Guidelines on APAs will be applied in the Dutch practice.

Details regarding the procedures to be followed and the information to be provided in an APA request are provided in the separate section 4814 on APAs.

#### *Decrees on financing companies (IFZ2004/126M and IFZ2004/127M)*

The regime for finance companies is applicable to back-to-back inter-company loans and inter-company licensing transactions. Until 1 April 2001, it was possible to obtain a finance ruling when certain conditions were met. A finance company was not allowed to incur economic risk, or only very limited risk, and it had to report a net taxable income ('spread') on the average borrowed funds. Furthermore, withholding tax could only be credited on a pro rata basis. This ruling regime was abolished in April 2001 and existing situations were grandfathered until the end of 2005. This means that currently all companies engaged in these activities need to meet the requirements of the new regime.

Under this regime, a Dutch finance or licence company must meet the following requirements:

- The company must incur economic risk; and
- The company must have sufficient operational substance.

These requirements are further elaborated in two Decrees that were published by the Dutch Finance Ministry in 2004. The first Decree (IFZ2004/126M), focuses on companies involved in inter-company finance activities without economic substance, and is an update of the original Decree of 30 March 2001 (IFZ2001/294 M) on this subject. The second Decree (IFZ2004/127M) contains questions and answers on the Decree's application.

The importance of the regime lies in what happens if the requirements are not met. In such a case, interest and/or royalties paid and received are not included in the Dutch tax base. In addition, the Dutch Revenue may spontaneously exchange information with local tax authorities of the countries to which the loan/licence is granted. This will likely result in an increase of withholding tax on these payments, which can subsequently not be offset in the Netherlands as the interest and royalty are not included in the Dutch tax base.

Although this regime on finance and licence companies contains more requirements than the old regime, in practice these requirements are easily met, and they effectively enhance the beneficial ownership position compared to the situation under the old regime. Furthermore, it is also fairly straightforward to obtain a unilateral APA in the Netherlands in which the Dutch tax authorities confirm (1) that the requirements are met, and (2) that the remuneration applied (a spread determined on a case by case basis) is at arm's length.

#### *Resolution on EU Arbitration Convention*

A Resolution dated 28 November 1995 explains the Dutch approach to certain practical matters related to the Arbitration Convention, such as the language to be used in the arbitration procedure and the cost of the process. The procedure for presenting a case for arbitration is also set out in this Resolution.



### *Advance tax rulings (ATRs)*

Effective from 1 April 2001, the former Dutch ruling practice was converted into an 'APA/ATR' practice. Reference is made to the APAs in the 2004 Decrees on APAs and finance companies.

ATRs typically deal with issues such as the applicability of the participation exemption, hybrid loans, and the existence of a PE.

### **4904 Legal cases**

There are relatively few court cases on transfer pricing issues. One reason is the ability to obtain an APA (historically unilateral advance rulings) from the Dutch tax authorities on the arm's length nature of certain transfer pricing arrangements. Another factor may be that the burden of proof in transfer pricing disputes historically lies with the tax authorities, and the confidence of the tax authorities in this regard may have been a relevant factor.

This is illustrated by a Supreme Court decision of June 2002, which involved a Japanese parent with a distribution subsidiary in the Netherlands (Supreme Court, 28 June 2002, No. 36 446). The Dutch subsidiary sold a certain product at a loss for a lengthy period of time while the remaining product range was profitable. The transfer prices for all products were set by the parent company without clear evidence of negotiations. The Dutch tax authorities challenged the arm's length nature of the transfer price for the loss-making product, arguing that a third party would not have continued selling this product under these conditions. The High Court argued that the tax inspector wrongfully looked at only the loss-making product. Also, the Court held that the tax inspector had the burden of proof and failed to demonstrate that third party distributors would not have agreed to the pricing arrangements for the transactions under review. The Supreme Court upheld the decision of the High Court and decided in favour of the taxpayer.

From this Supreme Court decision, one may conclude that the burden of proof rests with the tax authorities even if a taxpayer reports a profit margin that is relatively low and differs from the industry average. The Supreme Court also ruled that for the arm's length test, certain transactions can be aggregated and a particular product may be unprofitable if the overall result for the company represents a fair return on the capital employed and the business risks incurred.

On 13 September 2002, the State Secretary of Finance issued a Decree (IFZ2002/830M) on the consequences of this Supreme Court decision. In the Decree, it was concluded that the Supreme Court decision results in a heavy burden of proof for the tax authorities for the years prior to 1 January 2002. Furthermore, the Decree indicates that the Ministry of Finance is considering whether the new transfer pricing legislation will lead to an equitable allocation of the burden of proof between the taxpayer and the tax authorities in transfer pricing disputes.

Furthermore, this Decree takes the position that aggregation of transactions is possible if these transactions have been agreed upon in one contract.

In October 2005, the Supreme Court ruled on a case (Supreme Court, 14 October 2005, No. 41 050) which dealt with the issues of dual residency and the existence of a permanent establishment. A multinational group with a head office located in the Netherlands operated its group financing function through a company located and

incorporated in Belgium. The Supreme Court ruled that since a significant part of its core activities were on a day to day basis performed by the Belgium employees, the company should not have had dual residency and was therefore not subject to Dutch corporate income tax. Moreover, the involvement of the Dutch head office had not exceeded a normal level of involvement within a group, and as a result it could not be concluded that the Belgium group company had a PE in the Netherlands.

#### **4905 Burden of proof**

As indicated previously, there is a legal obligation for the taxpayer to maintain certain transfer pricing documentation. To the extent that this requirement is not met, the burden of proof is ultimately transferred to the taxpayer.

In general, there are no statutory provisions to indicate how the burden of proof is divided between the taxpayer and the tax authorities. The allocation of the burden of proof between the parties is at the discretion of the court. However, in practice and as a result of Dutch case law, if the company's revenue is adjusted upwards because of transfer pricing issues, the burden of proof usually lies with the tax authorities. On the other hand, the burden lies with the taxpayer to prove the deductibility of expenses.

In transfer pricing cases the burden of proof transfers to the taxpayer if the pricing arrangements are unusual; for example, if comparable uncontrolled prices (CUP) are available but not used, or goods or services are provided at cost or below cost. The burden of proof is also transferred to the taxpayer, and will be more onerous, if he/she refuses to provide information requested by the tax authorities where there is a legal obligation to do so, or if the requisite tax return is not filed. Finally, the court sometimes allocates the burden of proof to the party best able to provide the evidence.

#### **4906 Tax audit procedures**

##### *Selection of companies for audit*

There is no clear criteria as to how companies are selected for a transfer pricing investigation, but a company bears an increased risk of such an investigation if one of the following situations occurs:

- The company has suffered losses for a number of years;
- The company is involved in transactions with related parties in tax havens;
- The company shows fluctuating results from year to year;
- Closure of the company;
- Reorganisation of the company's activities;
- The results of the company are lower than the average for the industry; or
- The company pays substantial royalties or management fees.

The Dutch tax authorities conduct centrally coordinated transfer pricing investigations for certain specific industries, such as the pharmaceutical or the automobile industry.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

In accordance with the General Tax Act, a taxpayer can be compelled by the tax authorities to provide access to all books and other documentation relevant to the

determination of the facts of the company's tax position. If a taxpayer does not provide the requested information to the tax authorities, the burden of proof is transferred to the taxpayer. Furthermore, failure to comply can be considered a criminal offence, which could ultimately result in penalties or even imprisonment.

Transfer pricing legislation does not give a clear indication as to exactly what the minimum requirements are in terms of documentation. However, in the Explanatory Memorandum on the legislation, reference is made to the OECD Guidelines in this respect. The Decrees of March 2001 and August 2004 also provide some guidance on the documentation that should be maintained. It is understood that the documentation should include the following:

- A summary of the relevant intra-group transactions;
- A functional analysis;
- An industry analysis;
- A summary of the TPMs and margins used, including evidence that the methods have resulted in an arm's length outcome;
- Details on the company's strategies, including critical assumptions; and
- Intra-group arrangements, including the trading conditions.

These documentation requirements also apply to arrangements entered into by affiliated companies before 1 January 2002 but which are still effective subsequent to that date.

With respect to requests for information regarding foreign group companies, which can affect the Dutch company's tax position, the situations set out below can be distinguished.

#### *A Dutch company with a majority shareholding in a foreign company*

In this situation, the Dutch tax authorities can require the Dutch company to provide information on, and give access to, the books and records of the foreign subsidiary. If the requested information is not provided, the burden of proof will be transferred to the taxpayer.

#### *A Dutch company with a foreign parent company or fellow subsidiary*

The Dutch tax authorities can request a Dutch company to provide information on its foreign parent company or fellow subsidiary. However, a taxpayer is not obligated to provide this information if the parent company or fellow subsidiary is resident in either the EU or a country with which the Netherlands has a tax treaty that includes a provision for the exchange of information. In this case, the information should be requested directly from the tax authorities. If this process fails, no tax treaty exists, or the treaty does not include an exchange of information Article, the Dutch tax authorities can request access to the books and records of the foreign parent company or fellow subsidiary. If the requested information is not provided, the burden of proof will be transferred to the taxpayer.

### **4907 The audit procedure**

Transfer pricing matters usually form an integral part of a general state audit. The

Dutch tax authorities aim to audit every company at least once every five years and larger companies once a year. A state audit comprises an 'on-site' examination of the company's books, which usually covers a number of years, taking into account the five-year period within which the tax authorities may statutorily reassess taxes. This period is extended with the extension period granted for filing the tax return. Historically, the tax authorities concentrated largely on examining intra-group charges for service fees and royalties. Recently a lot of attention is focused on the transfer pricing of goods, the treatment of intangible assets, and the allocation of head office costs by Dutch multinationals. These may be examined through separate transfer pricing state audits, as the Dutch tax authorities are more active in this area.

The conduct of the taxpayer during the investigation, particularly with respect to any requests for information from the tax authorities, could have an effect on the outcome of the dispute and size of the adjustment. Transfer pricing disputes between the Dutch tax authorities and the taxpayer are usually solved through negotiation rather than litigation. It should be noted, however, that an additional assessment is the most likely outcome since most disputes are solved through compromise.

#### **4908 Revised assessments and the appeals procedure**

The taxpayer may appeal against the revised assessment and should do so within six weeks of the date when the additional assessment was raised. The tax authorities should make a formal decision on the appeal in 8 weeks. In case the tax authorities are not able to give a decision within this term, they should inform the tax payer and set a new (reasonable and final) term.

The tax authorities must also provide an explanation for its decision. If the initial appeal has been rejected by the tax authorities, the taxpayer can file an appeal with the District Court against the decision. This appeal must be filed within six weeks of the tax authorities' formal decision. As of January 2005, the formal appeal procedures have changed. To speed up the decision process, if there is mutual consent between the taxpayer and the tax inspector, the appeal to the tax inspector can be bypassed by sending the appeal directly to the District Court. This will then be treated as an appeal with the District Court.

There is no time limit within which the District Court must make its decision. Following its decision either the taxpayer or the tax authorities can file an appeal with the Dutch High Court within six weeks. Once the High Court has made a decision, either the taxpayer or the tax authorities may appeal the decision on points of law to the Supreme Court. Such an appeal must also be filed within six weeks of the High Court's decision. The Supreme Court is the final court; its decision is binding, and there is no further appeal. There is no time limit within which the Supreme Court must make its decision. To speed up the decision process, and with mutual consent between the taxpayer and the tax inspector, the appeal to the High Court can be bypassed by sending the appeal directly to the Supreme Court. Generally, a taxpayer will try to avoid litigation since it can be a very time consuming and costly exercise.

#### **4909 Additional tax and penalties**

The Dutch legislation does not provide for specific transfer pricing penalties. Nevertheless, the existing penalty rules are applicable on any additional tax resulting from transfer pricing adjustments. The penalties vary from zero to 100% of the

additional tax, depending on the degree of the intent to avoid tax or gross negligence of the taxpayer. Penalties are not deductible for corporate income tax purposes. It should be noted that transfer pricing adjustments do not often result in penalties since the taxpayer's position is usually more or less defensible and therefore is not strictly tax avoidance. However, an additional tax assessment will result in interest charges.

#### **4910 Resources available to the tax authorities**

Transfer pricing enquiries are conducted by the local tax inspector and the tax auditor, usually in consultation with specialised accountants from the Transfer Pricing Co-ordination Group. This group is dedicated to transfer pricing and includes individuals from the Ministry of Finance and from the tax authorities. Its main task is to prepare policies for those instances of incorrect application of the arm's length principle. Furthermore, the group should be consulted by the tax authorities and the Ministry of Finance on any transfer pricing issues (including allocation of profit between head office and PE), and it should guarantee a consistency in dealing with transfer pricing matters. Transfer pricing cases dealt with by the local tax inspector should also be reported to this group. This particularly applies to the following scenarios:

- Cross-border transactions with related entities established in tax havens;
- Proposed transfer pricing audits;
- Cross-border transactions that are, or will be, assessed as part of an industry examination;
- A request by a taxpayer for a corresponding adjustment in the area of transfer pricing as a result of a (proposed) adjustment at a related entity in another state;
- If it is likely that a mutual agreement or arbitration procedure will be started;
- A cross-border transfer of intangible assets within a group; and
- A request for advance certainty on the extent of the documentation requirements of Article 8b of the Corporate Income Tax Act.

The group reviews (interim) reports, provides binding advice to the local tax inspector, and will also operate as a help-desk for staff members of the tax authorities. This binding advice does not relate to APA requests because the local tax inspectors should involve the centralised APA/ATR team for these.

#### **4911 Use and availability of comparable information**

##### *Use of information*

As indicated above, the principles in the OECD Guidelines have been accepted by the Netherlands and will generally be applied. Since the OECD Guidelines recommend the use of comparable information, a comparables study is an appropriate means to justify a transfer pricing policy. Furthermore, the reference to comparables in the explanatory notes on the transfer pricing legislation make it evident that comparables information will be a crucial element in defending transfer prices in the Netherlands. The tax authorities have access to its own comparable data, and they use commercially available databases (see below). According to the transfer pricing legislation and

their explanatory notes, it is, strictly speaking, not mandatory for a taxpayer to perform a comparables study (i.e. benchmarking) to support its transfer pricing policy. On the other hand, in the absence of a comparables study, it is likely that the Dutch tax authorities will perform such a study itself. It is therefore advisable for a taxpayer to perform a comparables study to support the arm's length nature of its pricing arrangements. In case of an APA, a comparables study is required as part of the information to be provided to the tax authorities (reference is made in the APA section below).

### *Availability*

Dutch companies are required to file its statutory financial statements in full or abbreviated form (depending on the size of the company) with the local chamber of commerce. This information is compiled on a publicly accessible database and may be used by other companies in similar situations to justify or defend a pricing policy.

The tax authorities can also obtain and use all information that is publicly available, including external databases, to support its position. In addition, the tax authorities may use information (e.g. gross margins or net operating profit margins) obtained from corporate income tax returns and state audits. However, it should be noted that such information is rarely used as evidence before the courts since the tax authorities might be compelled to disclose the underlying financial information and this might put the tax authorities in breach of its confidentiality obligations.

### **4912 Risk transactions or industries**

No transactions or industries are excluded from the scope of the transfer pricing legislation. Historically the Dutch tax authorities have primarily focused on intra-group charges such as royalties, management fees, commissions, and interest payments, as well as intra-group transactions with low tax countries, and intra-group transactions involving intangible assets.

More recently, particularly since the introduction of the Transfer Pricing Decrees and the legislation, there is a tendency for more queries to be raised concerning the transfer prices and margins of goods, as well as the allocation of head office costs and related service charges by Dutch multinationals. In addition, the Dutch tax authorities are increasingly becoming sophisticated in the area of inter-company financial transactions, including the arm's length nature of the interest rates applied on group loans, cash pooling, and credit guarantees.

### **4913 Limitation of double taxation and competent authority proceedings**

Most tax treaties for the avoidance of double taxation concluded by the Netherlands include provisions for a mutual agreement procedure (MAP). In the Netherlands, a request to initiate the MAP should be filed with the Dutch Ministry of Finance, generally within three years of the date when the taxpayer becomes aware of the possibility of double taxation. There are no specific provisions on the method of making such a request.

No information is available on the number of requests made since the Ministry of Finance has not disclosed this information. The competent authority procedure is

not well used in the Netherlands, as there is no certainty for the taxpayer that the relevant authorities will come to an agreement. The procedure is usually time consuming, taking up to a couple of years, and is also costly. Additionally, with the opportunity in the past of obtaining an advance ruling on many issues and the fact that transfer pricing challenges are often settled locally through compromise, in practice a relatively low number of competent authority cases arise. It is understood that it is part of the Dutch treaty policy to include an arbitration clause in future tax treaties. One of the treaties that already includes an arbitration clause is the treaty concluded between the Netherlands and the US.

In this context it is worth noting that, together with other EU member states, the Netherlands has ratified the Protocol to the Arbitration Convention applicable as per January 2000.

#### **4914 Advance pricing agreements (APAs)**

As indicated previously, there are formal procedures in the Netherlands for setting pricing policies in advance through a unilateral or bilateral APA. The authority for the APA procedures lies in the amended APA Decree published by the Ministry of Finance on 11 August 2004, which replaces the 30 March 2001 Decree. APAs may include transfer pricing methodologies covering different types of related party transactions or specific transactions, including transfers of tangible or intangible property, financing and licensing activities, and the provision of services. APAs may cover all the taxpayer's transfer pricing issues or may be limited to one or more specific issues.

The number of APAs concluded by the Dutch tax authorities is increasing significantly. An APA request requires a certain amount of detail to be disclosed to the tax authorities. However, this is not materially different from the documentation that the taxpayer must maintain under the transfer pricing documentation requirements, effective 1 January 2002.

The information to be provided to the tax authorities by the taxpayer as part of an APA request generally includes, among other things, the following:

- Details on transactions, products and agreements relating to the proposal;
- Details on the entities and PEs involved;
- The relevant jurisdictions;
- Details on the worldwide group structure, history, financial data, products, functions, risks and (in)tangible assets involved;
- A description of the proposed transfer pricing method, including a comparables analysis;
- Details on the critical assumptions applied in the proposal and the implications of changes therein. This would allow a certain flexibility in the actual application of the APA, provided that the critical elements (e.g. market share or value chain) fluctuate within a certain predetermined range;
- The accounting years involved; and
- General information on the market conditions (i.e. industry analysis).

The APA request needs to be filed with the tax inspector. In all cases, the inspector is obliged to present the request to the APA/ATR team of the Dutch tax authorities for

binding advice (in cases of new policy after consultation of the Transfer Pricing Co-ordination Group). In the case of a bilateral APA request, the Dutch Ministry of Finance will initiate the bilateral agreement procedure with the other country involved. In principle, an APA will be applicable for a period of four to five years unless longer term contracts are involved. Under certain conditions an APA can be applied retroactively, for example as part of a conflict resolution during a state audit. The Dutch tax authorities are eager to make the APA regime work and therefore, according to the Dutch State Secretary of Finance, the Dutch tax authorities will maintain its professional, flexible, and cooperative international reputation in this area. The APA Decree of 11 August 2004 (IFZ2004/124M) entails various measures to further develop the APA practice and to streamline the filing process. These measures relate to the possibility of a pre-filing meeting, the introduction of a case management plan, and the possibility of assistance by the tax authorities in identifying comparable data for small businesses (i.e. companies with a balance sheet total of less than EUR5 million and with an average number of employees of less than 50).

The pre-filing meeting creates the potential to discuss the APA request with the APA team before it is actually filed. The benefit to the taxpayer is a clarification of the information that is likely to be required and any specific elements likely to be pertinent to the formal APA request.

In cooperation with the APA team, a joint case management plan (i.e. a work plan) will be prepared describing the process and timing between the filing and the completion of an APA request. The intention of this case management plan is to reduce the uncertainty for the taxpayer with respect to the handling process of the application. The case management plan should provide a realistic time frame for the completion of the request as agreed by both parties.

To decrease the administrative burden for smaller companies, the tax authorities will, to the extent possible, provide comparable financial information of independent enterprises. This assistance should make it easier for relatively small companies to file an APA request, as many small companies are reluctant to enter the APA process due to the administrative burden and related costs. The taxpayer still must provide the necessary information on the organisation and functional analysis of the company, as well as the rationale for the proposed transfer pricing method and mechanisms, for example.

#### **4915 Anticipated developments in law and practice**

With the existence of specific transfer pricing legislation in the Netherlands and considering the increased awareness of the Dutch tax authorities with respect to transfer pricing matters, the most likely development is that, in practice, intra-group transactions will be reviewed even more closely and challenged even more frequently than is the case presently. This is also a result of the active approach to transfer pricing by the authorities of the most important Dutch trade partners, such as Germany and the US. These developments will force multinationals to review their transfer pricing policies and carefully document them in order to defend their prices against any future challenge.

#### **4916 Liaison with customs authorities**

The exchange of information between the corporate income tax authorities and the



customs authorities takes place as part of the daily routine of the Dutch tax authorities. The special customs valuation team based in Rotterdam now directly co-operates with the corporate tax authorities throughout the process of an investigation for customs purposes. Also, combined customs and corporate income tax teams exist within other major offices of the Dutch Revenue. Furthermore, Customs have now implemented a database containing pricing structures and price levels for different industries.

In case of a customs valuation audit, the following information may be requested by the customs authorities:

- General information on the company;
- Any available information on transfer prices;
- Annual accounts;
- Legal structure;
- Specific information on the goods flow, invoicing structure (including retrospective price adjustments), any special arrangements (e.g. tools, machines, goods, or materials provided to the manufacturer, so-called 'assists'), royalties, warranty, marketing, etc; and
- Reports of foreign customs audits.

A copy of the customs valuation report is usually forwarded to the corporate tax authorities. In principle, any transfer pricing adjustments made for corporate income tax purposes should be reported to the customs authorities, unless the adjustments relate to items that are not dutiable for customs purposes. A request for a refund of customs duties, in the event that the import prices are adjusted downwards, should be submitted within three years of the date of actual importation. In the event that the import prices are adjusted upwards, an adjustment should be reported to the customs authorities. The customs authorities will then issue an assessment for the underpaid customs duties. The customs authorities can impose an additional assessment within three years of the date of actual importation. In cases where the customs authorities feel that the underpayment of customs duties had been a deliberate action to avoid payment of customs duties the period for assessing the duties may be extended to five years. Recently the customs authorities have raised more queries on the intra-group purchase prices in situations where the group company purchasing the goods has little or no real economic risk. This may apply to distribution centres with a cost plus remuneration but which are still part of a buy/sell structure, or low-risk distribution companies. In these situations, Customs may attempt to argue that the intra-group purchase price, although in line with the transfer pricing policy, does not qualify as transaction value according to the customs valuation regulations. This is because the customs authorities believe the purchase prices do not represent normal market prices, due to lack of economic risk by the purchasing company. With respect to this, it is advisable to also consider customs valuation issues when implementing transfer pricing or corporate income tax arrangements (this is only relevant when the imported products are subject to an actual duty levy). Furthermore, if Customs does not accept a transaction value, some questions need to be dealt with from a VAT perspective also, i.e. who may deduct the VAT at import and what is the VAT status of the service provider in the case of a cost plus arrangement.

**4917 OECD issues**

The Netherlands is a member of the OECD and according to the Transfer Pricing Decrees of 30 March 2001 and 21 August 2004, the OECD Guidelines are directly applicable in the Netherlands. Also, the Explanatory Memorandum to the October 2001 proposals on the transfer pricing legislation, effective from January 2002, reconfirms the adoption of the OECD Guidelines by the Dutch tax authorities.

**4918 Joint investigations**

In principle, the Netherlands could join with another country to undertake a joint investigation of a multinational group for transfer pricing purposes. However, this does not happen very often and when it does, the joint investigation has usually been initiated by the foreign tax authorities.

**4919 Thin capitalisation**

The Netherlands has thin capitalisation rules, effective 1 January 2004. In summary, interest is not deductible to the extent that interest is payable on group loans that exceed a three to one debt to equity ratio (safe harbour). For determination of the debt position of the company, the net third party loans and the net group loans payable should be taken into account. If the debt to equity ratio of the Dutch company exceeds the fixed ratio of three to one, the debt to equity ratio of the consolidated group to which the Dutch company belongs, according to its commercial financial statements, may be applied. In that case, the interest payable on group loans is not deductible to the same extent. For the purpose of this ratio, the gross amount of the liabilities of the Dutch group and the equity as reported in the commercial accounts should be taken into account. Special rules exist for the determination of the equity and liabilities of the Dutch company and for certain specific situations. Further, for the application of these rules, a fiscal unity for Dutch corporate income tax purposes is considered to be one single taxpayer.

# 50 New Zealand

## 5001 Introduction

New Zealand enacted new transfer pricing legislation on 12 December 1995, with effect from the income year ending 31 March 1997. The Inland Revenue Department (Inland Revenue) issued transfer pricing guidelines in final form in October 2000.

## 5002 Inland Revenue's current focus

The Inland Revenue is continuously fine-tuning its targeting approach in terms of taxpayers and risk areas. This is clearly evidenced through our dealings with the Inland Revenue and commentaries published by the Inland Revenue in the last two years. The Inland Revenue has expressed its views on the transactions they will monitor, expectations for New Zealand based companies when expanding offshore and risk areas that foreign multinationals should be aware of when restructuring their New Zealand operations. These actions clearly indicate the Inland Revenue's desire to lift its game and sophistication in terms of its transfer pricing enforcement activity.

In this regard, the Inland Revenue have instigated a number of specific programmes over the last few years. In particular they maintain a special focus on the top 100 foreign-owned multinationals, New Zealand's top 40 exporters and the top 10 financial institutions (collectively referred to as the Top 150).

The Inland Revenue also commenced a special project during 2006 on associated party interest rates and guarantee fees, especially where those financing costs exceed NZD1 million per year.

In 2007, the Inland Revenue announced through its website that it will focus on royalties, intangible assets, business restructures and private equity. The Inland Revenue has issued specific commentaries on these areas of focus on its website.

Royalties have been a particularly hot topic for the Inland Revenue since 2005. The Inland Revenue requires a taxpayer to be able to demonstrate that the royalties paid to offshore affiliates produce appropriate profits for the taxpayer's functions, assets and risks post the royalty payments. The Inland Revenue are taking a more thorough approach in researching and understanding profit drivers and are not likely to just accept a claim that there is value in the underlying intellectual property. The Inland Revenue also focuses on whether there are locally created intangibles and if so, that the profit achieved reflects the intangibles.

Business restructures is another key focus area for the Inland Revenue. The Inland Revenue is aware that multinationals continuously alter their supply chains in their quest to maximise efficiencies in their networks. The Inland Revenue is looking closely at supply chain restructures, particularly restructuring a standard-risk operation to a low-risk operation. In this type of restructuring, the Inland Revenue will be focusing on the economic substance underlying the low risk operation, i.e. structural changes need to be real, not just on paper. In this regard, the Inland Revenue has issued a commentary outlining ten key questions that need to be considered and included in a taxpayer's documentation in respect of the restructure.

The Inland Revenue is also monitoring acquisitions of New Zealand businesses by offshore private equity interests. The Inland Revenue is monitoring such businesses to ensure that there is no undue erosion of the New Zealand tax base through excessive gearing and interest rates.

Recurring losses remain a key focus area. The Inland Revenue continues to focus on companies that exhibit a low level of operational functionality which have incurred losses over a sustained period of time. The Inland Revenue has indicated that further audit work is likely to occur where the company fails to lift its performance following a transfer pricing review by the Inland Revenue. Transfer pricing adjustments could follow.

The Inland Revenue has also shown a great deal of interest and willingness to entertain Advance Pricing Agreements (APAs). Key areas covered by APAs that have been recently negotiated include distribution entities with large exposures, business restructures and complicated royalty structures. Our experience to date with the Inland Revenue in relation to APAs has been a positive one. We believe this is due to the Inland Revenue's informal approach to APAs and their pragmatic view on commercial realism.

### **5003 Inland Revenue's review mechanism**

The main tool used by the Inland Revenue in assessing taxpayers' compliance with the transfer pricing rules is the issuing of a 'Transfer Pricing Questionnaire'. There are three versions of the questionnaire – one for foreign-owned multinationals, one for New Zealand owned multinationals and one for New Zealand branches. Each version varies slightly from the other. However, the main questions asked are the same.

The questionnaire requires taxpayers to provide details of, among other things: their financial performance, the worldwide group's financial performance, the type and amounts of cross-border associated party transactions, the method or methods used to test the transactions and whether documentation exists to substantiate the transfer prices. Also included in the version pertaining to foreign-owned multinationals are questions designed to assess taxpayers' compliance with the thin capitalisation rules. The questionnaire is a risk assessment tool and does not constitute notice of the commencement of a transfer pricing audit.

The questionnaires were first issued as part of the Inland Revenue's transfer pricing risk review project (i.e. 'bulk' rounds of questionnaires sent to multiple taxpayers) and during general tax audits. Two questionnaire 'rounds' were conducted in 2000. The Inland Revenue issued a further round of questionnaires in December 2003. The taxpayers targeted in the 2003 round were from a broad range of industries and included both subsidiaries of offshore multinationals and New Zealand based companies with overseas subsidiaries.

Taxpayers with potential transfer pricing issues receive the questionnaire as a matter of standard practice during a tax audit. We have seen an increasing number of taxpayers being asked by the Inland Revenue to complete questionnaires during routine tax investigations. In many cases, the issuing of the questionnaire during a tax audit has been accompanied by a request for transfer pricing documentation. Inland Revenue auditors have received transfer pricing specific training and recent experience suggests an increasing number of auditors are making transfer pricing queries.

Some taxpayers have also received the questionnaire as a 'one-off', i.e. not as part of a specific review project or a tax audit. We suspect in these incidences, the Inland Revenue is seeking to obtain an understanding of the transfer pricing issues and risks associated with a particular industry.

The types of response given by the Inland Revenue to a taxpayer following submission of the questionnaire include: 'no further action required', 'please provide further information' and 'please explain'. The second of these responses has generally involved the Inland Revenue requesting the taxpayer to complete a further questionnaire for a subsequent financial year. The third response has usually entailed the Inland Revenue requiring the taxpayer to explain the nature of a particular (and perhaps unusual) transaction or the reasons for a loss being incurred.

In addition, the Inland Revenue has indicated to some taxpayers that have received the questionnaire that they are maintaining a 'watching brief' of their transfer pricing practices. The Inland Revenue monitors the financial performance of these taxpayers by accessing publicly available financial statements from the New Zealand Companies' Office website.

#### 5004 Statutory rules

The Income Tax Act 2004 (New Zealand Tax Act) underwent a rewrite in 2007. The rewrite aimed to make the New Zealand Tax Act easier to understand and while the text changed, the interpretation of the New Zealand Tax Act was meant to remain as before. The current transfer pricing legislation is contained within Sections YD5, GB2 and GC6 to GB14 of the Income Tax Act 2007<sup>19</sup>. The transfer pricing legislation closely follows the current OECD Guidelines and the United States Section 482 rules. Other features of the legislation are as follows:

- (1) The basic principle is that of arm's length, as defined by the OECD Guidelines, using five permitted pricing methods (i.e. comparable uncontrolled price (CUP), resale price, cost plus, profit split and comparable profits methods);
- (2) The arm's length amount of consideration must be determined by applying whichever method or combination of methods listed above will produce the most reliable measure of the amount completely independent parties would have agreed upon after real and fully adequate bargaining.;
- (3) The substitution of an arm's length price applies only so as to increase New Zealand's tax base (GC7 and GC8)<sup>20</sup>. The burden of proof as to the arm's length nature of consideration rests with the Commissioner of Inland Revenue (the Commissioner), unless the Commissioner can show the taxpayer has not co-operated or can demonstrate another amount to be a more reliable measure of an arm's length amount (GC13(4))<sup>21</sup>;
- (4) There are specific powers, in addition to those in the double taxation agreements (DTA), to allow compensating adjustments (GC9 and GC10<sup>22</sup>) and corresponding adjustments (GC13(11))<sup>23</sup>;

<sup>19</sup> The relevant sections in the Income Tax Act 2004 are GD13, FB2 and GC1.

<sup>20</sup> Income Tax Act 2004 Sections GD13(3) and (4).

<sup>21</sup> Income Tax Act 2004 Section GD13(9).

<sup>22</sup> Income Tax Act 2004 Section GD13(10).

<sup>23</sup> Income Tax Act 2004 Section GD13(11).

- (5) Section GB2<sup>24</sup> contains an anti-avoidance provision that includes arrangements entered into for the purposes of defeating the provisions of GC6 to GC14<sup>25</sup>; and
- (6) Section YD5<sup>26</sup> stipulates the use of the arm's length basis to apportion income between New Zealand and other countries in the case of branches and agencies.

### **5005 Guidance on applying New Zealand's transfer pricing rules**

The following additional guidance on the application of the legislation is currently available from the Inland Revenue:

- a technical information bulletin, which deals with the introduction of the new legislation and provides an indication of how the Inland Revenue will interpret the legislation; and
- transfer pricing guidelines.

The Inland Revenue initially released draft guidelines in two parts – part one in October 1997 and part two in January 2000. There have been no subsequent guidelines published to date after the 2007 re-write of the Income Tax Act 2004. The first part of the draft guidelines covered the arm's length principle, transfer pricing methodologies, theoretical and practical considerations, principles of comparability, practical application of the arm's length principle, documentation and the Inland Revenue's approach to administering New Zealand's transfer pricing rules. Part two of the draft guidelines covered the treatment of intra-group services, the treatment of intangible property, and cost contribution arrangements (CCA). The Inland Revenue issued final transfer pricing guidelines (the Guidelines) in October 2000. The Guidelines consolidate the draft guidelines previously issued with no substantive changes from the draft guidelines. The Guidelines specifically do not apply to permanent establishments (PEs) and branches that are covered by Section YD5<sup>27</sup> of the New Zealand Tax Act.

The Inland Revenue state that the Guidelines are intended to supplement the OECD Guidelines rather than supersede them. In fact, the Inland Revenue fully endorses the comments set out in chapters one to eight of the OECD Guidelines. In the Guidelines, the Inland Revenue indicates that the OECD Guidelines are relevant to DTA issues and issues not addressed by the Guidelines.

Taxpayers are also directed to guidelines issued by the Australian Taxation Office (ATO) and the United States 482 Regulations, as long as the latter source is consistent with the overall approach adopted by the Inland Revenue. However, on issues concerning the administration of New Zealand's transfer pricing rules, the Guidelines are stated as being paramount.

The comments in the Guidelines dealing with the arm's length principle and pricing methods are broadly consistent with the OECD Guidelines, except there is no explicit hierarchy for the transfer pricing methods. However, taxpayers must use the most reliable method.

In relation to the transfer pricing methods prescribed in the New Zealand Tax Act, a particularly interesting comment is made in the Guidelines:

---

<sup>24</sup> *Income Tax Act 2004 Section GC1.*

<sup>25</sup> *Income Tax Act 2004 Section GD13.*

<sup>26</sup> *Income Tax Act 2004 Section FB2.*

<sup>27</sup> *Income Tax Act 2004 Section FB2.*

'...Inland Revenue does not consider that there is any practical difference between the TNMM espoused by the OECD, the comparable profits method favoured in the United States, and the profit comparison method adopted by Australia.' It was also noted [previously in the Guidelines] that the reference to 'comparable profits methods' in Section GD13(7)(e) [of the New Zealand Tax Act] is wide enough to encompass all three approaches,' (the Guidelines, paragraph 141)<sup>28</sup>.

With respect to tested parties the Guidelines specifically allow taxpayers to benchmark the foreign party in particular circumstances where they believe that that is more appropriate to determine the most reliable measure of the arm's length price. However, where a taxpayer does decide to use the foreign party as the tested party they should be aware that the Inland Revenue is likely to also test the New Zealand party and, therefore, it is important there is some analysis in relation to the New Zealand operations. Specifically, the Inland Revenue is prepared to accept a foreign analysis provided that the analysis represents a fair application of the arm's length principle and results in a return from the New Zealand operations that is, prima facie, commensurate with the operation's economic contribution and risks assumed.

The Inland Revenue recognise that applying the transfer pricing methods can often result in a range of arm's length outcomes, as opposed to a single arm's length outcome. Where a range is established, the Inland Revenue consider that, rather than applying statistical measures to that range, the more important issue is to assess whether the comparables used to construct the range are reliable.

The New Zealand transfer pricing rules do not contain an explicit statutory provision requiring taxpayers to prepare transfer pricing documentation. However, Section GC6 to GC14<sup>29</sup> of the New Zealand Tax Act requires taxpayers to determine transfer prices in accordance with the arm's length principle by applying one (or a combination of) the methods set out in Section GC13(2)<sup>30</sup> of the New Zealand Tax Act. To demonstrate compliance with this requirement, the Inland Revenue considers it necessary to prepare and maintain documentation to show how transfer prices have been determined and to demonstrate compliance with the arm's length principle. The Inland Revenue considers there are two reasons for making this assertion. The first of these is the burden of proof rule in Section GC13(4)<sup>31</sup> of the New Zealand Tax Act. Under this section the price determined by the taxpayer will be the arm's length price, unless the Commissioner can demonstrate a more reliable measure or the taxpayer does not co-operate with the Commissioner's administration of the transfer pricing rules. If a taxpayer does not prepare documentation there are two exposures. First, it is more likely the Inland Revenue will examine their transfer pricing in detail and second, if the Inland Revenue as a result of the examination substitutes a new transfer price, the lack of documentation will make it difficult for the taxpayer to rebut that position.

The second consideration sustaining the Inland Revenue's view is the proposed application of the penalty provisions of the Tax Administration Act 1994 (Tax Administration Act) contained in the Guidelines:

'In Inland Revenue's view, adequate documentation is the best evidence that can be presented to demonstrate that these rules have been complied with. If a taxpayer

<sup>28</sup> This reference provided by the Guidelines refers to the *Income Tax Act 2004*. The relevant section in the 2007 rewrite is GC13(2)e.

<sup>29</sup> *Income Tax Act 2004* Section GD13.

<sup>30</sup> *Income Tax Act 2004* Section GD13(7).

<sup>31</sup> *Income Tax Act 2004* Section GD13(9).

has not prepared any transfer pricing documentation, and Inland Revenue is able to demonstrate a more reliable measure of the arm's length amount, Inland Revenue's view is likely to be that the taxpayer has, at a minimum, not exercised reasonable care (carrying a 20% penalty under Section 141C of the Tax Administration Act) or has been grossly careless (carrying a 40% penalty under Section 141C of the Tax Administration Act), in its determination of an arm's length amount under Section GD13,' (the Guidelines, paragraph 316)<sup>32</sup>.

The Inland Revenue accepts that the creation and maintenance of documentation imposes costs on taxpayers. In the Inland Revenue's opinion, if a taxpayer has reached the conclusion on the basis of a sensible cost-benefit analysis that it is not prudent to pursue a full transfer pricing analysis this would be strongly suggestive that reasonable care has been taken by the taxpayer. The Inland Revenue would of course expect to see a document explaining how the conclusion was reached. In respect of the issue of whether or not a taxpayer has an acceptable interpretation, the Inland Revenue considers the taxpayer must have explicitly considered that its transfer prices are at least broadly consistent with the arm's length principle. In assessing the risk of a potential transfer pricing adjustment, it is suggested that at least the following minimum documentation should exist:

- an identification of the cross-border transactions for which the taxpayer has a transfer pricing exposure;
- a broad functional analysis of the taxpayer's operations, to identify the critical functions being performed;
- an estimate of the business risk of not undertaking and documenting a more detailed transfer pricing analysis; and
- an estimate of the costs of complying with the transfer pricing rules.

It is emphasised that this will not preclude the Inland Revenue from substituting a more reliable measure of the arm's length price. Where a cost-benefit analysis indicates the need for a full analysis, the Inland Revenue would expect to see the following documentation:

- some form of functional analysis;
- an appraisal of potential comparables;
- an explanation of the process used to select and apply the method used to establish the transfer prices, and why it is considered to provide a result that is consistent with the arm's length principle; and
- details of any special circumstances that have influenced the price set by the taxpayer.

It should be noted that the above documentation requirements have no legislative authority and are not, therefore, binding on the taxpayer. They are rather an indication of the Inland Revenue's approach to an interpretation of New Zealand's transfer pricing rules.

The Guidelines also consider cross-border transfers of intangible property, which

---

<sup>32</sup> This reference from the Guidelines refers to the Income Tax Act 2004. The corresponding references for the Income Tax Act 2007 are GC6 to GC14.



includes any rights to use industrial property (such as patents, trademarks, trade names, designs or models), any literary or artistic property rights (copyrights, etc) and any intellectual property, such as know-how or trade secrets.

The Inland Revenue acknowledges that the application of the arm's length principle to transfers of intangible property can be problematic because appropriate comparable transactions can be difficult, if not impossible, to identify. Despite these difficulties, the Inland Revenue emphasises that applying the arm's length principle is no different than for other types of property.

The Guidelines also discuss the provision or receipt of intra-group services. Services can be either specific benefit or indirect services. Specific benefit services are normally charged to the recipient entity directly. Indirect services should be charged using a cost allocation or apportionment approach.

The most significant departures in the Guidelines from the OECD Guidelines relating to services are:

- the Guidelines contain a detailed discussion of the different allocation methods that may be appropriate in the charging of indirect services; and
- the provision of a safe harbour mark-up on cost of 7.5% in applying the cost plus method for non-core activity services and for services under a NZD100,000 *de minimis* threshold. A non-core activity is defined as an activity that is not integral to the profit earning or economically significant activities of the group. This will relieve taxpayers from having to benchmark these services. However, it does not relieve their obligations to demonstrate the benefits derived from the services or prepare adequate transfer pricing documentation.

Cost contribution arrangements (CCAs) are also discussed in the Guidelines. The Guidelines emphasise that to satisfy the arm's length principle a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances. CCAs remain an evolving concept from a transfer pricing perspective. The Guidelines on CCAs should clearly be considered by taxpayers if they are participating in, or considering participating in a CCA.

### 5006 Legal cases

There have not yet been any court cases in connection with New Zealand's current transfer pricing rules. It should be noted, however, that even under the previous legislation there were effectively no transfer pricing court cases in the 20 years prior to its repeal. There were two main reasons for this:

- (1) the previous legislation was considered to be defective; and
- (2) as most transfer pricing disputes were settled by negotiation, there was no need to proceed to court.

### 5007 Burden of proof

In New Zealand, the burden of proof normally lies with the taxpayer, not the Commissioner. However, Section GC13(4)<sup>33</sup> places the burden of proof on the Commissioner where the taxpayer has determined its transfer prices in accordance

---

<sup>33</sup> 3 Income Tax Act 2004 Section GD13(9).

with Sections GC13(1) to 13(3)<sup>34</sup> of the New Zealand Tax Act.

Where the Commissioner substitutes an arm's length price for the actual price, then the Commissioner must prove that either:

- (1) this is a more reliable measure; or
- (2) the taxpayer has not co-operated with the Commissioner.

The Guidelines provide guidance on what is considered to be non-co-operation:

- where the taxpayer does not provide the requested relevant information to the Commissioner; or
- if a taxpayer does not prepare adequate documentation, and provide it to the Inland Revenue if requested.

The burden of proof rule is very important in the context of transfer pricing within New Zealand. Clearly, if taxpayers maintain basic documentation and produce it on request to the Inland Revenue, the risks of an intensive transfer pricing audit will be substantially reduced and in any event the burden of proof will be upon the Commissioner to demonstrate that they have a more reliable measure of the arm's length price.

### **5008 Tax audit procedures**

The Inland Revenue will perform audits or investigations specifically for transfer pricing issues. Transfer pricing audits or investigations may also be combined with normal audits and investigations.

#### *Selection of companies for audit*

Whether or not a company or group is selected for investigation will depend on a variety of factors or situations, which are as follows:

- whether there have been any previous transfer pricing disputes with the tax authorities, particularly if the authorities consider that these were unsatisfactorily resolved in the past;
- the industry within which the company operates;
- where an application for an advance pricing agreement (APA) has been withdrawn or unsatisfactorily resolved;
- following receipt of information passed to the tax authorities from overseas;
- where there is evidence of transfer pricing disputes with other revenue authorities overseas;
- as a result of desk audits of returns and replies to correspondence seeking information; and
- Inland Revenue risk assessment by reference to the following:
  - (a) no evidence of negotiations with parent;
  - (b) no economic or commercial basis for price;

---

<sup>34</sup> *Income Tax Act 2004 Sections GD13(6) to 13(8).*

- (c) poor co-operation; and
- (d) limited documentation.

Inland Revenue's compliance programme focuses its resources on perceived risk to the Inland Revenue. Transfer pricing specific reviews would ultimately depend on the extent of perceived tax risk associated with the affected taxpayer's transfer pricing practices. The Guidelines indicate that the Inland Revenue is likely to inspect transactions involving an entity resident in a country in which New Zealand does not have a DTA, more closely than transactions involving tax treaty countries.

#### *The provision of information and duty of the taxpayer to co-operate with the tax authorities*

Information that tax authorities can request during the course of investigations and the authorities' powers to enforce provision of the information are contained within Sections 16, 17, 17A, 18, 19 and 21 of the Tax Administration Act. The most important are Sections 16 and 17, which give the Inland Revenue extensive powers, both to carry out investigations and to demand information. The Guidelines make it clear that the Inland Revenue expect New Zealand taxpayers to obtain information from overseas associated entities on request from the Inland Revenue to justify the arm's length nature of transfer prices. Section 21 provides the Inland Revenue with further powers to require information, particularly in respect of information held offshore. Any information that is not produced in response to a Section 21 request will not be available to the taxpayer as part of his/her defence in any subsequent court action relating to such matters.

Effective 22 June 2005, taxpayers can claim a right of non-disclosure for certain tax advice contained in documents prepared by tax advisers. However, this right of non-disclosure can only be claimed in respect of 'tax advice documents'. The Inland Revenue has issued a standard practice statement (SPS 05/07) to provide guidance to taxpayers on this matter. The definition of 'tax advice documents' in the Inland Revenue's standard practice statement excludes transfer pricing reports.

### **5009 The audit procedure**

Investigations in New Zealand are conducted by way of visits to the company's premises and interviews with personnel. In some cases these visits may be preceded by requests for the provision of documentation.

It is normal in New Zealand for the outcome of the investigation to be decided as a result of negotiation but it may proceed to litigation if the issues raised cannot be resolved through negotiation. In connection with this, however, there is a dispute resolution procedure, which will also apply to transfer pricing disputes. This provides a form of dispute resolution that is primarily aimed at attempting to settle prior to the issue of an assessment. During the course of this procedure, notice of intended assessment is given, followed by compulsory meetings. At the meetings, full disclosure of all relevant facts is required to be made, and it should be noted that any information not produced for these meetings is banned from any future court action.

### **5010 Revised assessments and the appeals procedure**

There is an appeals procedure that starts with the dispute resolution procedure. After

proceeding completely through the dispute resolution procedure, any further appeal would be heard by the courts.

### **5011 Additional tax and penalties**

There are penalties that may be applied to adjustments arising from transfer pricing issues. Determination of the penalties focuses on culpability. The shortfall penalties that are provided are:

- not taking reasonable care – 20% of tax shortfall;
- unacceptable interpretation – 20% of tax shortfall;
- gross carelessness – 40% of tax shortfall;
- abusive tax avoidance – 100% of tax shortfall; and
- evasion – 150% of tax shortfall.

These penalties can be adjusted up or down to reflect the level of co-operation by the taxpayer with the authorities during the course of the investigation and the existence or otherwise to any disclosures to the tax authorities. Penalties are not tax deductible. In addition to the shortfall penalties, there is also an interest charge (deductible), which is automatically applied from the date on which the tax should have been paid to the date on which it is finally paid. The rate is adjusted from time to time to reflect economic circumstances.

### **5012 Resources available to the tax authorities**

The International Tax Policy Unit of the Inland Revenue has advised that transfer pricing will not be dealt with by a separate, discrete transfer pricing unit. Rather, all tax inspectors and auditors will be capable of handling transfer pricing issues. The inspectors will be supported by the International Tax Policy Unit and will also receive relevant data and particulars of any APA applications being sought. The Inland Revenue have economists available as part of their staff resources and it is clear that they will not hesitate to contract outside experts, both economists and industry experts, to assist them with their deliberations.

### **5013 Use and availability of comparable information**

That a transfer price is at arm's length would, in theory, be demonstrated by means of one or more of the prescribed methods in Section GC13(2)<sup>35</sup> of the New Zealand Tax Act. In practice, unless either a CUP or sufficient data to apply a resale price method or cost plus method is available, justification of the pricing used would almost certainly depend on a comparison of net profit margins. In most cases, unless the company has information available regarding its competitors and/or CUPs, or internal comparable transactions, the company would be dependent on information available from commercial databases. This information, likely to be an analysis of published annual accounts, would almost certainly force any defence to be based on the comparison of net profit margins. In some cases, within particular industries, more detailed information is available but this is the exception rather than the norm. Due to

---

<sup>35</sup> *Income Tax Act 2004 Section GD13(7)*

the small number of independent companies and large number of 'controlled entities', New Zealand taxpayers are often forced to look for comparable entities in foreign jurisdictions (e.g. Australia or the US). The Inland Revenue recognise taxpayers may need to look overseas to find comparable data, which may need to be adjusted to ensure comparability.

#### *Non-publicly available information*

The Guidelines raise the issue of the Inland Revenue's use of non-publicly available information. The Guidelines state the Inland Revenue does not intend as a matter of course to use non-publicly available information in attempting to substitute an alternative measure of an arm's length amount. The Inland Revenue concede there are difficulties, including the likelihood that such information could not be provided to taxpayers whose transfer prices are under review because of the secrecy provisions of the Tax Administration Act. However, the Inland Revenue does not rule out the possibility that non-publicly available information will be used in administering the transfer pricing rules as the New Zealand Tax Act requires that the most reliable measure of the arm's length amount must be determined.

#### *Use of hindsight*

The Guidelines make it clear that the use of hindsight is inconsistent with the arm's length principle. However, the Guidelines state that the use of hindsight may be valuable in appraising the reliability of comparables used. The Guidelines provide an example of a newly developed intangible being difficult to value because of uncertainty as to its future value. Even if time does prove the intangible to be valuable, this is not grounds for automatically adjusting the transfer price.

#### *Availability*

The Inland Revenue could access information on other companies, either during the course of investigations into those companies or through a direct request for information under Section 17 of the Tax Administration Act. The latter would enable the Inland Revenue to obtain precise information. Indeed, a recent comment from the head of the International Tax Policy Division of the Inland Revenue indicated that such information might be used to select companies for audit, although it is uncertain whether, or under what authority, information obtained in this way could be used as the basis for transfer pricing adjustments.

As noted above, the information available to taxpayers is likely to be limited to analyses of published accounts as found on commercial databases.

### **5014 Risk transactions or industries**

The transactions which can be attacked are specified within Sections GC6(2) and GC6(3)<sup>36</sup> of the New Zealand Tax Act. It is, however, clear that some industries are more likely to be attacked than others; particularly high on the list of priorities appears to be the pharmaceutical industry, motor vehicle industry, as well as the information technology industry and trading houses. In addition to certain industries, particular

---

<sup>36</sup> *Income Tax Act 2004 Section GD13(2).*

types of payment or receipt are also likely to be targeted. These include payment of royalties, interest, management fees and fees in relation to intangibles, together with fixed-rate preference shares. Effectively, the only item that is excluded is share capital, other than fixed rate preference shares.

### **5015 Limitation of double taxation and competent authority proceedings**

The competent authority process in New Zealand operates in the way set out in a typical DTA, with nominated officers of the Inland Revenue acting as competent authorities for particular topics. The head of the International Tax Policy Unit is the competent authority for transfer pricing matters. In addition to DTA provisions, there are specific provisions within the New Zealand Tax Act, which provide for both corresponding adjustments and compensating adjustments but only in consequence of adjustments made in New Zealand, not in consequence of foreign adjustments.

### **5016 Advance pricing agreements (APAs)**

APAs are available to taxpayers in New Zealand and the Inland Revenue are keen to see a greater number of taxpayers seeking APAs. The Inland Revenue has established its APA programme under a broad framework using informal procedures and has stated it will not issue formal APA guidelines. The Inland Revenue considers that its flexible approach to APAs minimises the possibility of the process becoming too bureaucratic and enhances the efficiency of its APA programme. The flexible approach adopted by the Inland Revenue means that most APAs can be concluded within a six month time frame.

The Inland Revenue concluded its first bilateral APA (with Australia) in 2001. Since then, the Inland Revenue has concluded several other bilateral APAs. The Inland Revenue is also party to a multilateral APA. The Inland Revenue has concluded several unilateral APAs and is currently negotiating a number of others.

The Inland Revenue expects to see a greater number of taxpayers seeking APAs, given the increased level of inquiries by its auditors. The Inland Revenue is encouraging taxpayers to seek unilateral and bilateral APAs (particularly with Australia). The tax authority believes it is better for taxpayers to obtain APAs rather than run the risk of potentially costly and time consuming transfer pricing audits. Its view is that given the subjective nature of transfer pricing, APAs are the best way for taxpayers to achieve certainty.

### **5017 Liaison with customs authorities**

The Inland Revenue will normally obtain information from the customs authorities and, in fact, is expected to use customs specifically as a source of transfer pricing information. Indeed, customs officers are currently very active in checking the transfer price of goods, although this is ostensibly for customs duty purposes. However, recently it has been determined that customs have raised queries specifically for the purpose of actively sharing information with the Inland Revenue in relation to the price of goods being imported into New Zealand.

While there is no legislation that directly requires transfer pricing adjustments to be reflected in returns made for customs or other indirect taxes, where transfer prices

have been adjusted for income tax purposes, this may require customs to review the price for customs duty.

### **5018 OECD issues**

New Zealand is a member of the OECD and has signed off on the OECD Guidelines and, as discussed previously, has stated express agreement with them.

### **5019 Joint investigations**

New Zealand would undoubtedly join with another country to undertake a joint transfer pricing investigation of a multinational group and, to this end, there is a formal, but private, agreement already in existence between the New Zealand and Australian tax authorities. In the past the tax authorities have traditionally co-operated informally with other tax authorities, either in the provision of information for other transfer pricing investigations or, in some cases, to join in joint audits or enquiries.

### **5020 Thin capitalisation**

New Zealand introduced a thin capitalisation regime to apply from the beginning of the 1996-97 income year. The key features are as follows:

- (1) The regime is fundamentally designed to deny a deduction for interest if a non-resident allocates an excessive proportion of its worldwide debt to its New Zealand operations. An apportionment of deductible interest is required where an entity's debt ratio (calculated as total debt/total group assets) exceeds both:
  - (a) 75%; and
  - (b) 110% of the worldwide group's debt percentage.
- (2) It is important to note that the use of debt to asset ratio differs from most thin capitalisation models, which monitor an entity's debt to equity ratio.
- (3) The regime potentially applies to:
  - (a) non-residents who derive New Zealand sourced income;
  - (b) New Zealand companies controlled by a single non-resident person (together with persons associated with that person); and
  - (c) non-qualifying trusts that are 50% or more settled by non-resident persons.
- (4) A concession exists for on-lent funds. One effect of this is to minimise the impact of the regime for financial intermediaries.

# 51 Norway

## 5101 Introduction

In Norway, the arm's length standard for related party transactions is incorporated in The General Tax Act (GTA) 1999 Section 13-1. New transfer pricing documentations rules have been introduced, with partial effect from fiscal year 2007 and with full effect from fiscal year 2008. The GTA Section 13-1 (4) makes a formal reference to the OECD Guidelines, where it is stated that the OECD Guidelines "shall be taken into account" when addressing transfer pricing issues under Norwegian law.

The resources of the authorities have generally been limited and their interest has tended to focus on intra-group services and the financing of operations, rather than on the sale or transfer of goods. However, this is changing rapidly as transfer pricing is increasingly becoming the focus of Revenue attention and the resource issues of the tax authorities are being addressed.

## 5102 Statutory rules

A general arm's length rule is laid down in Section 13-1 of the GTA. The Section provides that, where the income of a Norwegian resident is reduced due to transactions with a related party, the authorities are empowered to estimate the amount of the shortfall in income or wealth and assess this to Norwegian tax. The following three conditions have to be fulfilled for the tax authorities to adjust taxpayers' taxable income or assets in accordance with the GTA Section 13-1:

- (1) the parties involved in the transaction must have a certain relation to each other;
- (2) there must be an income or asset reduction (compared to what the situation had been had the parties not been related); and
- (3) the income or asset reduction must have occurred as a consequence of the relationship between the parties. Where the related party is resident outside Norway, the legislation assumes that the relationship is the reason for any deviation from arm's length income or wealth, and puts the onus on the taxpayer to prove otherwise. However, the Supreme Court has in a 1999 case (Baker Hughes) made some interesting statements regarding the burden of proof (see Section 3705 below).

In addition to the statutory rules, the substance over form principle is a general and important non-stap principle in Norwegian tax law. The substance over form principle has two different aspects.

The first and obvious aspect is that taxation should be based on the underlying real transaction. Thus, to the extent there is a type of pro forma transaction, the tax administration and the courts will look at the reality of the transaction(s) rather than the form when the transaction is being tested. Thus, pro forma transactions will be evaluated based on the real effect of the transaction.

Another important aspect of the substance over form principle is that also bona



fake transactions may be disregarded for tax purposes (contrary to the pro forma transaction where the transaction itself is not real). This concept has been developed through theory and tax practice. The concept is frequently applied by the tax authorities as a non-statutory legal basis for taxation of transactions.

As part of this principle, transactions that do not serve other purposes than a tax planning scheme, and where, apart from the tax effects, any real economic effect is non-existent or limited, will bear the risk of being disallowed by the tax authorities.

In an opinion dated 5 May 1998, the Ministry of Finance states the following:

*'It is often difficult to draw the line between acceptable tax planning and unacceptable tax evasion. The fact that the transaction is tax motivated is in itself not sufficient to disregard a transaction for tax purposes. In order for there to be illegal tax evasion two conditions must be fulfilled:*

- *the transaction has no or very limited effects except for the tax effects; and*
- *the result must be contrary to the basic purpose behind the actual tax law.'*

This statement from the MOF is solidly founded in tax theory and court practice. During the last few years there have been several Supreme Court cases confirming this position. In a Supreme Court case from 1999, the Court summarised the substance over form principle as follows:

*'The substance over form principle may not be used simply because the transaction is tax motivated. However, if the tax effects appear as the key element of the transaction, the transaction may be disregarded for tax purposes. The decision depends on an overall evaluation of the non-tax effects of the transaction, and to what extent the tax result, by following the form of the transaction, appears as being contrary to the purpose of the tax legislation. The latter evaluation has to be done based on an objective basis, independent of the parties' subjective positions.'*

This particular wording has also been repeated by the Supreme Court in two subsequent cases. Furthermore, a leading Norwegian tax expert summarised the position as follows:

*'The key element when evaluating whether the transaction should be accepted for tax purposes is to what extent the transaction has any significant effects for the taxpayer other than the tax effects, and to what extent the result would conflict with the purpose of the actual tax legislation.'*

Thus, it may be concluded that the substance over form principle is actively and relatively frequently used by Norwegian tax authorities as a basis for disregarding ('cutting through') the taxpayer's transactions. Through the recent Supreme Court cases, the conditions for using the substance over form principle must also be regarded as fairly clear. Even so, it may be difficult to draw the exact line between 'acceptable' and 'non-acceptable' transactions.

### **5103 Other regulations**

Norway has specific legislation (in the Petroleum Tax Act) to deal with the pricing of petroleum for tax purposes. Regulations concerning the 'norm price' of petroleum were laid down in the Royal Decree of 25 June 1976. This established the principle

that the norm price of petroleum would be equivalent to the price at which it could be sold between unrelated parties in a free market (i.e. an arm's length price). When establishing the norm price, a number of factors shall be taken into account, including:

*'...The realised and quoted prices for petroleum of the same or a corresponding type with necessary adjustments for quality variations, transport costs, etc to the North Sea area or other possible markets, delivery time, time allowed for payment and other terms.'*

Supplementary regulations were issued in a Royal Decree of 17 December 1976 to regulate the use of the norm price in tax assessments. The norm price is decided by a separate Governmental Board (Norm price Board). The norm price is decided individually for each field on a monthly basis (though it is only published quarterly). The taxpayer will be taxed based on the relevant norm price irrespective of the actual sales price. Norm price will be used both for internal and external transactions. So far norm price has been set only for crude oil, but may also be set for natural gas.

### **5104 Legal cases**

There have been relatively few decisions from the Norwegian Supreme Court concerning transfer pricing but there are several decisions from the lower courts. Several of the large transfer pricing cases in Norway over the last 10–15 years are related to the petroleum activity on the Norwegian Continental Shelf. Cases heard by the courts prior to 1990 have to a large extent dealt with issues such as the allocation of costs between two Norwegian resident companies but these cases generally offer little assistance in considering transfer pricing issues today.

#### **Bareboat charter rate – pricing methods**

##### *Trinc and Trag – Supreme Court decision 1997*

The Trinc and Trag case is primarily an important decision with respect to tax liability to Norway for a foreign rig-owner but also (particularly in the verdicts from the lower courts) contains interesting elements of transfer pricing. Two foreign companies, Trinc and Trag, were controlled by the same owners. Trinc was the Ownership Company of a drilling rig, while Trag operated the rig under a bareboat charter. Trag operated the rig on the Norwegian Continental Shelf, and was liable to tax in Norway for that activity. It seems that the companies had not used any specific pricing method, while the tax authorities used a cost plus method to set an appropriate bareboat charter rate. The Court stated that no significant income reduction was required in order to adjust the income in accordance with GTA Section 13-1. Further, the Court stated that the tax authorities were entitled to use the cost plus method in a situation where it was difficult to find comparable transactions in the market, and that the discretionary elements used by the tax authorities in the cost plus calculation were acceptable. The taxpayer argued to no avail that the resale price method was more appropriate. The historic cost of the rig was used as a basis for the computation. This part of the case was not appealed to the Supreme Court.

Regarding Trinc, the Supreme Court held that this company was not tax liable to Norway. The fact that there was very close co-operation between the two companies and that Trinc's income from the lease was dependent on the income actually generated by Trag was not sufficient to claim that Trinc had a business operation in

Norway jointly with Trag. The splitting of ownership and operation through two different legal entities must be respected. A pure bareboat charter was not sufficient to trigger tax liability to Norway under internal Norwegian tax legislation.

### *Captive insurance issues*

There are basically two issues regarding captive insurance. The first question is whether or not payments to a captive represent real insurance. The second question, if payments to the captive are accepted as real insurance, is to what extent the insurance premiums meet the arm's length standard. One key issue is to what extent the benefits from gathering the group's insurance in a captive should be taken by the captive or by each insurer.

This is a complex area where it often is difficult to find comparable transactions between independent parties. Some of the cases that are mentioned below were brought up by the tax authorities in the late 1980s.

### *Amoco – Supreme Court Case 2002*

The question was to what extent Amoco's captive represented a real insurance. Through previous Supreme Court decisions (Dowell Schlumberger 1995) it has been concluded that premiums paid to a captive insurance company in principle will be accepted as a valid deduction for income tax purposes. However, this is subject to two conditions:

- (1) a formal insurance policy that transfers the risk from the insured to the captive; and
- (2) the captive must have the financial capacity to meet any claims under the insurance policy, i.e. there must be a real transfer of risk.

Regarding the latter, the tax authorities (in this case, the Oil Taxation Office) have focused on the exposure ratio (maximum payout for one accident/the captive's equity).

It is unclear what level of exposure ratio will be accepted but according to the Oil Taxation Office, the captive should be capable of meeting at least two to four maximum losses during the insurance period (one year). In the Amoco case the exposure ratio was more than 100% (i.e. the captive could not even meet one maximum loss).

Contrary to the City Court and the Appeal Court, the Supreme Court concluded that Amoco's captive insurance arrangement qualified as real insurance. The main reason for this was the fact that Amoco Norway had placed its insurance policy in an independent insurance company (fronting arrangement). The fronting insurance company had then reinsured all the risk with the Amoco captive company and Amoco Corp. had guaranteed coverage from the captive to the fronting insurance company.

However, based on the fact that the fronting company would be in a position to cover any losses incurred by Amoco Norway, irrespective of the captive's financial position, the Supreme Court concluded that the risk effectively had been shifted from Amoco Norway to the insurer. Therefore, from a Norwegian perspective, this represented a true and valid insurance.

However, it should be noted that the Supreme Court in principle accepted the 'exposure ratio' as a key factor in order to test the captive's financial capability. Therefore, it was also concluded that the Amoco captive in itself 'clearly did not qualify as a true and valid insurance company'.

Nevertheless, the lesson learned from the Supreme Court decision seems to be that a fronting arrangement may effectively 'cure' a captive's lack of financial strength.

#### *Statoil – Oslo City Court 2000*

The court concluded that vertical captive insurance (i.e. to use a 100% subsidiary as captive insurance company for the parent) was acceptable. Remarkably, this verdict was not appealed.

#### *Agip – Supreme Court 2001*

The Petroleum Tax Board of Appeal did not accept Agip's insurance premiums as being in line with the arm's length standard. In order to find the 'correct' arm's length price the Appeal Board made use of other captive insurance premiums paid by companies operating on the same petroleum field as comparables. Further, the Appeal Board did not seem to pay too much attention to statements made by independent insurance expertise as provided by the taxpayer. The Appeal Board made the following statement:

*'Within captive insurance it is difficult to find comparable rates between independent insurance companies. A comparison with rates paid by other companies on the same or similar fields will be relevant for the evaluation of whether an arm's length price exists, even if the comparable insurances are with captives. The key point is to thoroughly evaluate the comparability of the policies, and to make any required adjustments in order to get a relevant basis for the comparison.'*

The taxpayer argued that the comparisons and the adjustments made by the Appeal Board were not representative.

The Supreme Court's conclusion was in line with that of the Appeal Board. The Supreme Court referred to the OECD Guidelines and concluded that the Guidelines can and should be used as a supplement to GTA Section 13-1, and that there is no conflict between the two. As the Court found that insurance policies differ significantly from field to field, it was deemed acceptable to use other captive insurances (i.e. controlled transactions) on the same petroleum field as comparables.

With respect to transfer pricing methodology, the Court stated that the OECD Guidelines cover several methods but that none of these methods were directly applicable in this particular case. The Court then stated that in such a situation, the OECD Guidelines must be 'adapted' to the specific situation. Thus, the Supreme Court accepted that the Appeal Board had determined an arm's length insurance premium using a combination of several methods as well as its own discretionary judgment.

Another issue was to what extent the taxpayer could present new information for the Courts, i.e. information that had not been presented for the Appeal Board. In this specific case, the Court found that the new information could be presented.

#### *Fina – Borgarting Appeal Court 2003*

The tax assessment in this case was to a large extent supported by a cost plus method. The City Court accepted the use of a cost plus method to adjust Fina's insurance premiums. The City Court (1999) stated the following:

*'The Appeal Board conducted comparisons with other companies' insurances in the same field but concluded that such a comparison would not give sufficient guidance and it was therefore decided to support the assessment by using a cost plus method. The court has evaluated the methods used in the assessment, and agrees with the Appeal Board that it was correct to supplement the assessment with a cost plus method, and reference has been made to the actual OECD Guidelines, which accept such a methodology. It was therefore not incorrect not to include comparative studies with insurance on other petroleum fields.'*

The Appeal Court upheld the decision of the City Court (and supported its argumentation). The case was appealed to the Supreme Court, but the appeal was dismissed.

### *Financing of subsidiaries*

During the mid-1990s there were several cases regarding Norwegian parent companies' financing of foreign subsidiaries. The key issue is to what extent capital injected into the foreign subsidiaries should generate an interest income for the Norwegian parent company. The first question is whether the capital injection represented loan or equity. Based on a Ministry of Finance position from 1995, and the result from the cases heard so far, it seems clear that the taxpayer's actual treatment in the statutory accounts will be a very important factor – even if not entirely decisive.

Having established whether the capital injection in reality represents loan or equity, the next question is whether (and to what extent) the foreign subsidiary would have been able to borrow money in the market, based on the subsidiary's actual financial position.

If the answer to the two questions raised above is in the affirmative, the Norwegian parent company would have to include an interest income (deemed interest) from the foreign subsidiary in its tax accounts.

The two most important court decisions in this area are the Nycomed decision from the Appeal Court in 1998 and a 1998 Appeal Court decision regarding Norsk Hydro, followed by a 1999 Supreme Court decision.

In the Nycomed decision, the Court concluded that the tax authorities were entitled to charge interest on a part of the non-interest bearing funds provided to the subsidiary but did not accept the tax authorities' discretionary judgment as to how much of the funds should be regarded as loans and therefore subject to interest payment. Thus, the tax authorities were ordered to provide a new assessment. The Court also made a statement that the basis for comparison had to be similar loans in the market, and not an alternative transaction that the company could have elected.

In the Hydro case, the factual situation was a bit different as Hydro had remitted debt on an actual interest-bearing loan, due to a negative development of the subsidiary's economy. However, there had not been any formal changes in the loan agreements to reflect the new situation. Hydro claimed that it was a clear understanding between the two companies that no interest should be charged until the financial situation for the subsidiary was improved, and that the funding had to be characterised as equity. However, both the Appeal Court and the Supreme Court concluded that the funding had not changed character from loan to equity, that it was

a true debt remission, and that the subsidiary's financial situation could not justify such debt remission. The fact that the subsidiary's home country regarded the funds as equity could not be decisive for Norwegian tax purposes.

### *Inter-company charges*

During 2002, the Appeal Court made an interesting decision regarding inter-company charges received by the Norwegian subsidiary of the US-based 3M group. The decision was appealed but the Supreme Court dismissed it. Anyway, the case represents an important contribution to tax practice in this area.

3M had for several years charged its local sales companies, including the Norwegian sales company, a licence fee for various inter-company services and use of trademarks. The licence fees ranged from 2-5% of actual turnover in each single sales company.

The deduction for the licence fees was disallowed by the Norwegian tax authorities, as 3M Norway AS could not provide sufficient documentation for services received. The tax authorities also charged 3M Norway a penalty tax, as they were of the opinion that the company had not provided sufficient information.

However, the City Court, as well as the Appeal Court, concluded that the licence fee was in line with the arm's length principle. The court stated that as long as the OECD Guidelines accepted the indirect method for inter-company charges, it would also have to be accepted that detailed documentation could not always be given. In this particular case the 3M group's accounting system was not designed to give a detailed breakdown/documentation for the various types of inter-company charges. The court further concluded that there was no doubt that the Norwegian subsidiary had received a number of significant services, and given the fact that the Norwegian subsidiary had showed good financial results over several years it was assumed that a third party also would have been willing to pay the same level of licence fee.

### *Business restructuring – transfer of intellectual property*

In September 2007, the Borgarting Appeal Court issued its verdict in the Cytec case. (Cytec's appeal to the Supreme Court was dismissed in January 2008). Cytec Norge AS (Norway) was originally a fully-fledged manufacturer, but was changed into a toll manufacturer in 1999. Customer portfolio, technology, trademarks and goodwill were apparently transferred to the related entity, Cytec Industries Europe (the Netherlands) free of charge. The Appeal Court found that Cytec Norge AS held intellectual property rights of considerable value prior to the 1999 restructuring, and that the Norwegian entity should have received an arm's length remuneration for the transfer of these rights to the related Dutch entity. Hence, the court accepted the Norwegian tax authorities' calculation of such remuneration and the according tax increase.

### **5105 Burden of proof**

The authorities carry the burden of proving that there is due reason to believe that income charged to tax in Norway has been reduced because of transfer pricing. They must also demonstrate that such transactions took place with a related party. This position was tested and approved in the case of *Kronos Titan AS v Fredrikstad Municipality*.

In *Kronos Titan AS v Fredrikstad Municipality*, a 1992 case, the municipality objected to the deduction of royalties, set at a rate of 7% of net sales, as paid to the US

resident parent company of Kronos Titan AS. The City Court found that the authorities had not discharged the burden of proving that the transfer price was less than an arm's length rate and ruled in favour of Kronos Titan AS. The municipality appealed the decision but the matter was settled before going to a superior court.

Once the authorities have discharged this burden, if the related party is resident outside Norway, Section 13-1 of the GTA assumes that the relationship is the reason for the income reduction and puts the onus of proving otherwise onto the taxpayer. However, a recent Supreme Court case (Baker Hughes-1999) makes the following statement:

*'Use of the GTA Section 54 (now GTA Section 13-1) will under any circumstances require that it is more likely than not that the income has been reduced.'*

There are also cases that deal with issues such as the obligations on taxpayers to co-operate with the authorities in providing information (even if there is not yet any statutory requirement to provide information).

In *Dowell Schlumberger*, a 1995 Supreme Court case, the question of the obligation placed on taxpayers to co-operate with the authorities was tested. The case concerned deductions due in respect of payments to an associate (captive) insurance company resident outside Norway.

The authorities argued that they required access to accounts and other information concerning the offshore company relevant to the question of whether it actually carried on the business of insurance. As the company had not provided such information and therefore not substantiated its tax deductions, the Court ruled that no tax deduction was allowed for 'insurance premiums' paid. The Court rejected claims that the information requested amounted to 'business secrets' and therefore ought not to be disclosed.

## **5106 Tax audit procedures**

### *Selection of companies for audit*

Companies or groups might be selected for transfer pricing audit in several ways and there is no specific guidance on how to select companies for an audit. An audit might be of a general nature, i.e. an audit of the company as such (i.e. a combination of various tax issues), or the tax authorities might pick out specific issues/areas.

The provision of information and duty of the taxpayer to co-operate with the tax authorities

Under the Act of Assessment, the authorities have extensive powers to collect information relevant to settling the tax liabilities to Norway as well as to the level of income subject to Norwegian taxation. The authorities may request any information they believe to be relevant to the point at issue. This would extend to requesting information from third parties.

There is a general obligation on taxpayers to substantiate their tax position and to co-operate with the authorities in the provision of information relevant to deciding their tax liabilities. Where the taxpayer does not co-operate in the provision of information, as in the Supreme Court case of *Dowell Schlumberger* (see Section 3705), the Norwegian taxpayers' position is likely to be refused.

### **5107 The audit procedure**

Investigations are conducted using correspondence, interviews and site visits, as appropriate. Once the investigation has been undertaken, the authorities complete a report that indicates any areas in which they disagree with the taxpayer. They then make proposals for a revised assessment. The taxpayer responds to this report in writing, rejecting any arguments or conclusions of the authorities with which she/he disagrees. Any supporting documentation is included in this response. The authorities then review the position in the light of the taxpayer's response and notify the taxpayer of their decision.

#### *Audit period*

The tax authorities may go back ten years but usually the audit period is three years. However, if correct and sufficient information has been provided in the tax return, the tax authorities may only change the assessment in disfavour of the taxpayer for the two previous years.

### **5108 Revised assessments and the appeals procedure**

If the taxpayer disagrees with the decision of the authorities, she/he may appeal to the Assessment Board. This appeal must be in writing, and would detail the claims of the taxpayer and the basis for those claims.

If the taxpayer disagrees with the decision of the Assessment Board there is one further administrative appeal level: the Superior Assessment Board. For companies taxed by the Oil Taxation Office, there is only one administrative level (Special Appeal Board for Petroleum Tax). If the taxpayer still disagrees, she/he may take the case to court. Norway has three levels of courts but has no specialised tax court.

### **5109 Additional tax and penalties**

Norway uses an additional tax ('penalty' tax), which would be charged administratively under the Act of Assessment. The standard rate is 30% (rates from 7.5-60% may be used) of any tax not levied as a consequence of errors made by the taxpayer. Additional tax is generally not used where the tax issue arises from different interpretations of laws and regulations. However, in situations where the taxpayer is or should be aware that the tax situation is uncertain, sufficient information about the transaction should be filed as a part of the tax return in order to avoid use of penalty tax. Ordinary interest for late payment of tax will also be charged. Penalty tax is not tax deductible. As a starting point, penalty tax is levied on a strict objective basis. There are currently some initiatives to review the penalty tax system.

### **5110 Resources available to the tax authorities**

Norway has three central tax offices and a large number of local tax offices (basically one for each municipality). The three central tax offices are the Central Tax Office – Foreign Tax Affairs, the Central Tax Office for Larger Enterprises, and the Oil Taxation Office. In addition there is the Tax Directorate as a central tax authority.

The Central Tax Offices have a high level of competence and resources, and often pursue aggressive positions in transfer pricing cases. The local tax authorities often have limited resources, and are usually not in a position to handle an extensive



transfer pricing investigation. However, the Tax Directorate often investigates transfer pricing issues and supports/assists the local tax authorities.

It is worth noting that the resources targeted at transfer pricing have been increased and are likely to be increased further over the coming years. It should also be noted that the tax authorities over the last few years have used quite a lot of resources in developing various IT solutions. As a result, it would be easier to pull out relevant information and also to follow up more closely with respect to internal pricing issues.

### **5111 Use and availability of comparable information**

#### *Use*

Where the taxpayer is involved in the offshore oil industry, Norway has specific legislation that deals with the pricing of petroleum (Petroleum Tax Act) for tax purposes, as noted above (see Section 3703).

In respect of all other commodities and services, the brief provisions of Section 13-1 of the GTA lay down the arm's length principle and its application. There is no legislation and no guidance as to the appropriate methodology for establishing arm's length pricing but as Norway is a signatory to the OECD Guidelines, the methodologies laid out therein would generally be regarded as supporting the (limited) statutory law in the transfer pricing area (see Section 3715 below). As mentioned above, the OECD Transfer Pricing Guidelines have also recently been translated into Norwegian by the Ministry of Finance. Therefore, to the extent that comparable information may be used within the terms of the Report, then it may also be used in Norway.

#### *Availability*

The published annual accounts of companies are the only information available in Norway about the businesses of third parties. For some business sectors statistical data concerning gross profits is also published but this is not detailed to the degree of discussing individual companies. Some tax offices also issue a yearly overview of the tax assessment on an anonymous basis.

A potential problem in this area is the fact that the tax authorities may compare data/pricing used by other taxpayers, without being able to give any detailed information regarding the data which the taxpayer is compared against. Thus, in such situations a taxpayer may find it difficult to prepare an appropriate defence.

#### *Benchmarking*

Although Norwegian tax authorities recognise that in theory, benchmarking studies may provide valuable guidance on profit margins etc, they consider the preparation of a sufficiently detailed and probing study to be rarely feasible in practice. From the tax authorities' point of view, such a study would require in-depth analysis of all comparables to an extent that is most likely not possible, and which, in any case, would entail inordinate costs and time consumption. It is hardly surprising, then, that the Norwegian tax authorities are highly sceptical of the value of benchmarking studies based on database searches (e.g. AMADEUS) and comparatively high-level analyses – the kind of analyses typically provided in support of a taxpayer's transfer prices. As with all other factual information available in a transfer pricing case, the tax authorities will consider whether a benchmarking study presented to them is relevant, but normally, such a study will not be awarded much significance.

### **5112 Risk transactions or industries**

In the past three years the transfer pricing focus in Norway has been on both the financing of business operations (thin capitalisation and interest free loans to foreign related companies) and also on the intra-group service arrangements, rather than on the transfer of goods. For oil companies captive insurance remains a significant issue. Several captive insurance cases are now in the court system, and while some of them have already been decided by the Supreme Court, others will probably still be brought forward for the Supreme Court. See also Section 3705 above. Inter-company and intra-group leasing arrangements also seem to be a focus area for the Central Tax Office – Foreign Tax Affairs.

### **5113 Limitation of double taxation and competent authority proceedings**

Generally, in order to hinder or limit double taxation, the GTA provides for a tax credit system for direct and indirect foreign taxes paid by a Norwegian taxpayer or its subsidiaries. Tax treaties signed post-1992 are generally based on the credit method. Older tax treaties are typically based on the exemption method.

Double taxation arising due to a transfer pricing issue will often have to be handled through a competent authority process. The competent authority in Norway is the Ministry of Finance. The authority for specific cases may, however, be delegated to the Tax Directorate.

### **5114 Advance pricing agreements (APAs)**

There are no general formal APA procedures enacted in Norwegian legislation. One reason for this is that the assessment boards cannot be instructed by the local or central tax authorities. However, transactions involving sale of gas can in accordance with the Petroleum Tax Act Section 6 (5) be covered by APAs.

A general system of binding advance rulings has been introduced, but issues with respect to transfer pricing will not be handled.

It is, however, possible to obtain an informal statement from the tax authorities regarding the tax consequences of future transactions, and this procedure has been used in relation to both domestic and Nordic situations.

### **5115 Documentation requirements**

After the recent changes in the Tax Assessment Act (TAA) Section 4-12, with corresponding regulations, the qualifying taxpayers are obligated to file a high level statement on the type and extent of all inter-company transactions and outstanding accounts in a standardised form. The form is to be submitted together with the tax return for fiscal year 2007 and forward. Taxpayers who own or control at least 50% of another entity or are at least 50% owned or controlled by another entity are obligated to file the form, unless their total inter-company transactions amount to less than MNOK 10 and the total outstanding accounts amount to less than MNOK 25.

With effect for fiscal year 2008 the Tax Authorities can request the taxpayer to present transfer pricing documentation. The documentation shall provide sufficient basis for the Tax Authorities' assessment of whether the Norwegian taxpayer's inter-company transactions are in accordance with the arm's length principle. The transfer pricing documentation has to be presented to the Tax Authorities within 45 days after

the request. Taxpayers subject to file the high level statement will also be subject to the transfer pricing documentation requirements, unless they on a consolidated basis have less than 250 employees, and either a turnover of less than MNOK 400 or a total balance of less than MNOK 350. Taxpayers subject to Special Tax under the Petroleum Tax Act or that are involved in transactions with jurisdictions where Norway does not have a Double Tax Treaty will be subject to the documentation requirement regardless of the number of employees or the consolidated turnover or balance level.

All inter-company transactions shall be addressed in both the high-level statement and the transfer pricing documentation. It should be noted that transactions between Norwegian entities are also to be covered by the high level statement and are subject to the documentation requirements. In addition, transactions between a Norwegian PE and its foreign head office shall be covered, as shall transactions between a Norwegian head office and its PE abroad.

If a Norwegian taxpayer fails to submit the high-level statement and/or the more extensive documentation in accordance with the regulations the appropriate tax can be estimated by the tax authorities. Breach of the regulations covering the high-level statements and documentation can cause the taxpayer to be cut off from making an appeal and from presenting additional information during a subsequent court case.

### **5116 Liaison with customs authorities**

Until recently the tax and customs authorities have not co-operated closely in transfer pricing investigations. In the last couple of years, however, this has been changing and the exchange of information is now quite common. While transfer pricing adjustments agreed for corporation tax purposes would not normally be reflected in the returns for customs duty or VAT purposes, there is a high risk that information exchanged between the different authorities might lead to further investigation and adjustments.

### **5117 OECD issues**

Norway is a member of the OECD and has approved the OECD Guidelines. Traditionally, Norwegian tax authorities have seemingly had a preference for the cost plus method in transfer pricing issues. It has therefore often proved difficult to get full acceptance for other methods such as the profit split or the transaction net margin method (TNMM). However, the tax authorities currently seem to be developing a more varied approach, and have lately signalled that they are getting more favourable to the profit split method.

After recent changes of The GTA Section 13-1 there is now a formal reference to the OECD Guidelines. According to the GTA section 13-1 (4) the OECD Guidelines "shall be taken into account" when addressing transfer pricing issues under Norwegian law.

It should also be noted that Norwegian tax authorities, despite the negative result in the *Trinc and Trag* case as referred above, may try to claim tax liability for a foreign enterprise on the basis that they have a common business enterprise in Norway with a subsidiary. This may particularly be the situation when there is a very close connection between the financial result of the foreign company and its Norwegian affiliate with respect to the Norwegian operation.

### **5118 Joint investigations**

Norway has already been involved in joint transfer pricing investigations with other Nordic countries, and there is nothing to prevent Norway from undertaking joint investigations with the authorities of any other country.

### **5119 Thin capitalisation**

Formerly, specific legislation for companies engaged in the exploitation of petroleum resources on the Norwegian Continental Shelf provided for a debt to equity ratio of 4:1, based on the balance sheet in the financial statements, for trading companies. This legislation was repealed effective 1 January 2007.

Hence, Norway currently has no statutory rules on thin capitalisation. Thin capitalisation issues are decided based on the general arm's length standard in the GTA Section 13-1. The equity level is subject to a specific evaluation, and therefore, the 20% equity level formerly applying to petroleum companies cannot automatically be considered as a 'safe harbour'. In a relatively recent decision (2004) the Appeal Court agreed with the tax authorities that the Norwegian taxpayer (Scribona) was thinly capitalised. When the tax authorities computed how much of the interest deduction that should be denied, they based their computation on an equity ratio of 15% of the total capital in the company. In addition, the Court confirmed the general view that a thin capitalisation evaluation has to be based on several elements and that the crucial question is if an independent lender (normally a bank) would have been willing to finance the taxpayer under the current circumstances.

There are several interesting court decisions regarding debt/equity levels for foreign subsidiaries of a Norwegian parent company, even if this is not a direct thin capitalisation issue. The debt/equity level will have to be decided based on a discretionary judgment, where all relevant factors are taken into account (e.g. current and expected cash flow, type of business, contract situation, level of interest bearing debt, interest coverage, etc). It should also be noted that the Norwegian Company Act has certain requirements regarding the equity level of a company, even if this has no direct relevance for tax.

# 52 Peru

## 5201 Introduction

As from January 2001, the Peruvian income tax law (PITL) introduced transfer pricing rules governing transactions entered into between related parties, as well as transactions with entities operating in tax havens. These rules are applicable for transactions with all kinds of goods and services.

The rules governing Peruvian transfer pricing are set forth in articles 32 and 32(A) of the PITL as amended in 2003, and Chapter XIX of the regulations, published in December 2005 and effective as of January 2006. Penalties are established in the Peruvian Tax Code. Article 32 of the PITL establishes the principle of arm's length pricing. In addition, the PITL sets forth the obligation for qualifying taxpayers, i.e. taxpayers falling within the 'scope of application', to (1) annually file an informative return describing transactions carried out with related parties or parties resident in low tax jurisdictions (tax havens), (2) to prepare a transfer pricing study, and (3) to keep supporting documentation.

## 5202 Statutory rules

### *Arm's length principle*

The PITL establishes that all transfers of goods and services must be carried out at fair market value. According with the PITL, fair market value is the price that is normally obtained by the same entity when engaging in transactions with non-related parties under the same or similar conditions. If such comparable transactions (internal comparables) are not available, then the fair market value will be established by reference to prices agreed to between two different unrelated parties for the same or similar transactions.

### *Scope of application*

According to the PITL, the transfer pricing rules must be applied when the transfer price used has led to a lower income tax payment than that which would have been determined if market value was used. In any case, the rules must be applied in the following cases:

- (1) When one of the parties is a resident of a foreign jurisdiction.
- (2) When the company has performed transactions with parties resident in tax havens.
- (3) When the intervening parties are domestic and one of them is either an exempted taxpayer (with the exception of the Public Sector); is subject to a beneficial tax treatment such as an exoneration from income tax; is subject to a special income tax regime (like that for entities in the jungle region); or has in force a contract that guarantees fiscal stability.
- (4) When the intervening parties are domestic entities and at least one of the parties has had tax losses in one of the past six (6) fiscal years.

The transfer pricing rules must also be applied to the value added (VAT) and the selective consumption (excise) taxes, except when the adjustment would determine an increase in refundable VAT. Transfer pricing rules are not applicable for customs valuation, where World Trade Organisation regulations apply.

### *Related parties*

Two or more individuals, companies, or entities are considered related if one of them participates directly or indirectly in the administration, control, or capital of the other; or if the same person or group of persons participate directly or indirectly in the administration, control or capital of various person, companies, or entities.

In addition, there shall be a relationship if the transaction is carried out using third party intermediaries whose sole purpose is to hide a transaction between related parties.

The PITL regulations specify, among others, the following forms of 'economic relationship':

- A natural person or company owns more than 30% of the capital of another company directly or indirectly through a third person;
- More than 30% of the capital of two or more companies belongs to the same natural person or company, directly or through a third person;
- Companies that have one or more directors or managers in common with decision making power;
- When a person, company or other entity domiciled in the country performs in the fiscal year previous to the one under analysis, 80% of its sales of goods or provision of services to a person or company for whom those sales in turn represent 30% of their purchases during the same period; and
- When a person or a company has or exercises 'dominant influence' over the management decisions of one or more companies or entities.
- When companies consolidate financial information.

### *Transfer pricing methods*

Article 32A of the PITL states six transfer pricing methods. Regulations will establish the criteria to determine the most appropriate transfer pricing method for each case.

The following methods are acceptable:

- Comparable uncontrolled price method (CUP);
- Resale price method (RPM);
- Cost plus (CP) method;
- Profit split method (PSM);
- Residual profit split method (RPSM); and
- Transactional net margin method (TNMM).

In general terms, the application of the above-mentioned methods is governed by doctrine and by the OECD Guidelines, which now have explicit legislative recognition in the body of the PITL. Regarding comparability, the PITL establishes two general

guidelines:

- (1) Two transactions are comparable as long as none of the differences existing between the transactions compared or between the characteristics of the entities involved may materially affect the price or free market margin; and
- (2) Two transactions may be comparable even if (1) above is not met (i.e. the conditions of the transactions compared are not similar or the same), as long as adjustments can be made (and are made) to offset the effects of such differences.

#### *Informative return*

Beginning fiscal year 2006, taxpayers are required to render a TP Informative Return Form if they have carried out transactions with related parties for a total value of at least PEN200,000 (approximately USD72,700). By total value the law means the sum of the income accrued during the fiscal year and to the acquisition of goods and/or services made during the fiscal year without distinction or netting between positive and negative values, as long as these derive from transactions with related parties. The return has to be filed also by a taxpayer if it has performed a transaction with parties resident in tax havens without exception. The TP Informative Return Form must be filed every year on July.

#### *Transfer pricing study*

Early in 2001, transfer pricing regulations were passed under the PITL which established the obligation for taxpayers to keep documentation and information regarding the methods used to determine their transfer prices with related entities. The documentation must emphasise the criteria used to establish transfer prices and any other objective elements relevant to a transaction. A similar obligation was established for taxpayers in connection with their transactions with entities resident in tax havens.

In addition to the TP informative Return, beginning fiscal year 2006 the taxpayer is obliged to have a transfer pricing study if it has performed transactions with parties resident in tax havens or if it has transactions with foreign related parties for a total value greater than PEN1 million (approximately USD363,600<sup>37</sup>) and if the revenue accrued from the taxpayer exceeds PEN6 million (approximately USD2.182 million). However, in cases where a transfer pricing study is not required the taxpayer must have information and documentation that prove that transactions with local related parties were conducted at an arm's length value.

### **5203 Other regulations**

According to the PITL, the transfer pricing regulations are applicable for the income tax, VAT and special consumption selective taxes, and will not be applicable to custom duties.

VAT regulations state that the Administration may adjust the price of goods and services transferred if those prices are not considered to be reliable. The word a

---

<sup>37</sup> For the determination of the total value, transactions with related parties domiciled in the country must NOT be taken into account.

'reliable' price has been defined by the VAT regulations as the usual market value for the transfer of other similar goods or services in similar conditions.

#### **5204 Advance pricing agreements (APAs)**

The PITL makes expressed reference to the possibility of entering into advance pricing agreements. Chapter XIX of the PITL regulations sets forth APA procedures and characteristics. According with the aforementioned regulations, the APA objectives are: to set price, amount of compensation, profit margin, and the transfer pricing methodology supporting the values which the taxpayer will use in future operations with related parties or with entities operating in tax havens. The APAs cannot be modified or unilaterally terminated, except when any of the related parties involved in the APAs has been condemned by court for tax or customs crimes or if the terms of the APAs are not complied with.

Under the procedure, the taxpayer proposes the transfer pricing method (TPM), the comparable transactions or enterprises, and the supporting data, including years analysed, adjustments made to the selected comparables, the exact price or range of prices, amount of compensation or profit margin; also the hypothesis used for the proposal.

After reviewing the proposal, the Administration may approve it, approve an alternative version or reject it. The Administration will have a 12 month period to review the proposal, if after this period it has not issued a response, the proposal is automatically considered as rejected.

The APAs will be applicable to the fiscal year during which it was approved and to the 3 subsequent years.

#### **5205 Burden of proof**

The burden of proof lies with the taxpayer. However, a challenge by the tax authority (TA) would require some supporting evidence to be produced by them if that challenge is to be accepted by the Tax Courts (TC). It is expected that regulations to the recently passed legislation will shift the burden of proof to the authorities if it has an APA and, if proper transfer pricing documentation exists.

#### **5206 Tax audit procedures**

If a company has been selected for audit, the TA grants several days' notice of the impending audit to the company, requesting that all information be ready for their review. During the audit the taxpayer may informally clarify issues, produce evidence to support facts and discuss tax issues with the auditors. After the audit, the TA may or may not issue an assessment. If it does, the taxpayer may file an appeal if it does not agree with the assessment. If transfer pricing documentation was requested during the audit and was not provided, the documentation may not be presented during an appeal, unless the full amount of taxes assessed is either paid in advance or the debt is bonded. The attitude of the Peruvian TA can generally be considered as aggressive, although, so far, they are only beginning to focus on transfer pricing issues. No settlements are possible in the course of the audit or later. As of 2008 there have been no audits specialised in transfer pricing, the TA audits this matter as part of a general tax audit.



### *Additional tax and penalties*

Each transfer pricing violation is penalised, based on the Tributary Tax Unit, called Unidad Impositiva Tributaria (UIT). One UIT is PEN3,500 (approximately USD1,270). The following constitute violations of the related transfer pricing obligation.

- Not keeping the documentation and information, reports, analysis related to the operations that could create tax obligations; during the period of time of the obligation, will result in a penalty of 0.3% of the Net Income it may not be less than 10% of an UIT or greater than 12 UITs.
- Not providing the TP informative return according with the deadline set by the law will result in a penalty of 0.6% of the Net Income, it may not be less than 10% of a UIT or greater than 25 UITs
- Not exhibiting or presenting the documentation and information that supports the calculation of transfer prices according to law will result in a penalty of 0.6% of the Net Income; it may not be less than 10% of an UIT or greater than 25 UITs.
- Not counting with the documentation and information that supports the calculation of transfer prices according to law will result in a penalty of 0.5% of the Net Income (when the penalty is calculated over the annual net income it may not be less than 10% of an UIT or greater than 25 UITs.)
- Any adjustments to transfer prices as a result of information omitted in tax returns will automatically trigger a penalty equivalent to 50% of the taxes imposed on the adjustment.

In case a company has several transactions with a related party, the TA must take into account all the transactions made between the companies and not only limit its' analysis to the transactions made beneath market value.

### **5207 Legal cases**

Until the end of the year 2004, there have not yet been any court cases dealing specifically with the new transfer pricing provisions. However, there are several cases now where the TA has challenged the price used between related and un-related parties in their transactions based on this legislation.

The following are some of the most important TC rulings regarding the prices for transactions:

In the case of Lamitemp SA (a company specialising in the sale of glass), the TA considered there was an undervaluation of sales in two of the company's business lines due to the fact that the cost of sales for some months was above the sales value, and because there were discounts of 40% granted to a single client. The TC decided that market value does not necessarily have to be above the cost, a situation that can derive from technological factors, higher financial costs in comparison with other companies, and access to market of raw materials, among others. Thus, what should have been done is to prove that market value was above that considered by the company. Finally, in order to deny the discounts granted, the TC stated that the TA should have verified that these were not granted to other clients, that it was not a usual practice or that they did not correspond to the volume of items bought or

payment conditions. Therefore, it cannot be argued that the discounts do not comply with current legislation.

In a case against Aceros Arequipa SA (a company dedicated to the smelting and commercialisation of steel), the TC confirmed the adjustment made to discounts granted to clients for achieving certain volume goals. The TC stated that for such discounts to be valid, they must be offered to clients complying with certain criteria (general principle) and should be granted uniformly, criteria that was not met by the company (the company did not grant the discounts to certain clients that did meet their criteria but did grant them to other clients that did not). Thus, the deduction of all discounts was denied.

The Peruvian TA, based on a valuation report found during the audit process, pointed out that the company Hotel Macchu Picchu SA had undervalued the sales price agreed for the transfer of the right to use the Hotel Unit, which included assets and/or furniture. The company argued that the transfer value used corresponded to the valuation report with a minimum reduction of 1.1564%. The TC considered that the company should have used the value set forth in the valuation report with no adjustments.

In a case against a company dedicated to the renting of helicopters, the TA challenged the comparables selected in the transfer pricing study. The TC is still evaluating the case.

### **5208 Resources available to the TA**

There are special units being trained within the Peruvian TA in order to deal specifically with transfer pricing issues. At present, transfer pricing issues are being dealt with by the Peruvian tax inspectors during the course of a general tax audit, although it is expected that specific transfer pricing audits will start soon.

### **5209 Use and availability of comparable information**

Neither the law nor the regulations have established criteria as to which are the acceptable sources for comparable information. According to the Tax Code, the TA could use third party confidential information; however, the Peruvian Tax Court in its resolution N°02649-5-2006 indicated that in case a company has internal comparables the TA should consider them as a source of information.

If the TA uses third party information, the taxpayer has limited access to this data through only two nominated representatives. Nevertheless, it is understood that the authorities should only use publicly available information as, otherwise, constitutional rights to due procedure and defence could be violated. Due to the limited amount of local public information on comparable transactions, the use of foreign comparable transactions is acceptable; in this case, necessary adjustments should be made. Article 32 of the PITL explicitly establishes that in order to determine comparable transactions and, in the event that there is no locally available information, taxpayers are allowed to use foreign companies' information, provided that the necessary adjustments are made to reflect market differences. Said provision puts an end to the problem of having very little information available in countries where the financial market is underdeveloped, and therefore, the access to public financial information of companies is very limited.

Furthermore, local industries specific information can be obtained from a number

of industry associations, like the Sociedad Nacional de Industrias (SNI) for the manufacturing industry, Sociedad Nacional de Minería, Petróleo y Energía (SNMPE) for energy, mining and oil industry, Asociación de Exportadores (ADEX) for the exports trade, the Superintendencia Nacional de Bancos y Seguros (SBS) for the banking industry, Asociación Nacional de Laboratorios Farmacéuticos (ALAFARPE) for the pharmaceutical industry, Cámara Peruana de la Construcción (CAPECO) for the construction industry, and the Confederación Nacional de Comerciantes (CONACO) for the trade industry, among others. Membership of these organisations may be required to get any information. A second possibility for obtaining local comparable information is through the Comisión Nacional de Supervisoría de Empresas y Valores (CONASEV), the agency of National Supervisory Commission for Business and Securities where publicly traded companies file their financial statements.

### **5210 Risk transactions or industries**

There are no transactions or industries excluded from the transfer pricing regulations as set out above.

### **5211 OECD issues**

Even though Peru is not a member of the OECD, the OECD Guidelines are used to interpret transfer pricing regulations.

### **5212 Joint investigations**

There is no evidence of any joint investigations having taken place in Peru. However, the Peruvian TA may exchange information with other countries for transfer pricing purposes. For example, Peru has a treaty with the United States, which provides for the exchange of information.

# 53 Philippines

## 5301 Introduction

The Philippines' statutory transfer pricing rule is patterned after what is now Section 482 of the US Tax Code. It was codified in 1939 and has remained unchanged since. Court decisions have also confirmed that the US Section 482 transfer pricing regulations can be used for guidance when applying the Philippine transfer pricing rules; in practice, the Philippine Bureau of Internal Revenue (BIR) also relies heavily on the OECD Guidelines.

Since the last five years or so, the BIR has started challenging the transfer pricing arrangements of some taxpayers. These challenges arise mostly from *ad hoc* examinations during a regular tax audit. There are also indications that the BIR auditors are gaining sophistication in this area. They have in fact made significant transfer pricing tax assessments, although this could also be based on a misappreciation of issues. Because of these developments and the imminent issuance of more comprehensive transfer pricing revenue regulations in the future, companies are advised to pay attention to their arrangements when doing business in the Philippines.

## 5302 Statutory rules

The statutory rule on transfer pricing is found in Section 50 of the National Internal Revenue Code (NIRC). The rule has remained essentially unchanged since 1939, when it was patterned after the transfer pricing rule in the US Revenue Act of 1934. Section 50 allows the BIR to allocate income and deductions between related parties as a means to prevent tax evasion or clearly reflect the amount of income earned by each party.

## 5303 Other regulations

The only formal regulations for transfer pricing are found in Section 179 of Revenue Regulations No. 2, issued in 1940. These regulations were drawn directly from Article 45 of US Regulation 86, issued in 1935, and detailed the scope and purpose of the transfer pricing rule – to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.

More recently, the BIR has issued Revenue Audit Memorandum Order (RAMO) No. 1-98 and Revenue Memorandum Order (RMO) No. 63-99. The former, issued in 1998, provides audit guidelines and procedures for examining interrelated groups of companies, and endorses the use of the OECD Guidelines. The latter, issued in 1999, deals with intra-group loans, and broadly follows the US Section 482 regulations. Both documents are less authoritative than regulations but reinforce the general theme that Philippine transfer pricing rules should be applied in accordance with the arm's length principle as it is applied internationally.

The government is at present looking at issuing more detailed transfer pricing

regulations. The BIR has finalised its draft; the draft regulations are now only awaiting the final approval by the Secretary of Finance to become effective.

### **5304 Legal cases**

The broad doctrine followed in the Philippines is that when Philippine law has been sourced from an equivalent provision in the US Tax Code, the decisions of American courts construing the US Tax Code are entitled to significant weight in the interpretation of Philippine tax laws.

In two Philippine cases relating to transfer pricing, the Court of Tax Appeals (CTA) has taken the doctrine further and allowed the Section 482 regulations to have persuasive effect.

In Cyanamid (1995, affirmed by the Court of Appeals (CA) in 1999), the CTA held that the BIR had acted in an arbitrary, unreasonable and capricious manner when it made no apparent attempt to verify the comparability of pharmaceutical products being compared under a comparable uncontrolled price (CUP) method analysis.

In Filinvest (2002), the CTA upheld the imputation of interest by the BIR on an interest free loan. The CTA also required the BIR to allow correlative relief by way of an interest deduction, based on Section 1.482-(1)(g) of the US Regulations. Upon appeal, the CA reversed however, citing that the imputation of interest rule does not apply to alleged indebtedness which was in fact a contribution of capital; the CA appreciated the loan/advances made in the case to be capital contributions.

The same issue on imputation of interest was presented in the Belle Corporation case (2005) where the CTA ruled in favour of the petitioner company, deciding that RMO 63-99 was inapplicable on the facts of the case.

Two other cases decided by the CTA in early 2005, Avon Products and ING Barings Securities, validated the notion that the initial burden to prove that the inter-company pricing complies with the arm's length principle lies with the taxpayer. However, once the initial burden is complied with, the onus shifts and the revenue authority is supposed to prove that its basis for questioning the taxpayer's policy has sufficient support. Accordingly, in these two cases, the courts ruled in favour of the taxpayers after the BIR failed to produce evidence to refute oral explanations by the taxpayers during the trial proceedings.

### **5305 Anticipated developments**

The BIR has finalised a comprehensive Transfer Pricing Revenue Regulations (TPRR) that seeks to consolidate and expand the existing RAMO 1-98 and RMO 63-99. The provisions in the draft TPRR were heavily lifted from the US TP regulations and OECD Guidelines.

The draft TPRR includes a reiteration of the BIR Commissioner's authority to look at transfer pricing, as well as the Bureau's adoption of the arm's length standard in determining the true taxable income of a controlled taxpayer.

The draft TPRR also provides for various methodologies in determining the arm's length price. There are five methods identified and these are all accepted internationally. In broad terms, these methods can be grouped into two: one is the traditional transaction method consisting of (1) the comparable uncontrolled price (CUP) method; (2) the resale price method; and (3) the cost plus method; and the transactional profit

methods, involving (4) profit split method and (5) transactional net margin method.

The application of each method will depend on the transaction and the circumstances involved; the draft TPRR contains illustrations to show the interplay of the different methods. There is no hierarchy of methods provided in the draft regulations, but they do indicate that the method requiring the fewest adjustments and provides the most reliable measure of the arm's length result is preferred.

Also spelled out in a more detailed manner in the regulations, are the general rules that apply with respect to specific situations like loans or advances, performance of service for another, use and sale of tangible property, and transfer or use of intangible property. In all these cases, the concept of comparability, determination of the appropriate transfer pricing method, and the arm's length principle apply.

The draft regulations provide guidelines for the preparation of documentation to support the transfer price adopted. The BIR appears to be seeking fairly extensive documentation, including functional and economic analyses of the taxpayer's business and results, as well as benchmarking. When transfer pricing documents are requested by the BIR, the taxpayer must submit the same within 45 days of the request.

The TPRR still needs to be signed by the Secretary of Finance to become effective. Despite this, however, the BIR has started challenging taxpayers using the provisions of the TPRR. Assessments made to date run into hundreds of millions and there is reason to believe that this BIR challenge will continue. There are also indications that the BIR is conducting structured training for its personnel. The only thing that remains to be seen is whether they will form special teams to look at transfer pricing.

### **5306 Burden of proof**

As a general rule, taxpayers should be prepared to justify their transactions to the BIR. The NIRC affords the Commissioner fairly strong assessment and collection powers. However, the burden of proof shifts to the BIR once the taxpayer is able to demonstrate that its pricing complies with the arm's length principle, as the 2005 cases of Avon Products and ING Barings Securities demonstrate.

### **5307 Tax audit procedures**

To date, transfer pricing has been raised as an issue only in the context of regular audits by the BIR. A framework does exist, however, for issue-oriented audits to be undertaken.

Based on the informal indications that the BIR is training its people—the executives and officers have been confirmed to have received training from abroad and internally—and the likelihood that regulations will be issued, it seems reasonable to expect transfer pricing specific audits to occur in the future.

### **5308 The audit procedures**

The tax examination process starts with the issuance of a Letter of Authority (LOA) by the BIR. This authorises a named revenue examiner to gather documents and financial information from the taxpayer, such as books of accounts and other accounting records, for the purpose of determining whether the taxpayer is liable for any deficiency tax assessment.

If the revenue examiner finds that there may be deficiency tax, he/she is required to

prepare a report, stating also whether or not the taxpayer agrees with her/his findings. If the taxpayer does not agree with the examiner's findings, the BIR will communicate the examiner's findings to the taxpayer in writing, and will offer the taxpayer the opportunity to respond in an informal conference called for that purpose.

If the taxpayer fails to respond within 15 days from receiving the notice from the BIR, or engages in the informal conference but is unable to dissuade the revenue examiner from his/her findings, the case will be referred to the Assessment Division of the Revenue Regional Office (ADRRO) or to the Commissioner or his/her duly authorised representative for appropriate review and issuance of a deficiency assessment, if warranted. If the ADRRO determines that there exists sufficient basis to assess the taxpayer for deficiency tax, it will issue a Preliminary Assessment Notice (PAN), which the taxpayer must contest within 15 days from receipt. If the taxpayer does not contest the PAN, a formal letter of demand and assessment notice will be issued.

### **5309 Appeals procedures**

Within 30 days from receipt of a formal demand and assessment notice, a taxpayer must file an administrative protest with the BIR in the form and manner prescribed under regulations. Failure to file the protest in the prescribed period renders the assessment final, executory, and demandable.

The taxpayer then has 60 days from date of filing of the letter of protest to submit all the required documents supporting the protest. Failure to do so will result in the assessment becoming final, executory, and demandable.

If the protest is denied by the BIR, the taxpayer has 30 days from receiving advice from the BIR to appeal the decision to the Court of Tax Appeals (CTA). Alternatively, if the BIR fails to act on the taxpayer's protest within 180 days from submission of the documents supporting its protest, the taxpayer has the right to appeal to the CTA within 30 days from the end of that 180-day period to expedite resolution of the protest.

An adverse decision by a CTA division may be appealed to the CTA *en banc*, and from there to the Supreme Court.

### **5310 Additional tax and penalties**

The Philippines does not have any specific transfer pricing penalties, hence transfer pricing adjustments will be governed under the general penalty rules. A 25% surtax is generally imposed on tax deficiencies. Interest is imposed on the deficiency tax (but not on the surtax) at 20% per annum. A compromise penalty of up to PHP50,000 is also imposed.

### **5311 Resources available to the tax authorities**

No special unit has been set up to deal with the audit of transfer pricing issues, although with the current developments this may evolve.

In addition, the BIR's computerisation program is now producing positive results in terms of catching tax evaders. The efficiency of its system has, to date, generated a significant amount of tax collections, and there are indications that the BIR will leverage the system for its other revenue-generating efforts. However, whether it will

be used as an aid to challenge taxpayers' transfer pricing policies and arrangements remains to be seen.

Another related development is the BIR's issuance of RMO No. 4-2006 which directs the Revenue District Offices to benchmark the profit margin and tax payments (income tax, VAT, etc) of taxpayers in certain industries. The directive is clear that if a taxpayer's operating results in a particular year vary from the BIR's collected data, the taxpayer may be required to explain. The results of the BIR's benchmarking activities have not been made public, although certain taxpayers already received notice that their financial or tax results are lower than the BIR's benchmark. Accordingly, they are made to explain the discrepancy. They are assessed tax deficiencies if they fail to offer a reasonable explanation.

### **5312 Risk transactions**

The BIR is getting busy with transfer pricing these days. There has been an increasing challenge on the transfer pricing arrangements of multinationals, and the areas of concern are varied. For example, whereas previously the BIR will be content with brief explanations on payments for management services, they are now requiring further proof on the validity of these charges, sometimes asking for additional documentation such as passport details of visiting foreign employees and basis of the charges.

Arrangements that grant financing to an entity that do not provide for payment of interest (or low rate of interest) are now attracting attention. Specifically, inbound financing is a concern. Many multinationals are benefiting from tax incentives in the Philippines, such as income tax holidays or a 5% tax regime. Because the tax rate on any interest income imputed to a foreign entity exceeds the tax rate of Philippine entities entitled to incentives, adjustments to low or no interest loans will enable the BIR to collect additional revenues.

The provision of outbound services is now also attracting the BIR's attention. Previously, a 5-10% mark-up on cost could be safe harbour. However, it is difficult nowadays to say that even a 10% mark-up is defensible, especially if the services involved high-value adding activities such as R&D, technical design, or knowledge processing outsourcing services. Benchmarking therefore is key. What apparently alerts the BIR is that they are noticing a sharp decline in profitability in certain companies' operations once they finish their tax holiday, which is generally available for these sunshine industries. Certainly, this will be an area that the BIR will be looking into more closely in the future,

### **5313 Thin capitalisation**

The Philippines does not have any statutory rules dealing with thin capitalisation, although this will not prevent the tax authorities attempting to re-characterise interest as dividends. The TPRR also contains provisions on thin capitalisation, indicating that an interest payment or accrued interest attributable to the excess debt shall be treated as dividends and shall be taxed accordingly. If an entity is thinly capitalised, the interest may probably be non-deductible.

The proposed rules in the TPRR provide for a threshold of three to one (3:1) ratio, unless a different debt to equity ratio is prescribed by special laws or special provisions of any existing law. This 3:1 ratio does not apply to banks, financing companies, and non-bank financial intermediary performing quasi-banking functions.



**5314 Advance pricing agreements (APAs)**

The TPRR recognises that an APA could be useful in that it could avoid and resolve transfer pricing disputes. APAs look to the future in that the agreement will involve setting an appropriate set of criteria (e.g. methods, comparables and adjustments, and critical assumptions) for the determination of the transfer pricing for the covered transactions over a fixed period of time. What this results in is a stable transfer pricing environment for the parties involved, so much so that a taxpayer can rest assured that its transfer pricing arrangements will not be challenged by the BIR as long as it complies with the parameters set.

APAs may also involve the agreement of more than one revenue authority and taxpayer. The draft regulations provide details on how APAs may be initiated, monitored and concluded.

**5315 Joint investigations**

There is no public evidence to suggest that the BIR has been or is prepared to be involved in joint investigations with the authorities of other jurisdictions, although a framework exists under existing BIR issuances.

**5316 OECD issues**

The Philippines is not a member of the OECD. However, the policy of the BIR is generally to follow the OECD Guidelines and treaty models with regard to international tax issues. In a Revenue Memorandum Circular issued on 24 March 2008, the BIR acknowledged that it is finalising the TPRR and in the interim, to preclude any issue that may arise related to the transfer pricing arrangements of taxpayers, the BIR stated that as a matter of policy it subscribes to the OECD Transfer Pricing Guidelines. This should give taxpayers the assurance that they will be in a better standing if they follow the OECD Guidelines.

# 54 Poland

## 5401 Introduction

Poland has well-established TP regulations drawing widely on the OECD Guidelines (Poland has been a member of the OECD since 1996), applying both to cross-border and domestic transactions. The statutory thresholds for the documentation requirements (introduced in 2001) are relatively low and the requirements apply to a wide range of transactions. Since 2007, legislation also requires taxpayers to document the allocation of profits to permanent establishments.

On 1 May 2004 Poland joined the European Union. Poland, therefore, accepts the EU Transfer Pricing Code of Conduct. Nonetheless, based on local regulations, the tax authorities only accept a documentation developed in Polish and covering all items required locally.

In January 2006 Poland introduced APA legislation which, from 1 January 2007, also applies to the allocation of profits to permanent establishments.

## 5402 Statutory rules, other guidelines

### *Methods for determination of the arm's length price*

Since January 1997, Articles 11 of the Corporate Income Tax (CIT) Law and 25 of the Personal Income Tax (PIT) Law, have presented the methodology for determining arm's length prices by use of:

- (1) comparable uncontrolled price (CUP);
- (2) resale price; and
- (3) reasonable margin (cost plus).

Where these methods cannot be applied, transactional-profit methods may be used. However, the tax authorities prefer traditional transaction-based transfer pricing methods when estimating income from given transactions.

In October 1997 the Ministry of Finance issued a regulatory Decree on the methods and procedures for determining income by estimation of prices applied in transactions between taxpayers. This Decree presents in more detail the application of the five pricing methods in a manner similar to that outlined in the OECD Guidelines. The decree entitles the tax authorities to verify the application of these methods with regard to transfer prices.

### *Definition of related parties*

Polish transfer pricing regulations apply to both domestic and cross-border relationships. However, the definitions of these relationships differ.

A Polish and a foreign company are considered 'related' if one of three conditions is met:

- a Polish taxpayer participates directly or indirectly in the management or control of a company located abroad or holds a share in its capital;
- a foreign resident participates directly or indirectly in the management or control of a Polish taxpayer or holds a share in its capital; or
- the same legal or natural person, at the same time, participates directly or indirectly in the management or control of a Polish and a foreign entity or holds shares in their capital.

Polish companies are considered 'related' when one of the following conditions is met:

- a domestic entity participates directly or indirectly in the management or control of another domestic entity, or holds a share in its capital;
- the same legal or natural person participates, at the same time, directly or indirectly, in the management or control of two domestic entities or holds a share in their capital;
- relationships of a family nature, resulting from employment contracts or common property exist between (i) two domestic entities or (ii) persons involved in their management, control or supervision; or
- the same person combines managerial, supervisory or controlling duties in both entities.

From 1 January 2007 the transfer pricing regime, including documentation requirements, also applies to the attribution of profit to a permanent establishment.

#### *Documentation requirements*

From 1 January 2001 the CIT Law required compulsory documentation for taxpayers concluding transactions with related parties or transactions resulting in payments to entities located in tax havens. Entities are obliged to prepare documentation comprising:

- (1) a functional analysis;
- (2) the determination of costs, including the form and terms of payment;
- (3) the method and manner of calculating the profit and determination of the price applied;
- (4) the business strategy adopted;
- (5) other factors if they influenced the transaction; and
- (6) in the case of contracts relating to intangible products and services, determination of the benefits.

The reporting thresholds are EUR20,000 for transactions with entities located in tax havens and EUR30,000 – EUR100,000 (depending on the company's share capital and the nature of the transaction) for transactions with related parties.

The same requirements apply from 1 January 2007, to the allocation of profit to a permanent establishment.

A company is obliged to submit the required documentation within seven days of a tax inspector's request. If the tax inspector makes an assessment of the taxable

income/tax deductible costs and there is no documentation in place for the transactions subject to the assessment, the difference between the profit established by the tax authority and that declared by the taxpayer will suffer a 50% CIT rate (in comparison with the 19% CIT rate applicable for 2008).

When filing its annual tax return, the company is required to state whether it has maintained its transfer pricing documentation according to the requirements.

### *Reporting requirements*

Information on agreements concluded with related entities (ORD-U form)

A taxpayer is obliged to submit information on agreements concluded with related entities. Taxpayers are required to report related party transactions:

- concluded with non-residents where they exceed EUR300,000 in a given year with the same entity; and
- with both foreign and domestic related parties on the specific request of the tax authority.

The taxpayer is obliged to submit the information on a designated form (ORD-U). The information should be submitted to the tax office together with the annual tax return, i.e. by the end of the third month after the fiscal year-end. Failure to submit the notification is subject to a fine of up to 120 'daily rates' (the level of daily rate is decided by the court for each case), while submission of false information is subject to a fine of up to 240 'daily rates'.

Information on fees paid to specialist services providers (ORD-W1 form)

Polish entities must collect, draw up and submit information on fees paid for services provided by natural persons who are not Polish tax residents. The information should be presented on a special form (ORD-W1) by the end of the month following the month in which the non-resident started providing the services. This obligation only arises when:

- the fee is paid to a non-resident natural person by a foreign entity;
- the foreign entity is related to the Polish entity; and
- the amounts paid have an impact on the tax obligation of the natural person performing the services (the taxpayer is obliged to submit the information under the same conditions as for the ORD-U report).

Information on the obligation of maintaining transfer pricing documentation

Taxpayers are liable to tick a specific box in the annual tax return, confirming that they are liable to develop the transfer pricing documentation for the transactions they concluded with their related parties in a given year.

### *Tax havens*

Taxpayers concluding transactions that result in payments to companies located in tax havens, regardless of whether they are related or not, are required to prepare suitable documentation. A decree lists countries applying harmful tax competition (tax havens). From 1 January 2007, if the transactions concluded by Polish taxpayers with companies located in tax havens are not arm's length, the tax authorities may assess taxable income on the same grounds as income from intra-group transactions.

**5403 Legal cases**

In recent years there have been approximately 350 transfer pricing cases, heard by the Administrative Court. Most cases related to domestic transfer pricing. The majority of the cases were lost by the taxpayer.

**5404 Burden of proof**

Taxpayers are required to maintain specific documentation evidencing that they apply transactional prices in line with the arm's length principle. However, the burden of proof that non-arm's length prices are applied falls on the tax authorities.

The tax authorities when examining transfer prices must determine the arm's length value of a transfer using the method(s) previously applied by the taxpayer, provided that:

- the taxpayer established the transfer price using a traditional transaction-based transfer pricing method;
- the taxpayer submits documentation supporting the choice of a particular method, based on which the price calculation is performed;
- the objectiveness and reliability of the documentation submitted, based on which a transfer price was calculated, cannot be reasonably questioned; or
- another method would not have been self-evidently more appropriate.

**5405 Tax audit procedures**

Transfer pricing is examined as part of a normal corporate tax audit.

Foreign owned companies that have been loss-making for more than three years are likely to be targeted. The tax authorities can request any information deemed necessary for the investigation and have full search powers. Non-compliance with information requests can result in severe penalties.

A particular characteristic of the audit procedure is the short time frame that taxpayers have to respond to transfer pricing assessments:

- On completion of a tax audit, the tax inspector issues a written protocol setting out his/her preliminary findings;
- The taxpayer has 14 (calendar) days to respond to this protocol in writing, presenting his/her explanations and objections;
- Within 14 days the tax inspector issues a document of formal information on the method of dealing with the taxpayer's response;
- Subsequently, before issuing the tax decision, the tax authorities, inform the taxpayer about the intended decision. The taxpayer has seven days to review the data collected during the tax audit and to present his/her opinion;
- The taxpayer can expect a tax decision or formal closing of the proceeding, if the audit finds the taxpayer's reconciliation to be correct;
- The taxpayer may appeal in writing to the higher authority (the tax chamber) within 14 days;
- The verdict of the tax chamber may be further appealed, within 30 days, to the administrative court; and

- The taxpayer has the right to appeal against the court's verdict to the Supreme Administrative Court within 30 days.

Tax investigations may examine the previous five tax returns. Penalty interest may be charged on any underpaid tax, and the rate (April 2008) is currently 14.5% per annum. Penalty interest is not tax deductible.

#### *Special tax offices for large entities*

Special tax offices exist for large entities i.e. taxpayers that exceed an annual revenue threshold of EUR 5 million. Additionally, all entities with a foreign shareholding exceeding 5% of voting rights and Polish holding companies are recognised as large entities.

#### **5406 Comparable information**

During a tax audit Polish tax authorities try to use where possible internal comparables (sometimes without carrying out all necessary adjustments). They also use external comparables drawing on data gathered through controls of comparable taxpayers.

The tax authorities have access to databases to establish comparable information. However it is rarely evident that they use such comparables during tax audits.

The tax authorities take a relatively sceptical view of foreign comparable data. For taxpayers undertaking comparable analysis, the source of Polish company financial results is the government journal, Monitor Polski B. However, as fines for not submitting financial information are low, many companies either do not present their results or disclose them late.

#### **5407 Competent authority proceedings and advance pricing agreements (APAs)**

##### *Rulings*

Amended regulations relating to interpretations of the tax law by the tax authorities and the Minister of Finance were introduced on 1 July 2007. Currently there are two types of rulings issued by Polish tax authorities:

- General rulings – these are issued by the Minister of Finance where there are differences in the interpretation of tax regulations by the tax authorities. They apply to all taxpayers;
- Individual rulings – these are issued by tax chambers appointed by the Minister of Finance and apply only to the case of the requesting taxpayer.

The request for an individual ruling is filed on a special form, ORD-IN, and should include:

- The background to the case,
- The applicant's standpoint with respect to the interpretation of the tax law and
- A declaration that the case subject to interpretation is not subject to a tax proceeding, tax control or earlier tax decision. If this condition is not met, the

ruling is not binding and the person applying may be fined under the Penal Fiscal Code.

An individual ruling may not be “harmful” for the taxpayer i.e. if the taxpayer subsequently applies the ruling, no penalty interest or any sanctions under Penal Fiscal Code may be imposed. If the ruling is issued before the transaction starts, no tax other than that resulting from the interpretation may be imposed on the taxpayer with respect to the transaction. This does not apply if the ruling is issued after the transaction started.

An individual ruling may be amended by the Minister of Finance at any time. If the amendment is less favourable for the taxpayer, the taxpayer is entitled to apply the earlier ruling until the end of the running accounting period.

The tax authorities must issue individual rulings within three months (this may be extended in complicated cases). The fee for an individual ruling is PLN75 (approx. EUR20) per one question in the request.

Individual rulings cannot be used to confirm the correctness of the transfer pricing method.

### *Advance pricing agreements*

From 1 January 2006, a taxpayer may conclude an Advance Pricing Arrangements (APA) with the Minister of Finance to confirm the appropriateness of the taxpayer’s transfer pricing policy. The purpose of an APA is to agree upfront the arm’s length character of the terms of the transactions between related parties. From 1 January 2007, APAs also cover the attribution of profit to permanent establishments. As a result, the local tax authorities will not be able to question the arm’s length character of these transactions.

The tax law allows for the following types of APAs:

- Unilateral APA – for transactions between domestic entities or a domestic entity and a foreign entity; and
- Bilateral / multilateral APA – issued by the Minister of Finance after obtaining foreign tax authorities’ consent.

The administrative fee for the APA is approximately 1% of the transaction value. However, depending on the type of APA, the fee may not be lower than approx. EUR1,400 and may not be higher than approx. EUR55,500, (for exchange rate EUR1 = PLN3.6). The APA decision will include:

- determination of the entities covered by the agreement;
- determination of the type, subject and the value of the transaction covered by the agreement, as well as the period concerned;
- determination of the transfer pricing method, method of calculation of the transfer price and rules of application of this method, including all crucial assumptions; and
- period during which the decision remains in force.

Starting from 1 January 2007, an APA will be concluded for a maximum period of five years, with the possibility of extending the period by another five years.

### *Corresponding adjustments*

Poland ratified the Convention on the elimination of double taxation in connection with the adjustment of profit of associated enterprises of 23 July 1990. The Convention came into force on 26 August 2006.

### **5408 Liaison with customs and other tax authorities**

In 2002 the customs authorities (GUC) merged with the Ministry of Finance. As a result, the flow of information between the two tax authorities improved. The tax authorities are now working on the digitisation of the tax system. Once finished, the information gathered by various tax departments is likely to be made available to the tax police.

The tax authorities co-operate with the tax authorities of other countries in conducting multi-jurisdictional international investigations. Poland also applies the procedure of mutual communication.

The tax authorities are active in information exchange procedures.

### **5409 Thin capitalisation**

Thin capitalisation rules came into force on 1 January 1999. These rules generally apply to loans from a direct shareholder or a lending company, which has the same shareholder as the tested entity. The debt to equity ratio is 3:1. For the purposes of these rules, equity is defined narrowly as paid-up share capital.

The word loan for thin capitalisation purposes includes bonds and deposits.

### **5410 Management services**

Fees paid by Polish companies for consulting, accounting, market research, marketing, management, data processing, recruitment, guarantees and warranties, and other similar services are subject to 20% withholding tax, unless a relevant double tax treaty states otherwise. However, to apply the treaty withholding tax rate, the taxpayer needs a valid certificate of fiscal residence.



# 55 Portugal

## 5501 Introduction

Although the arm's length principle has been included in Portuguese tax law for many years, it has generally not been enforced, due to a lack of clarity and supporting regulations. However, this changed in December 2000 when new Portuguese transfer pricing legislation was enacted.

## 5502 Statutory rules

Detailed transfer pricing rules were introduced through Law number 30-G/2000 of 29 December 2000, which entered into force on 1 January 2001, by amending Article 57 of the Portuguese Corporate Income Tax (CIT) Code. This Article was subsequently changed into Article 58 by Decree-Law number 198/2001, dated 3 July 2001 (hereafter Decree-Law 198/2001). Article 58 of the CIT Code is applicable to tax years starting on or after 1 January 2002.

Article 58, number 13 of the CIT Code states that a Decree from the Minister of Finance will regulate, among others, the application of the transfer pricing methods, the type, nature and contents of the documentation and the procedures applicable to (corresponding) adjustments. This Decree, number 1446-C/2001, dated 21 December 2001 (hereafter Decree 1446/C-2001), was published in the National Gazette on 14 January 2002.

### *Article 58 CIT Code*

The key elements of the transfer pricing rules are as follows:

- the concept of 'special relations' between entities is broadly defined, including situations ranging from statutory to economic dependency, and also certain family relations;
- a set of defined methodologies for evaluating transfer prices and the comparability factors that should be taken into account when assessing their arm's length nature;
- the 'best method' or 'most appropriate method' for every transaction or series of transactions should be considered;
- extensive documentation requirements that require taxpayers to justify and document their transfer pricing arrangements; and
- a shift in the burden of proof from the tax authorities to the taxpayer ('self assessment procedure') in the case of controlled transactions with non-resident associated enterprises.

### *Arm's length principle*

Any commercial transactions, including transactions or a series of transactions related to goods, rights, services or financial arrangements between a taxpayer and another entity with which it has special relations must be conducted as if they were

independent entities carrying out comparable transactions.

The transfer pricing methodology adopted must ensure the best level of comparability between the tested transactions and the comparable data used to provide the benchmark. Factors affecting comparability include characteristics of the goods, rights or services, economic and financial environment, activities and functions performed, assets employed and risks borne.

The transfer pricing regulations also apply in cases of transactions between a non-resident entity and a permanent establishment (PE) in Portugal or between a PE of a non-resident entity with other PE's outside the Portuguese territory. The rules also apply to entities that are simultaneously exercising activities that are subject to CIT and activities that are exempt from CIT (e.g. entities based in the Madeira International Business Centre, MIBC).

### *Associated enterprises*

Special relations between two entities exist in case one entity has or may have, directly or indirectly, a significant influence in the management of the other entity. The law stipulates that a special relationship exists in the case of:

- an entity and its shareholders, or its relatives, that have directly or indirectly a participation greater than or equal to 10% of the capital or the voting rights;
- entities in which the same shareholders, or its relatives, have, directly or indirectly, an interest greater than or equal to 10% of the capital or the voting rights;
- an entity and the members, and their relatives, of its corporate bodies;
- entities in which the majority of the members of its corporate bodies, or of any other administrative body, board of directors or supervision or control, are the same persons or being different persons are connected with each other by marriage, other (legal) forms of joint households or by direct parental relation;
- entities connected by a contract of subordination or other with equivalent effect;
- entities that are required to prepare consolidated financial statements;
- entities where one of the following relationships exist:
  - (1) the activities of one entity substantially depend on industrial or intellectual property rights or know-how owned and granted by the other entity;
  - (2) the sourcing of raw materials or the access to sales channels of products, merchandise or services for one entity substantially depends on the other entity;
  - (3) a substantial part of the activity of one entity can only be performed with the other or depends on decisions taken by the other entity;
  - (4) the prices for goods or services rendered or acquired by one entity is, by provision set in juridical act, determined by the other entity; and

(5) terms and conditions of commercial or juridical relations between the parties have the effect that one entity can influence the management decisions of the other entity in a way other than between two commercial parties acting at arm's length; and

- an entity resident in Portugal or a non-resident with a permanent establishment in Portugal and an entity resident in a territory considered by Portuguese law as a territory with a clearly more favourable tax regime. These territories (83) are listed in the Decree number 150/2004 dated 13 February 2004 (hereafter Decree 150/2004).

### *Transfer pricing methods*

The methods to be used are:

- the comparable uncontrolled price method;
- the resale price method;
- the cost plus method;
- the profit split method;
- the transactional net margin method; or
- other methods when the methods mentioned above cannot be applied or if these methods do not give a reliable measure of the terms that independent parties would apply.

### *Tax information and documentation*

Every taxpayer shall indicate, in the annual declaration of accounting and tax information (IES/Declaração Annual), an integral part of the annual corporate income tax filings, the existence of transactions with entities with which it has special relations (associated enterprises) in that period. The requested information includes the associated enterprises, the amount of the controlled transactions with each of the associated enterprises and an indication as to whether supporting documentation for transfer prices existed at the time of the transactions (and is still available).

Taxpayers with turnover of EUR3 million or more should also comply with the documentation requirements below, which are further regulated by the Decree 1446-C/2001 (see 5506).

### *Corresponding adjustments*

Where the transfer pricing provisions apply to transactions between two parties that are both liable to Portuguese CIT, any adjustment to the taxable income of one should be reflected by a corresponding adjustment to the taxable income of the other. If a tax treaty is applicable, then the Portuguese tax authorities may also make corresponding adjustments through the competent authority procedure.

## **5503 Other regulations**

Article 23 of the Portuguese CIT Code considers that costs are only deductible if indispensable for generating profits or gains or for the maintenance of the production factors. Costs that are not (or not properly) documented are not deductible for CIT

purposes. Furthermore, such costs are subject to an autonomous tax rate of 50 percent, even in the case of tax losses.

The Decree 1446-C/2001 deals in more detail with the following issues:

- general rules on the arm's length principle;
- scope of application of transfer pricing rules;
- adjustments to taxable income and corresponding adjustments;
- transfer pricing methods and the best or most appropriate method;
- factors determining comparability;
- cost contribution and intra-group service arrangements;
- relevant information and supporting documentation; and
- special provisions.

### **5504 Legal cases**

There have been few court cases on transfer pricing issues under the previous legislation. The older case law is mainly related to cost contribution arrangements (CCAs). The lack of legal provisions and administrative guidelines regarding transfer pricing has given rise to discretionary and contradictory court decisions, some of which do not seem to be in accordance with the OECD Guidelines. More recent case law shows the importance of a well prepared factual and functional analysis to support arm's length dealings with associated enterprises.

### **5505 Burden of proof**

According to the General Tax Law (Lei Geral Tributária), the burden of proof lies with the tax authorities. However, under the recent transfer pricing rules, it is not entirely clear whether this rule is applicable. It can be argued that the burden of proof regarding transfer pricing has effectively shifted to the taxpayer, irrespective of the fact that the tax authorities must justify any (transfer pricing) adjustments made to the taxable income of the taxpayer.

In fact, the taxpayer must support the transfer pricing policy adopted with proper information and supporting documentation. In the case of controlled transactions with non-resident associated enterprises, the taxpayer must apply any necessary corrections in its corporate income tax return in order to reflect arm's length pricing ('self assessment').

### **5506 Documentation**

#### *Tax documentation file*

Based on Decree 1446-C/2001, taxpayers are required to keep a transfer pricing documentation file which is expected to include the following information:

- the terms and conditions agreed, accepted and observed in the open market in relation to the controlled transactions; and
- the selection and application of the method or methods most appropriate for benchmarking transfer prices through the use of arm's length comparables.

The transfer pricing documentation file should include the following major items of information:

- a description of any special relations that exist with any entities with which commercial, financial or other transactions are carried out;
- a record of the corporate relationship by which the special relationship arose, including any documents that demonstrate a subordination or dependency relationship as mentioned above;
- a description of the activities carried out during the controlled transactions, a detailed list of amounts recorded by the taxpayer over the past three years and, where appropriate, the financial statements of the associated enterprises;
- a detailed description of the goods, rights or services involved in controlled transactions and of the terms and conditions agreed if such information is not disclosed in the respective agreements;
- a description of the activities performed, the assets used and the risks assumed, both by the taxpayer and the associated enterprises involved in the controlled transactions;
- technical studies on essential areas of the business, namely investment, financing, research and development, marketing, restructuring and reorganisation of activities, as well as forecasts and budgets connected with the global business and business by division or product;
- guidelines regarding the transfer pricing policy of the firm, containing instructions on the methods to be applied, procedures for gathering information (particularly on internal and external comparables), analysis of the comparability of transactions, cost accounting policies and profit margins obtained;
- contracts and other legal instruments concluded with both associated enterprises and third parties, together with any other document that may govern or explain the terms, conditions and prices under those transactions;
- an explanation of the method or methods applied to determine arm's length prices for each controlled transaction and the rationale for the selection;
- information regarding comparable data used. The grounds for selection, research records and sensitivity and statistical analyses should all be documented;
- an overview of business strategies and policies, particularly regarding commercial and operational risks that may have a bearing on the determination of transfer prices or the allocation of profits or losses for the transactions; and
- any other information, data or documents considered relevant for determining an arm's length price, the comparability of transactions or the adjustments made.

The list of relevant information and documentation required is not exhaustive. The taxpayer is expected to maintain the documentation for a period of 10 years after the filing of the tax return and to deliver the documentation to the tax authorities upon

request. The documentation should help to verify the arm's length nature of the transfer prices without the need for the taxpayer to incur excessive compliance costs.

The tax authorities have four years to raise additional CIT assessments. If tax losses were offset against tax profits within the above-mentioned period, the tax authorities can also audit the accounts of the years in which the tax losses were incurred.

Taxpayers are expected to update the prior year documentation for transactions where the relevant facts and circumstances have changed to the extent that there is a material impact in the determination of the arm's length price.

### *Cost contribution arrangements (CCAs)*

With respect to CCAs, the taxpayer must maintain documentation supporting the following information:

- description of the participants and other associated enterprises involved in the activity covered by the agreement or that are expected to exploit or use the results of that activity;
- the nature and type of activities carried out within the scope of the agreement;
- the method by which each participant's proportionate share in the expected advantages or benefits are determined;
- the accounting procedures and methods applied to allocate costs, including the calculations made to determine each participant's contribution;
- the assumptions that underlie forecasts of expected benefits, frequency of review and forecasts of any adjustments arising from changes in the agreement or in other facts;
- expected duration of the agreement;
- anticipated allocation of responsibilities and tasks under the agreement.
- procedures for a participant entering or withdrawing from the agreement and conditions for the termination of the agreement; and
- penalty clauses.

### *Intra-group services*

Regarding intra-group services agreements, the supporting documentation must include the following data:

- a copy of the agreement;
- a description of the services covered by the agreement;
- a description of the recipient of the services; and
- a description of the costs of the services and the criteria applied for their allocation.

## **5507 Tax audit procedures**

The audit procedure can be either internal or external. During an internal audit, the taxpayer is requested to send documentation to the tax authorities for analysis; in an

external audit, investigations are carried out on the taxpayer's premises.

Furthermore, the audit procedure can be either global or partial. A global tax audit reviews the entire tax status of the taxpayer, while a partial tax audit will focus on only one or more (but not all) of the taxpayer's tax duties. An audit may address more than one taxable period. The tax audit procedure is continuous and must be concluded within six months. However, under certain circumstances, this period may be extended.

The audit procedure begins with a notification sent by the tax authorities to the selected taxpayer. This sets out the nature and scope of the audit, as well as the rights and obligations of the taxpayer during the audit process.

Audits are completed when the tax auditor considers that all the necessary information has been obtained to draw up a proposed tax audit report. This proposal is sent to the taxpayer who has the opportunity to oppose, in all or in part, against the conclusions of the proposal. After the objections have been heard, the tax auditor will issue a final audit report, which may give rise to an additional tax assessment.

### **5508 Revised assessments and the appeals procedure**

Following a tax audit, the taxpayer is allowed to challenge an additional tax assessment made by the tax authorities, either by means of an administrative claim submitted to the tax authorities, or via a judicial appeal to the tax courts. An appeal against an additional tax assessment does not prevent the collection of additional tax. Therefore, the taxpayer should either pay the tax due or provide a guarantee for its payment.

There are no specific regulations in respect of appeals connected with additional assessments based on the transfer pricing arrangements adopted by the taxpayer.

### **5509 Additional tax assessment and penalties**

In general terms, additional assessments usually carry penalties and fines. Currently there are no specific penalties in force for transfer pricing issues. However, a transfer pricing penalty regime may be introduced in the future (see Section 5515).

In the notifications that the tax authorities have issued to taxpayers to deliver the transfer pricing tax file, it is mentioned that a penalty from EUR200 to EUR2,500 may be applied if the transfer pricing file is not delivered, or not timely delivered. We note that if a taxpayer refuses to deliver the transfer pricing file this may result in a penalty that may range from EUR500 to EUR100,000.

Penalties for the non-payment of taxes range between 20% and 100% of the amount of tax due, capped at EUR110,000 in case of intention and EUR30,000 in case of negligence. The taxpayers are allowed to request a reduction of the penalty and to appeal against the penalties imposed by the tax authorities.

Late assessment interest (4% per year) is also charged. Neither penalties nor late assessment interest are deductible for tax purposes. In case of the late payment of an additional assessment made by the tax authorities, interest for late payment will be applied (1% per month).

### **5510 Resources available to the tax authorities**

#### *Practice*

It is believed that at present the tax authorities have already developed sufficient

experience to deal with transfer pricing issues. Various transfer pricing audits have been performed and recently the tax authorities have started to make transfer pricing adjustments to the taxable profit of taxpayers.

### **5511 Use and availability of comparable information**

#### *Use*

The taxpayer should select the transfer pricing method that assures the best grade of comparability between its transaction or series of transactions and the uncontrolled benchmarking data. Where possible, the comparable uncontrolled price (CUP) method should be used to establish an arm's length price, making use of available comparable price information.

#### *Availability*

There are commercial databases available that contain (financial) information about Portuguese companies. Nevertheless, third party financial data for Portuguese companies remains relatively sparse. This may represent an obstacle for taxpayers wishing to support their transfer pricing policies and methods with comparable data.

The tax authorities have been using information available from their own sources (i.e. information that is not publicly available but obtained from CIT returns and governmental tax audits). Recently, the tax authorities acquired AMADEUS, a financial database, to assess the compliance of controlled transactions with the arm's length principle.

In January 1999, the tax authorities published a list of ratios determined by dividing taxable income by turnover for the various sectors recognised for commercial register purposes. The ratios are based on taxpayer information for the years 1994, 1995 and 1996. Entities that in 1998 have a ratio that is inferior to the one determined for the relevant sector would, in principle, be subject to a tax inspection. We are not aware of such a study being repeated in later years. Furthermore, it is uncertain whether the tax authorities may use such data to support proposed adjustments to taxable income, since the underlying data may be considered confidential (secret comparables).

### **5512 Risk transactions or industries**

Transfer pricing is becoming an area of increasing focus for the Portuguese tax authorities. They have notified various companies to file the transfer pricing documentation for the years 2003, 2004 and 2005. To our understanding, such companies are in different types of industries and it does not follow that the tax authorities transfer pricing audits are focusing on certain industries or specific types of transaction. Therefore, as a general rule, all controlled transactions should be duly supported and documented in accordance with the arm's length principle.

### **5513 Limitation of double taxation and competent authority proceedings**

In principle, transfer pricing adjustments should be implemented so as to avoid double taxation. When the adjustment affects transactions between a Portuguese company and a non-resident, the mechanisms laid down in the relevant double taxation treaty should be applied. Where the non-resident is within the EU, the



provisions of the Arbitration Convention relating to the elimination of double taxation (EC Directive 90/436) can also be applied.

The procedures regarding corresponding adjustments are laid down in Decree 1446-C/2001.

#### **5514 Advance pricing agreements (APAs)**

The Decree 1446-C/2001, stipulated that after relevant experience would have been gained regarding the application of the new transfer pricing rules, the Portuguese tax system would be in a position to adopt the OECD's recommendations in the area of APAs. The State Budget for 2008 introduced APAs rules by means of adding article 128-A to the CIT Code.

Article 128-A, Number 9 of the CIT Code, states that a Decree from the Minister of Finance will regulate the requirements and conditions for preparing and filing a request, as well as what procedures, information and documentation are to be applied in the APAs.

The APA is valid for a maximum of three years.

#### **5515 Anticipated developments in law and practice**

It is expected that existing transfer pricing regulations will be extended by the publication of specific legislation on penalties for non-compliance with the obligations as set out in Decree 1446-C/2001, especially in respect of non-compliance with documentation requirements. In addition, a Decree on the requirements and conditions of an APA procedure is expected in the short term (see Section 5514).

#### **5516 Liaison with customs authorities**

In practice there is little communication and exchange of information between the tax authorities and the customs authorities.

#### **5517 OECD issues**

Portugal is a member of the OECD. The new transfer pricing rules reflect the approach set out by the OECD Guidelines. Decree 1446-C/2001 indicates that in more complex cases, it may be advisable to consult the OECD Guidelines for further clarification.

Under a reservation made in Article 9 of the Model Tax Convention on Income and Capital, Portugal reserves the right not to insert paragraph two (regarding corresponding adjustments) in its tax treaties. The 'older' tax treaties, most of them with EU countries, do not contain a corresponding adjustment provision. However, in the more recent treaties a corresponding tax adjustment provision equivalent to the above-mentioned paragraph of the Model Tax Convention on Income and Capital, is included.

#### **5518 Joint investigations**

Portuguese law does not prevent Portuguese tax authorities from joining the equivalent body of another state to set up a joint investigation into a multinational company or group.

### **5519 Thin capitalisation**

Portuguese taxation rules for thin capitalisation were introduced in January 1996. Where the indebtedness of a Portuguese taxpayer to an entity not resident in Portugal or in a EU country with whom special relations exist is deemed excessive, the interest paid in relation to the part of the debt considered excessive will not be deductible for the purposes of assessing taxable income.

In determining whether special relations exist, reference is made to Article 58 of the CIT Code regarding transfer pricing (i.e. special relations exist if the non-resident entity has or can have substantial influence, directly or indirectly, in the management decisions of the resident entity).

Excessive indebtedness occurs where the value of the debts in relation to each of the entities is more than twice the value of the corresponding shareholding in the taxpayer's equity. Any disallowed interest is not re-qualified as a dividend for withholding tax purposes. This means that withholding tax should be levied on the full amount of the interest, including the interest related to the part of the loan that exceeds the 2:1 debt to equity ratio.

In order to determine the qualifying debt, all forms of credit will be considered, whether in cash or in kind, including credit resulting from commercial transactions that are overdue for six months or more. In order to determine qualifying equity, paid in share capital includes all equity capital except for unrealised capital gains or losses, including those arising from revaluation not authorised by the tax legislation, and amounts resulting from the equity method of accounting.

In cases where the 2:1 ratio is exceeded, the taxpayer may be able to avoid adjustments under the thin capitalisation rules where it can be shown that the same level of indebtedness could have been obtained with similar conditions from an independent party. Such evidence must be kept in the annual tax file of the company for 10 years. This option is not applicable where the indebtedness is towards an entity resident in a territory considered by Portuguese law as a territory with a clearly more favourable tax regime.

# 56 Romania

## 5601 Introduction

The Romanian transfer pricing legislation follows the OECD Guidelines and requires that transactions between related parties be carried out at market value. In case transfer prices are not set at arm's length, the Romanian tax authorities have the right to adjust the taxpayers' revenues and expenses so as to reflect the market value. Profit adjustments on transactions between related parties can be performed only within the domestic statute of limitation period (i.e. five years).

The trend in transfer pricing developments in Romania reveals a growing interest of the Romanian tax authorities towards transfer pricing, which is becoming one of the main areas of tax investigation. Under these circumstances, multinational companies are advised to pay close attention to the arm's length of their related party transactions and their documentation so as to be prepared in case of any transfer pricing disputes with the tax authorities.

## 5602 Statutory rules

The arm's length principle was first introduced in domestic tax law in 1994. An important milestone in the development of the transfer pricing legislative framework occurred in 2004, upon the introduction of the Fiscal Code, which set out in a systematic manner the definition of related parties, the statement of the arm's length principle and the methods for setting transfer prices at arm's length.

The Fiscal Code Norms detail the scope and the application of transfer pricing rules. Although Romania is not a member of the OECD, these Norms expressly stipulate that in the application of transfer pricing rules, the Romanian tax authorities will also consider the OECD Transfer Pricing Guidelines.

### *The arm's length principle*

The arm's length principle is applicable to all related party transactions, including those between a foreign legal entity and its Romanian permanent establishment. Nevertheless, related party transactions carried out between two Romanian legal entities are currently excluded from the scope of transfer pricing investigations.

### *Definition of related parties*

Two legal entities are related parties provided that:

- one entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the other entity or it effectively controls the other entity;
- one entity holds directly or indirectly (through the shareholding of related entities) a minimum of 25% of the number/value of shares or voting rights in the two entities.

An individual is a related party with a legal entity provided that he/she holds directly or

indirectly, including the shareholding of related entities, a minimum of 25% of the number/value of shares or voting rights in the legal entity or it effectively controls the legal entity (unfortunately the legislation is silent on what the meaning of 'effective control' is). Two individuals are related parties provided that they are spouses or relatives up to the third degree.

### *Transfer pricing methods*

Local legislation provides that taxpayers may use traditional transfer pricing methods (comparable uncontrolled price, cost plus and resale price), as well as any other method that is in line with the OECD Transfer Pricing Guidelines (transactional net margin and profit split). If the comparable uncontrolled price or a traditional transfer pricing method is not used, as it is the case, the taxpayer should set out in the documentation the reasons for not doing so.

Taxpayers should consider the following main criteria when selecting the most adequate transfer pricing method:

- activities carried out by the related parties;
- availability of data and justifying documents;
- accuracy of adjustments to meet comparability criteria; and
- circumstances of the specific case (e.g. characteristics of the tangible goods transferred, stage within the supply chain, payment conditions, guarantees, discounts, etc).

For specific types of transactions, guidance is provided on the application of transfer pricing methods and the comparability factors that should be considered by the taxpayer:

Provision of services: the arm's length transfer price should be set using the comparable uncontrolled price method, by considering the usual fees for each type of activity or the standard rates in certain fields. In the absence of comparable transactions, the cost plus method should be used.

Inter-company loans: the arm's length transfer price is represented by the interest that would have been agreed upon between third parties in comparable circumstances, including the commission for handling the loan. Comparability factors that should be considered in assessing the arm's length interest rate include: amount and duration of the loan, nature and purpose of the loan, currency and foreign exchange risk, existence of guarantees, costs of hedging the foreign exchange risk, etc.

### *Documentation requirements*

In line with the Fiscal Procedure Code, taxpayers engaged in related party transactions are required to prepare a transfer pricing documentation file that needs to be presented upon request of the tax authorities during a tax audit. The deadline is to be set at maximum three months from the date of receiving the formal written request, with the possibility of a single extension with a period equal to the term initially established.

*In February 2008, detailed regulations regarding the content of the local transfer pricing documentation file were published. The content of this file is in line with the Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union (EU TPD).*

There is currently no minimum threshold for documenting controlled transactions or any simplified documentation rules and therefore, irrespective of materiality, Romanian tax authorities can scrutinise the arm's length nature of any controlled transaction.

#### *Advance pricing agreements (APA)*

In Romania, taxpayers engaged in related party transactions have the possibility to apply for APAs. Details regarding the application procedure and the documentation that needs to be prepared by a taxpayer intending to request an APA are provided in a Government Decision issued in June 2007.

The APA is defined as an administrative act issued by the National Agency for Tax Administration in the view of addressing a taxpayer's request in relation to establishing the conditions and methodology to set transfer prices in related party transactions for a fixed period of time.

The procedure is initiated by the taxpayer through submission of a request for an APA that can be preceded, if desired by the taxpayer, by a pre-filing meeting. The documentation that needs to be provided upon request for an APA is similar to the transfer pricing documentation file and needs to suggest upfront the content of the APA.

The APA can be issued for a period of up to five years and is generally valid starting from the fiscal year subsequent to the filing of the request. By exception, its validity may be longer in case of long term agreements. The APA is opposable and binding on the tax authorities as long as its terms and conditions are observed. In this view, taxpayers need to submit an annual report on these terms and conditions, by the deadline for submitting the statutory financial statements.

If the taxpayer does not agree with the APA, a notification can be sent to the issuing tax authority within 15 days from the communication date and the APA no longer produces legal effects.

The deadline for issuing APAs is 12 months in case of unilateral and 18 months in case of bilateral or multilateral APAs. In case of large taxpayers and for transactions with an annual value exceeding EUR4 million, the fee for issuing an APA is EUR20,000 and the fee for amending it is EUR15,000. For the rest of the taxpayers, the fee for issuing an APA is EUR10,000 and the fee for amending it is EUR6,000.

Taxpayers are classified as large taxpayers provided that their annual turnover exceeds EUR19 million or if they are banks, insurance companies or other financial institutions.

#### **5603 Risk transactions or industries and legal cases**

No industries or types of transactions are considered to be at particular risk for investigation, but none are excluded from the possibility of a transfer pricing investigation in the near future. We expect that in the initial stage, the Romanian tax authorities will focus on controlled transactions with non-resident related parties.

As of 2000, we have witnessed the tax authorities' increasing interest in management services contracts, which currently represent the most commonly challenged type of transaction. In this respect, the Romanian tax authorities will scrutinise the deductibility of inter-company service fees.

We are also aware of an increasing number of cases where the Romanian customs authorities have challenged the value of imported goods and adjusted accordingly the value in customs by including the value of related royalties.

#### **5604 Burden of proof and tax audit procedures**

In Romania, the burden of proof lies with the taxpayer that should prepare transfer pricing documentation in order to defend the arm's length of its transfer prices. In the case of litigation, the burden of proof may shift to the tax authorities in order to demonstrate that the transfer prices set by the taxpayer are not at arm's length.

The Romanian tax authorities should first assess the arm's length character of the controlled transaction by using the method applied by the taxpayer. However, in case the tax audit reveals that the arm's length principle is not observed, the Romanian tax authorities may apply the most appropriate method from the ones listed above.

#### **5605 Comparable information**

The detailed regulations regarding the content of the local transfer pricing documentation file include specific provisions on the procedure to conduct benchmarking studies. These should include local comparables. European or international benchmarking studies are accepted provided that there are no local comparables or if the set of local comparables is too limited.

Another particularity of the way to carry out the benchmarking study is that the comparability range is narrowed to the interquartile interval. If the taxpayer's transfer prices fall outside the arm's length range, the adjustment shall be carried out to the median.

In Romania, information on the performance of companies is only available in the form of published annual financial statements. These statements contain information that can enable computation of various profit level indicators. However, in some cases, segregation of transactions and identification of the cost base may prove to be difficult due to the particularities of the Romanian accounting system.

#### **5606 Additional taxes and penalties**

Failure to present the transfer pricing documentation file may result in fines ranging from RON12,000 to RON14,000 (i.e. approx EUR3,300 to EUR3,900 at the current foreign exchange rate) and estimation of transfer prices by the tax authorities based on generally available information on similar transactions, as the arithmetic mean of prices on three similar transactions.

The additional taxable profits resulting from this estimation or any transfer pricing adjustments are subject to the general 16% profit tax rate and related late payment interest of 0.1% per day of delay. Under Romanian legislation, late payment interest is non-deductible.

#### **5607 Inter-company loans**

Under the Romanian Fiscal Code, interest expenses incurred in relation to inter-company loans having a maturity that exceeds one year are subject to the following two limitations:

### *Safe harbour rules*

Interest expenses on these inter-company loans are deductible within the limit of:

- in the case of loans denominated in hard currency (any other currency than the local currency), a ceiling established annually through Government decision (currently set at 7%); and
- in case of loans denominated in local currency, the reference interest rate of the National Bank of Romania.

The particularity of these 'safe harbour' rules is that taxpayers are not exonerated from their documentation obligations.

Interest expenses exceeding these limits are non-deductible and cannot be carried forward to subsequent years. This limitation is applied separately to each inter-company loan before considering the thin capitalisation rules detailed below.

### *Thin capitalisation rules*

Interest expenses on inter-company loans are deductible provided that the debt to equity ratio is lower than or equal to three. In case the debt to equity ratio is negative or higher than three, interest expenses are non-deductible in the current year and can be carried forward to subsequent years.

The debt to equity ratio is determined as a ratio between the company's related party liabilities with a maturity exceeding one year (including liabilities whose maturity was extended so that it exceeds one year) and the owner's equity, by considering the average of the book values recorded at the beginning and at the end of the year.

In particular, expenses with foreign exchange differences also need to be considered. Therefore, in case expenses with foreign exchange differences exceed revenues from foreign exchange differences, the difference is treated as interest expense and is subject to the limitation mentioned above. The expenses with foreign exchange differences subject to this limitation are those related to the liabilities considered for determining the debt to equity ratio.

This limitation is not applicable to banks, Romanian legal entities or branches of foreign banks, leasing companies for their leasing operations, real estate mortgage companies, credit institutions and non-banking financial institutions.

### *Other considerations*

In case of related party financing, the following should be also analysed:

- whether the loan granted serves the business interest of the beneficiary and has been used for that purpose; and
- whether there has been a profit distribution scheme.

Requalification of an inter-company loan into a profit distribution scheme occurs if, at the moment of granting the loan, a reimbursement is not expected and the agreement includes unfavourable conditions for the borrower. Under these circumstances, the loan can be reclassified as share capital, the deductibility of interest expenses and any foreign exchange differences can be challenged and they can be assimilated to dividend payments.

**5608 Liaison with customs authorities**

The tax and customs authorities in Romania do not usually co-operate when it comes to transfer pricing issues. The majority of customs value investigations to date have been related to the adjustment of the customs value according to Article 8 of the WTO Customs Valuation Agreement. Issues including the adjustment of customs value for royalties, licence fees, assists (e.g. packaging design, tools), and the inclusion of transport expenses were among the favourites of the customs inspectors.

However, given the recent changes in the customs legislation (e.g. new opportunities such as the First Sale principle) and the exchange of practice between customs authorities as a result of the EU accession, we expect that the customs authorities will intensify monitoring and inspections in the field of customs valuation. For this purpose, the customs authorities are preparing a database containing price levels for different industries.

In this context, we expect that transfer pricing adjustments, although not automatically notified to the customs authorities, will lead to further investigations and adjustments in customs as a result of the exchange of information between tax and customs authorities or as a result of their reflection in the business transactions.



# 57 Russia

## 5701 Introduction

As part of Russia's ongoing tax reform, Part I of the Tax Code introduced the much anticipated Russian transfer pricing legislation. The Russian transfer pricing provisions have been effective since 1 January 1999. Under the headings 'Principles of determining the price of goods, work or services for purposes of taxation' (Article 40 of the Tax Code) and 'Interdependent parties' (Article 20 of the Tax Code), the rules provide a basis for the tax authorities to challenge transfer pricing arrangements in certain circumstances. They also set out the basic rules for determination of market prices against which the prices used by taxpayers are to be compared.

The concept of transfer pricing and the arm's length principle is relatively new to the Russian tax law. Under the pre-code tax legislation only limited provisions effecting transfer pricing existed. These focused principally on circumstances where goods, work or services were sold at, or below, cost and when goods, work or services were bartered or transferred without charge. The introduction of separate legislative provisions in the Tax Code for determining prices has completely changed the approach to inter-company pricing arrangements for tax purposes (e.g. profits tax, value added tax, turnover taxes, etc) and has raised a myriad of questions that remain to be answered.

As initially drafted, the new Russian transfer pricing rules were rather vague and terms employed were often subjective or undefined. As a case in point, the new rules were modified within six months of introduction. However, they still present the basis for future transfer pricing legislation rather than the detailed guidance for dealing with transfer pricing arrangements. The general rules for determining prices for tax purposes were expanded by the Profits Tax Chapter of Part II of the Tax Code, which came into force as of 1 January 2002, containing some elements of transfer pricing to deal specifically with individual situations.

Reform in current Russian transfer pricing rules was imminent and for that reason the Russian Ministry of Finance and the Russian Finance Academy have both prepared their version of the Draft Law, which after a June 2008 meeting with the Vice Prime Minister have declared to have an equal power to be considered for becoming a Law. The major differences between the two Draft Laws can be summarised as follows:

- the number of transfer pricing methods under the Russian Finance Academy version is limited to traditional methods that are currently available in Article 40 of the Tax Code with addition to Resale Minus of the Secondary Product method, whereas Ministry of Finance's version with its introduction of profit based methods will become a close resemblance to the methods used by OECD member countries;
- the definition of interdependent parties remains unchanged as it appears in the current version of Article 40 of the Tax Code under the Russian Finance Academy version, whereas the Ministry of Finance offers a wider range of persons that can be considered as dependent; and

- the tax authorities under the Ministry of Finance's Draft Law will have the right to control both cross-border and domestic transactions regardless of the value of the transaction, whereas under the Finance Academy's proposal, tax authorities will have the right to control transactions only in cases where such value is exceeding RUB1 million (approximately USD43,000).

However, it still remains unclear as to when and in which form the Transfer Pricing Draft Law will be enacted. There will be a compromise between the two current Draft Laws that are expected to be adopted either from 2009 or 2010 at the latest.

For the purposes of this Chapter, we will be looking at the Ministry of Finance's version of the Draft Law.

The Draft Law aims to both make the Russian transfer pricing rules work in practice and to make them more severe. The proposed amendments will give the tax authorities significant additional powers to propose transfer pricing adjustments and uphold them. For instance, the Draft Law abolishes Articles 20 and 40 of Part I of the Russian Tax Code and replaces them with Section V "Related Parties. General Provisions on Prices for Tax Purposes. Controlled Transactions".

Below follows a brief summary of the overall differences between the current Russian TP rules (Articles 20 and 40) and the proposed Draft Law by the Ministry of Finance.

## **5702 Statutory rules**

### *Controlled transactions*

Under Article 40, the tax authorities may challenge the pricing arrangements between taxpayers only in the following cases:

- transactions between interdependent (related) parties, domestic as well as cross-border;
- barter transactions;
- foreign trade transactions; and
- transactions where the prices within a short period of time deviate by more than 20% either way from the prices set by the taxpayer for identical or similar goods (work, services).

The term 'short period of time', while extremely important, is still undefined in the Tax Code.

The Draft Law abolishes the existing allowable 20% fluctuation from the market price and introduces a different list of controlled transactions, in particular the following transactions will be treated as controlled under the revised Draft Law:

- Transactions between related parties;
- Barter transactions;
- Cross-border transactions involving services (work), property rights, information and intellectual property (IP);
- Cross-border transactions with certain commodity groups traded in global exchange trading (oil and oil products, ferrous and non-ferrous metals, and precious metals and stones); and

- Transactions between Russian entities (foreign entities through their permanent establishments in the Russian Federation, Russian tax resident individuals) and entities located (residing) in the foreign states and territories under the jurisdiction of such foreign states, included in the list approved by the Ministry of Finance of the Russian Federation.

#### *Interdependent parties*

Currently the definition of 'interdependent parties' is found in Article 20 of Part I of the Tax Code and describes three situations where:

- one party has a greater than 20% direct or indirect equity participation in the other. The participatory share of indirect participation of one party in another through a sequence of other parties is determined in the form of multiplying the participatory shares of direct participation of parties of this sequence one to another;
- one individual is subordinate to the other with regard to official position; or
- individuals have a marital, kinship, affinity, adoptive or adopted, trustee or ward relationship.

While the list of interdependent parties in the Tax Code appears to be exhaustive, it does not encompass more complicated cases where parties not meeting the above formal criteria, may, nevertheless, be found to be truly interdependent in nature. It is worth noting that, unlike the tax authorities, which may undertake transfer pricing adjustments only with respect to controlled transactions, meeting the Tax Code's definition of interdependent parties, courts are not subject to this restriction. Courts can declare 'persons' to be interdependent for reasons other than those defined in the Tax Code if the relationship between the parties could affect the transaction's outcome.

The Draft Law broadens the definition of interdependent parties to include:

- parent company/partnership and subsidiaries;
- organisation and a member of its board of directors/supervisory board, another collegial management body or its member, or an individual acting as its sole executive body;
- parties, when a direct participation interest held by each preceding party in each subsequent party exceeds 50%;
- employer and employee relationship; and
- under certain circumstances courts can declare settlers, trustees and beneficiaries of the trust interdependent.

#### *Basis for transfer pricing adjustment*

The tax authorities may make a 'justified decision' to levy additional tax and interest (for outstanding tax liability, if any) if the result of the controlled transaction was calculated based on the market price of identical or similar goods (work, services) when the price used in the controlled transaction differs from the market price by more than 20%. However, the Tax Code provisions do not appear to allow the tax authorities to reduce the tax base accordingly. The absence of a correlative adjustment provision in Article 40 is likely to lead to double taxation after a transfer pricing

adjustment. Some Russian tax treaties provide for correlative adjustment provisions. However, in practice we have not come across such incidents where the Russian tax authorities are unlikely to honour transfer pricing treaty protection for transfer pricing cases.

### *Transfer pricing methods*

In addition to the three existing pricing methods under the current Russian transfer pricing rules (1-3) mentioned below, the Draft Law introduces three new methods (4-6):

- (1) Comparable Uncontrolled Price (CUP);
- (2) Resale Price method;
- (3) Cost Plus method;
- (4) Sale of Processed Product (Secondary Product) method;
- (5) Comparable Profits Method (CPM); and
- (6) Profit Split method.

The CUP method will remain the primary transfer pricing method to be used over all other methods. If this method is not applicable, the taxpayer is free to choose between the remaining five, though, with the Profit Split method serving as the method of the last resort.

It should be noted that the wording of the Tax Code presumes that only one market price exists, rather than a range of market prices. It is unclear how the tax authorities will select the market price in cases where several market prices exist for certain goods (work or services). In practice though, some courts admit the existence of a range of market prices; however, they have not clarified which price out of the range should be taken for the purposes of comparison with the actual price applied by a taxpayer.

The new Draft Law seems to address this problem by introducing a market price interval concept. However, the formula suggested by the Draft Law is different from the market range including interquartile range formula traditionally applied by the OECD member countries to determine the market prices. The formula currently suggested by the Draft Law makes the market price interval highly dependent on abnormally high or low prices applied in comparable transactions, which are used to build the range. In particular, the market price interval is determined as follows: the minimum  $(3a + b)/4$  and the maximum  $(a + 3b)/4$ , where "a" is the lowest price and "b" is the highest price values in the market price range.

### *Safe harbours*

In determining the market price the tax authorities are required to take into account usual discounts from, or mark-ups to prices. For example, such discounts or mark-ups can be caused by the following:

- seasonal or other fluctuations in consumer demand of goods (work, services);
- loss of goods' quality from luxury goods and other consumer properties;
- expiration (approaching of the expiry date) of the goods' shelf-life or realisation period;

- marketing policy, including new product promotion and new market penetration; and
- test models and sample goods sales for the purpose of consumer familiarisation.

The Draft Law excludes test models and sample goods sales as the factor to be considered and brings some clarity into this wording.

The Tax Code incorporates the commonly used principle that, for the purpose of determining the market price, only transactions carried under comparable conditions should be taken into account. In particular the following factors should be evaluated:

- quantity (volume) of supply;
- period within which liabilities should be fulfilled;
- terms of payment; and
- other reasonable circumstances, which may influence the market price.

The list of the above factors is not exhaustive.

The Draft Law appears to be more prescriptive than the current Russian transfer pricing rules leaving less opportunity for the taxpayer's discretion and interpretation. For this reason "other reasonable circumstances" were replaced with a precise valuation factor like inflation and exchange rate of the Russian rouble.

Currently, there are no changes that have been prepared by the Russian Ministry of Finance to articles of Part II of the Tax Code, which contain some elements of transfer pricing rules. For instance, the Profits Tax Chapter further lists special comparability factors that should be looked at in order to identify borrowing that may be treated as being under comparable circumstances. In particular, borrowing should be:

- in the same currency;
- on the same terms;
- with guarantees of the same quality; and
- falling within the same category of credit risk.

### *Securities and derivatives*

The Profits Tax Chapter of Part II of the Tax Code came into force on 1 January 2002 and introduced special transfer pricing rules with respect to securities and derivatives. The rules set out conditions that should be met when the actual price of a transaction is deemed to be the market price and, therefore, can be used as a basis for calculation of taxes.

### **5703 Other regulations**

Current Russian transfer pricing rules, as codified by the Tax Code, are vague and it is difficult to apply them in practice. To date, there have been no official guidelines or recommendations on the application of the Tax Code's transfer pricing provisions other than official explanations to courts of general jurisdiction and arbitration courts. These were issued by the plenum of the Russian Federation Supreme Court and the plenum of the Russian Federation Supreme Arbitration Court (Resolution of the plenum of the Russian Federation Supreme Court and the plenum of the Russian Federation

Highest Arbitration Court # 41/9 of 11 June 1999), 'On certain issues in conjunction with the enactment of Part 1 of the Russian Federation Tax Code'. By and large, the joint resolution simply reiterates the Tax Code provisions, failing to address a number of profoundly controversial issues, thus giving evidence of the lack of relevant experience and ability of the courts to resolve transfer pricing disputes.

At the same time certain unofficial clarifications on the application of transfer pricing rules are being issued from time to time by the Russian Ministry of Finance (e.g. letter on non-application of transfer pricing rules to interest on the loans was published in April 2007 and letter on expected margins was released in July 2007).

### **5704 Legal cases**

Although case law does not exist in Russia, the vagueness of the tax laws and the contradiction between laws and their broad interpretation by the tax authorities means that the courts play an important role in the development of tax interpretations in Russia. That is, decisions of various courts construe the law in particular cases. However, for the reasons discussed, these decisions often serve as general guidance only in disputes between the tax authorities and taxpayers, where situations are similar.

The main factor explaining why taxpayers won the majority of the court cases is that the burden of proof in transfer pricing cases lies with the tax authorities which often fail to show that transfer prices were set incorrectly, or try to do so using unofficial sources of information.

For example, an analysis of the current Russian arbitration court practice on transfer pricing cases shows that:

- when applying the resale minus or cost plus methods, the tax authorities often fail to prove that the CUP method is impossible to apply in particular circumstances; and
- the court will recognise companies' interdependence on grounds other than those formal grounds listed in the Tax Code, only if the tax authorities prove that this interdependence had an impact on the results of sales transactions between them.

### **5705 Burden of proof**

The burden of proof rests with the tax authorities, who are required to demonstrate that the price charged by the taxpayer fluctuates by more than 20% from the market price. Unless otherwise proven, prices set by the taxpayers are deemed to be market prices.

In the Draft Law, the Government proposes to shift the burden of proof to the taxpayer by providing, in this respect, a pre-determined list of transactions where the taxpayer will be obliged to calculate taxes according to the market price. Thus, the court intends to abolish the presumption that the actual price used in the transaction corresponds to the market price until proved otherwise.

### *Reporting requirements*

The Draft Law introduces reporting requirements for the taxpayers who will be required to submit information on controlled transactions together with their tax returns if

income and expenses from all controlled transactions performed with the same entity (same several entities which are parties to a controlled transaction) during a tax period exceed RUB10 million (approximately USD422,165). Such information would include:

- A list of controlled transactions (specifying the type and subject of each transaction) concluded during the corresponding tax period;
- Income (profit) generated or expenses incurred as a result of the controlled transaction (or several controlled transactions) with identical (similar) goods (work, services);
- Information on the method and sources of information used for computing market prices in relation to controlled transactions; and
- A list of foreign parties with which controlled transactions were concluded, indicating the states of which they are residents.

#### *Documentation requirements*

Currently, there are no formal transfer pricing documentation requirements in Russia. However, in practice, during the course of a field tax audit, tax authorities may request supporting documentation confirming the calculation of transfer prices. Therefore, it is always recommended to document inter-company transactions in advance, rather than waiting for a request from the tax authorities to provide one.

The Draft Law formally introduces transfer pricing documentation requirements. The Draft Law provides that transfer pricing documentation should be presented within 10 days from the date the request is made from the tax authorities. Documentation can be prepared in a free format (provided that there is no legislative requirement for a specific format) and contain the following information:

- Detailed information on activities of a taxpayer connected with controlled transactions, including a description of the conditions of such transactions, information on the parties to those transactions and their respective functions, assets and risks, and any other information which might have had an impact on transfer price;
- Data used in determining transfer prices;
- Calculation of profit (income) from controlled transactions; and
- Description of economic benefit received by a taxpayer as a result of controlled transactions.

In cases where taxpayers have complied with the above mentioned procedure in a timely manner, the tax authorities will release taxpayers from the penalty in case of a tax adjustment. In these circumstances taxpayers will have to pay tax calculated in addition to what they have paid already plus late payment interest.

#### **5706 Tax audit procedures**

Currently, there are no specific procedures provided in the Tax Code to the tax authorities for conducting separate transfer pricing audits. Control of prices is made in the course of ordinary desk or field tax audits. A significant number of assessments under transfer pricing rules have already been made, including a few assessments

targeting large integrated oil and energy companies. Although, in the current version of Part I of the Tax Code the burden of proof of incorrect prices rests with the tax authorities, companies are advised to take Russian transfer pricing issues seriously and develop and maintain properly documented and defensible transfer pricing policies.

### **5707 Additional tax and penalties**

The most widely used interpretation of the Tax Code is that the general penalties for underpayment of taxes may not be imposed on a taxpayer in cases where the taxes were additionally accrued due to a price adjustment. Furthermore, no special transfer pricing penalties are provided under the Tax Code. Technically, the current version of Article 40 provides that only additional tax and late payment interest on underpaid tax may be charged by the tax authorities, i.e. on the face of it, no penalties currently apply to transfer pricing adjustments. Interest should be charged in accordance with the general rules at a rate of 1/300 of the Central Bank of Russia refinancing rate (set as 10.75% per day from June 2008).

If the proposed Draft Law is adopted in its current form the tax authorities will be able to impose penalties that are specific in amount or are determined, based on the amount of underpaid tax. These include penalties for gross violation of accounting rules with respect to income, expenses and objects of taxation, and penalties for underpayment of taxes resulting from the above violations. The penalty for violation of accounting rules would be within the range of RUB5,000 (approximately USD212) to RUB15,000 (approximately USD636), depending on the period of violation, or 10% of underpaid tax but not less than RUB15,000 if the above violation resulted in an understatement of the taxable base. Alternatively, the penalty for underpayment of taxes will be from 20-40% of underpaid tax, depending on whether or not the underpayment was intentional. For a failure to submit the information relating to controlled transactions within the specified term or submission of the knowingly false information by the taxpayer, the tax authorities will have the right to impose a penalty of RUB5,000 (approximately USD212).

The tax authorities may collect the underpaid tax and late payment interest without a special court order. However, tax penalties may only be enforced through courts. In cases where an underpayment of tax occurs due to reclassification of legal treatment of a transaction or legal status of a taxpayer by the tax authorities, the underpaid tax may only be collected through court (we interpret this provision as applying to situations when transfer pricing assessment is made by the tax authorities by treating parties to a transaction interdependent on grounds other than the formal grounds provided in Article 20 of the Tax Code).

### **5708 Resources available to the tax authorities**

To date, the tax authorities have not publicly indicated that a dedicated unit will be established to handle transfer pricing audits. Transfer prices are examined in the course of a general tax audit. However, it is expected that in the near future selected tax inspectors will be allocated to specialise in transfer pricing audits and in concluding Advance Pricing Agreements (APAs).



**5709 Use and availability of comparable information**

The Tax Code provides that comparables for determining market prices are to be taken only from official information sources of market prices and exchange quotes. The Code does not define what is meant by official information sources. In practice, most courts have only treated information provided by the Russian statistics authorities as information from official sources. However, there have been court cases where commodity exchange information was used.

The resources available to the tax authorities are currently limited to using the information on comparable market prices for goods (work, services) available from official statistics. Along with statistical information, it is likely that the tax authorities will look to the customs authorities for information and experience for identifying comparables. However, it is unclear if information provided by the customs authorities may be considered as an official source of information.

It seems that the Draft Law, if introduced in its current form, will provide some clarity to the taxpayers in this area by introducing an exhaustive list of information sources that can be used to establish the market price range. These sources include international exchange quotations, statistical data of Russian customs authorities and pricing information available from authorised state government bodies or publicly available information systems.

**5710 Limitation of double taxation and competent authority proceedings**

Russia is a party to over 60 double tax agreements, most of which have been concluded on the basis of the OECD Model (although often with significant deviations) and therefore contain the 'Associated Enterprises' (or 'Adjustment of Profits') Article. This Article provides for correlative adjustments in most of the agreements, although primarily in those that have been concluded recently. In the older treaties, this Article provided for a one-way adjustment that increases the profit of a treaty resident due to the use of non-market prices.

Very little information is available on the practice and procedure for invoking competent authority assistance. Experience suggests that it is not well used.

**5711 Advance pricing agreements (APAs)**

Currently, there is no legal procedure for obtaining an APA in Russia.

The Draft Law introduces an APA procedure that will become effective not earlier than from 2010. Under the current Draft Law only selected group of taxpayers ("large" taxpayers) will be given an opportunity to conclude an APA. As such a provision is discriminating towards other taxpayers, we are monitoring if it stays in the final version of the Draft Law. APA will represent an agreement between a taxpayer and the federal executive body responsible for control and supervision in the area of taxation represented by its chief officer (Deputy Chief Officer). The term of the APA would not exceed a 3 year period with the right given to the taxpayer to apply for the extension for up to 2 years provided that all the terms and conditions of the APA are being complied with by the taxpayer. Breach of the APA's conditions will lead to its premature termination and result in a penalty of RUB1.5 million (approximately USD63,625).

### **5712 Liaison with customs authorities**

As noted above, the Russian tax authorities may co-operate with the customs authorities in determining comparables. The customs authorities possess certain databases for comparable prices and have certain techniques for evaluating the customs value of goods, which may be used by the tax authorities when challenging prices in a controlled transaction. Moreover, the tax authorities will work in close co-operation with customs authorities on auditing prices in foreign trade transactions. However, it is unclear whether information provided by the customs authorities is considered as collected from official sources.

It should be noted that taxes payable on importation of goods to Russia (import VAT and customs duties) are calculated on the basis of the customs value determined by applying special rules contained in the customs legislation (Law on Customs Tariff of the RF dated 21 May 1993 with subsequent amendments on 1 July 2006) as opposed to the general transfer pricing rules contained in the Tax Code. The customs pricing rules provide for six different methods of determination of customs value and contain a much wider definition of interdependent parties than that in the Tax Code.

### **5713 OECD issues**

Russia is not a member of the OECD but is influenced by the OECD Guidelines and models. In December 2007, the Ministry of Finance initiated discussions with OECD officials regarding the possibility for Russia to become an OECD member.

### **5714 Thin capitalisation**

The Profits Tax Chapter of Part II of the Tax Code, which entered into force on 1 January 2002, introduced thin capitalisation rules on debts between interdependent parties. These rules apply when the loans due to a foreign creditor by a Russian enterprise more than 20% owned by a foreign enterprise, exceeds by more than three times (or 12.5 times in case of banks/credit institutions or enterprises engaged in leasing) the own capital of the Russian enterprise. From 1 January 2006 these rules also apply to loans received from third parties if such loans are guaranteed by the above foreign company or its Russian affiliates. Such loans are determined in the tax legislation as controlled debts.

If the conditions above are met, the maximum deductible interest would be determined by the ratio of the interest accrued on the 'controlled debt' to a capitalisation coefficient (a ratio of the controlled debt multiplied by percentage of direct or indirect shareholding to the Russian enterprise's own capital multiplied by three (or 12.5 in the case of banks/credit institutions or enterprises engaged in leasing)). Interest in excess of the maximum interest is treated as dividends that are non-deductible for the profits tax purposes and are subject to withholding tax.

# 58 Singapore

## 5801 Introduction

Although Singapore's income tax rates are traditionally lower than the income tax rates of the majority of Singapore's primary trading partners, the Inland Revenue Authority of Singapore (IRAS) is increasing its focus on transfer pricing issues.

## 5802 Statutory rules

The Singapore Income Tax Act (SITA) contains provisions that may be used in a transfer pricing context to effectively allow IRAS to challenge and revise inter-company transactions. Further, the IRAS has recently issued transfer pricing guidelines to provide greater clarity on transfer pricing matters and procedures in Singapore.

### *Anti-avoidance*

Section 33 of the SITA contains general anti-avoidance rules that allow IRAS to disregard or revise any arrangement in order to counteract any tax advantage obtained under an existing arrangement. The rules are applicable to any scheme, agreement or transaction as a whole, as well as the component steps by which the arrangement was carried into effect. The anti-avoidance rules do not apply if the arrangement is conducted for bona fide commercial reasons and the reduction or avoidance of tax is not one of its main purposes.

### *Related party transactions*

Section 53(2A) of the SITA applies where a resident and a non-resident are closely connected and conduct business in such a way that produces profits to the resident that are less than the ordinary profits that might be expected to arise in such transactions. In such a case, IRAS may assess and charge the non-resident tax in the name of the resident, as if the resident were an agent of the non-resident. Where the 'true' amount of the profit is not readily ascertainable, IRAS has the power to assess tax on a 'fair and reasonable' percentage of the turnover of the business done between the resident and the non-resident.

### *Tax authorities' powers*

As a final measure, IRAS has the power to simply refuse to accept a tax return as filed and assess tax based on taxable income determined according to the best of its judgment.

### *Singapore transfer pricing guidelines*

## **Background**

The Singapore transfer pricing guidelines (the guidelines) were issued by the IRAS in February 2006. These guidelines provide guidance to Singapore taxpayers on application of the arm's length principle and on documentation matters.

The said guidelines also provide the procedures for applying for the Mutual Agreement Procedure (MAP) and Advance Pricing Arrangement (APA) facilities in order to avoid or eliminate double taxation.

### **Scope**

The guidance on application of the arm's length principle is applicable to all related party transactions of goods, services and intangible properties. The guidance on MAP and APA are only applicable to related party transactions involving at least one party resident in Singapore or a jurisdiction with which Singapore has a comprehensive Double Taxation Avoidance Agreement.

Further, the guidelines are applicable where at least one related party is subject to tax in Singapore.

### **Definition of related party**

The guidelines define a related party for Singapore transfer pricing purposes, as under:

*'The related party, in relation to any entity, means any other entity who directly or indirectly, controls that entity or is controlled, directly or indirectly, by that entity, or where both entities, directly or indirectly, are under the common control of a common entity.'*

### **The arm's length principle**

The arm's length principle described in the guidelines is in line with the arm's length principle in the OECD Model Tax Convention on Income and Capital and in the OECD Transfer Pricing Guidelines (i.e. the arm's length principle requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent entity).

The guidelines, however, recognise that establishing and demonstrating compliance with the arm's length principle requires exercise of judgment and recommends that taxpayers adopt a pragmatic approach to ascertaining arm's length pricing for related party transactions.

The guidelines seek to provide guidance / recommendations on application of the arm's length principle with the following three-step approach:

#### **(1) Step 1 – Conduct a comparability analysis**

A comparability analysis is conducted to analyse whether the uncontrolled price / margins being compared to the controlled price / margins have all economically relevant characteristics similar such that:

- (a) none of the differences of the situations being compared can materially affect the prices or margins being compared; or
- (b) reasonably accurate adjustments can be made to eliminate the effect of any such differences.

The guidelines also suggest that a comparability analysis should examine the comparability of the transactions in the following three aspects:

- (a) Characteristics of goods, services and intangible properties;
- (b) Analysis of functions, assets and risks; and

- (c) Commercial and economic circumstances.

The ultimate aim of the comparability analysis is a comprehensive assessment and identification of the areas and extent of significant similarities and differences (such as product characteristics, functions performed, etc.) between the transactions / entities in question and those to be benchmarked against.

- (2) Step 2 – Identify the appropriate transfer pricing method and tested party

The guidelines indicate that, in theory, the traditional transaction methods provide for a more direct comparison with independent party transactions and hence would be superior to the transactional profit methods. However, the guidelines do recognise that in practice, the reliability of the results produced by any method would be crucially affected by the availability and quality of data as well as the accuracy with which adjustments can be made to achieve comparability. Hence, the guidelines do not have a specific preference for any one method. The guidelines recommend the adoption of the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments.

The guidelines allow the Singapore taxpayer to select any one of the below methods for its transfer pricing purposes:

- (a) Comparable Uncontrolled Price Method;
- (b) Resale Price Method;
- (c) Cost Plus Method;
- (d) Profit Split Method; and
- (e) Transactional Net Margin Method.

The guidelines also allow the taxpayer to use a modified version of one of these methods to comply with the arm's length principle, as long as the taxpayer maintains and is prepared to provide sufficient documentation to demonstrate that its transfer prices are established in accordance with the arm's length principle.

- (3) Step 3 – Determine the arm's length results

Once the appropriate transfer pricing method has been identified, the method is applied on the data of independent party transactions to arrive at the arm's length result.

### **Documentation**

The guidelines provide guidance on the type of documentation that taxpayers should keep to demonstrate that reasonable efforts have been taken to comply with the arm's length principle.

The guidelines indicate that the following information (not exhaustive) would be useful in substantiating that the taxpayer's transfer pricing analyses are in accordance with the arm's length principle and that the taxpayer has made reasonable efforts to determine arm's length transfer prices, margins or allocations:

- (1) General information on the group;

- (2) Information on each related party in Singapore (Singapore entity);
- (3) Details of transactions between Singapore entity and all related parties; and
- (4) Transfer pricing analysis.

However, the guidelines are conscious that keeping robust documentation may result in compliance and administrative costs for taxpayers. In this respect the guidelines indicate the following principles with regard to documentation:

- (1) Taxpayers are only required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm's length principle.
- (2) Singapore currently does not impose a penalty specifically for the lack or insufficiency of documentation. However, if the taxpayer violates the record keeping requirements under Sections 65, 65A and 65B of the SITA, the IRAS would not in any way be precluded from enforcing these relevant provisions.
- (3) The IRAS does not require documentation to be submitted when the tax returns are filed. The documentation should be kept by the taxpayers and submitted to IRAS only when requested to do so.

● **Guidelines in connection with MAP**

The guidelines also provide the IRAS' position on the MAP process as well as provide guidance on the manner in which taxpayers may apply for the MAP with respect to transfer pricing adjustments.

The MAP aims to provide an amicable way by which competent authorities may eliminate double taxation. Though IRAS would endeavour to eliminate or reduce the double taxation that may be encountered by the taxpayer, the same would be possible only if there is concurrence by all competent authorities involved in the process and full cooperation by the taxpayer.

The guidelines indicate that the IRAS will generally accept a taxpayer's request for MAP if:

- (1) taxpayer has complied with the time limit specified in the applicable DTA for presenting the MAP request; and
- (2) Double taxation is almost certain and not just a possibility; and
- (3) Taxpayer is willing and able to render full cooperation.

Further, the guidelines also provide the procedural aspects involved in making a MAP request to IRAS. The procedure involves:

- (1) Step 1 – Notification of intention to make MAP request

The notification to IRAS should be made in writing and should describe briefly the circumstances and provide basic information concerning the cause of double taxation.

- (2) Step 2- Preliminary meetings

In the preliminary meetings, the IRAS will evaluate the taxpayer's situation and grounds for making the request as well as the quality and adequacy of taxpayer's documentation.

(3) Step 3- Formal submission of request

Unless IRAS or other competent relevant authorities disagree to taxpayer's MAP request, taxpayer should formally submit a MAP request to the IRAS.

(4) Step 4 – Review and resolution of double taxation

IRAS will commence the process of MAP and try and resolve the double taxation issue with the other relevant competent authorities.

(5) Step 5 – Post agreement meeting and implementation of agreement

On reaching agreement with the other competent authority, the IRAS will meet the taxpayer to discuss the details of the agreement and for implementation of the same.

● **Guidelines in connection with APA**

An APA determines in advance, an appropriate set of criteria to ascertain the transfer prices of specified related parties' transactions over a specified period of time. The treaty provisions and the domestic tax provisions enable Singapore competent authorities to accede to requests from taxpayers for APAs and enter into such agreements. Singapore allows for unilateral as well as bilateral APA.

The circular provides the guidance on the procedural matters relating to making an APA request. It involves:

(1) Step 1 – Preliminary meetings

Generally, at preliminary meetings, the taxpayer is expected to present the salient information such as the company's business model and industry information, transactions to be covered, the period of APA, etc. The IRAS, if willing to accept the APA, will advise the taxpayer on follow-up action.

(2) Step 2 – Formal APA submission

Unless IRAS or relevant foreign competent authorities disagree, the taxpayer should formally submit an APA request.

(3) Step 3 – Review and negotiate APA

On receipt of formal application, the IRAS will commence the process of seeking an APA with relevant foreign competent authorities (in case it is a bilateral APA).

(4) Step 4 – Post agreement meeting and implementation of APA

On reaching agreement, the IRAS will meet the taxpayer to discuss the details of the agreement and for implementation of the same.

**5803 Other regulations**

The IRAS releases Interpretation and Practice Notes as well as Administrative Statements to provide guidance to taxpayers on a variety of issues. These publications do not have the force of law and are not binding. However, they do provide the IRAS' view on the law and its administrative practices in its application of the law. To date, no release has directly dealt with the issue of transfer pricing.

### **5804 Legal cases**

To date, there have not been any specific cases relating to transfer pricing issues. However, case law from other common law jurisdictions may be applicable on a case-by-case basis.

### **5805 Burden of proof**

It is common for the IRAS to query the basis of inter-company charges or transactions by requesting a taxpayer to provide evidence that such transactions are at arm's length. The burden of proof lies with the taxpayer.

### **5806 Tax audit procedures**

To determine the accuracy of a tax return, the IRAS may require any taxpayer to provide their books, documents, accounts, returns and any other information that would allow the IRAS to obtain full information in respect of the taxpayer's income. Business records are required to be maintained for at least five years.

### **5807 Revised assessments and the appeals procedure**

Where the IRAS does not agree with the tax return provided by the taxpayer, it may, within six years after the year of assessment, issue a notice of assessment based on its 'best judgment.' A taxpayer that disagrees with a notice of assessment must object in writing within 30 days from the date of the notice. As the taxpayer is required to provide detailed grounds for objection, documentation to support its inter-company pricing should be available at this time. The IRAS will consider the objection grounds including any documentation received, and may issue an amended assessment. If the IRAS and the taxpayer are unable to reach an agreement, a 'Notice of Refusal to Amend' will be issued.

Taxpayers have the right to appeal to the Board of Review if they are dissatisfied with the IRAS' decision. Based on the decision of the Board of Review, either the taxpayer or the IRAS may choose to appeal to the High Court. Subsequently, application may be made to the Court of Appeal if either party is dissatisfied with the High Court's decision. However, the Court of Appeal will not hear appeals on a question of fact.

### **5808 Additional tax and penalties**

The legislation and the transfer pricing guidelines do not provide penalties specifically directed at transfer pricing 'offences.' However, the general provisions relating to offences and penalties are applicable where the IRAS has a dispute with a taxpayer in relation to its inter-company transactions.

A taxpayer that omits or understates any income may be subject to a fine equal to the amount of tax that has been or would have been undercharged. Where a taxpayer is found to be negligent in omitting or understating income, the penalty is double the amount of tax that has been undercharged, in addition to a fine not exceeding SGD5,000 or to imprisonment for a term not exceeding three years or to both. A taxpayer who is found to have wilfully understated their income with intent to evade tax will be subject to more severe penalties.



Penalties and interest charges on the underpayment of tax are not deductible for tax purposes.

### **5809 Resources available to the tax authorities**

The IRAS has obtained training on transfer pricing from other tax authorities and shares information on a regular basis with other ASEAN (Association of South East Asian Nations) tax jurisdictions in relation to the taxpayers.

### **5810 Use and availability of comparable information**

Although Singapore does not mandate contemporaneous documentation requirements, it requires taxpayers under review to verify and confirm the arm's length nature of its related party transactions through sufficiently detailed and comprehensive documentation. The documentation should include an analysis of the functions and risks undertaken by the Singaporean taxpayer and the methodology upon which it derived the transfer price, including benchmarking.

#### *Availability*

The IRAS requires transfer prices to be comparable to industry standards. Comparable information is available through databases.

### **5811 Limitation of double taxation and competent authority proceedings**

In addition to the limited agreements dealing with the taxation of the international traffic of ships and aircraft, Singapore has a fairly extensive network of comprehensive double tax agreements modelled based on the OECD convention.

The majority of Singapore's treaties contain an 'Associated Enterprises' article, which permits the respective tax authorities to adjust the profits of an entity where the transaction did not occur at an arm's length price. However, very few of its treaties contain the accompanying relieving provisions in the article that effectively requires one country to reduce the amount of tax charged to offset the increased tax liability imposed by the other country as a result of reflecting the transaction at arm's length.

Where a treaty does not contain the relieving provisions, a taxpayer must apply to the competent authorities under the Mutual Agreement Procedure (MAP) article in order to obtain relief from double taxation. The details relating to the same have been provided above in the section relating to statutory rules.

### **5812 Advance pricing agreements (APAs)**

The treaty provisions and the domestic tax provisions enable Singapore's competent authorities to accede requests from taxpayers for APAs and enter into such agreements. The details relating to the same have been provided above in the section relating to statutory rules.

### **5813 Management services**

A number of entities have been set up in Singapore to provide services to related parties in the region. Transfer prices for such services are typically determined on a cost plus basis. The IRAS generally accepts the transfer price for management

services where the service actually performed for the benefit of the payer can be identified and the transfer price reflects at least a 5% profit on the total cost of the service. It should be noted that a 5% profit is accepted for general administration type of services. The IRAS would expect a higher profit in the case of greater value added services provided by a Singaporean entity, for example, research and development.

Where a non-resident related party provides management services to a Singaporean entity, the fee charged to the Singaporean entity is generally deductible if the services provided can be identified and the fee is reasonable and appropriate, based on the costs actually incurred by the service provider. Further, there must be a direct benefit to the Singaporean entity to receive a deduction. There is no Singaporean withholding tax levied on the payments made by Singaporean entities that represent reimbursement or cost allocation of administrative expenses incurred by the related entities that are located and perform the services outside Singapore.

The IRAS is increasingly scrutinising intra-group recharges to ascertain that services have provided a direct benefit to the Singaporean entity. Taxpayers are required to justify the level of service received vis-à-vis the recharge and confirm that the recharges exclude any shareholder costs.

### **5814 Business profits**

Singapore's comprehensive double tax agreements contain a 'Business Profits' article that provides, in general, that business profits of an enterprise are not taxable in Singapore unless that enterprise has a permanent establishment (PE) in Singapore. Where an enterprise has a PE in Singapore, only those profits attributable to that PE may be taxed in Singapore.

# 59 Slovakia

## 5901 Introduction

The Slovak tax system was established in 1993. Tax legislation attempted, in basic terms, to prevent deviations from arm's length prices in related party transactions. Since 1993, the tax authorities' understanding of transfer pricing principles has grown significantly, and with it the need for taxpayers to comply with arm's length pricing regulations. One major milestone in Slovak transfer pricing history was December 2000, when Slovakia joined the OECD. This meant that taxpayers could adopt the OECD Guidelines with some degree of certainty that the treatment would be acceptable to Slovak tax authorities. Further, the Slovak Ministry of Finance has issued an official translation of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published by the OECD. Despite this, practical experience with transfer pricing principles is limited, compared to more developed countries. However, it is increasing.

## 5902 Corporate income tax

The Slovak Income Tax Act and Slovak transfer pricing regulations cover foreign related parties. "Foreign related parties" are defined as a Slovak tax resident and a non-Slovak tax resident which are:

- relatives;
- entities that are economically or personally related; or
- entities with certain other relationships.

Economically or personally related means:

- when one entity directly or indirectly holds more than 25% of the share capital or voting rights of the other;
- an entity and its statutory representative or a member of its supervisory board;
- two or more entities in which a third entity directly or indirectly holds more than 25% of the share capital or voting rights; or
- entities having the same person as their statutory representative or a member of their supervisory board.

However, according to the full extensive definition set in the Slovak Income Tax Act, all companies within the company group most likely qualify as related parties.

Entities with certain other relationships are parties connected solely for the purpose of reducing the tax base. Furthermore, a Slovak permanent establishment (PE) and its foreign headquarters, as well as foreign PEs and their Slovak headquarters, are also considered foreign related parties. In addition, for Slovak personal income tax purposes, the Slovak transfer pricing regulations are applicable on any transactions between an employer and its employee.

Generally, the prices in transactions between foreign related parties are required to be at arm's length.

In 2001, the transfer pricing legislation introduced a number of methods to determine the arm's length price for cross-border transactions between related parties. These methods broadly equate to the transaction-based methods and profits-based methods according to the OECD Guidelines. The transaction-based methods stated include comparable uncontrolled price, resale price and cost plus methods. The profit-based methods stated include the transactional net margin and profit split methods.

The Slovak taxpayer can also use a combination of the above-mentioned methods, or choose any other method, provided the method used is in accordance with the arm's length principle. However, transaction-based methods should be used if possible.

There are no formal advance pricing agreements (APA) in Slovakia. The Slovak tax authorities can however approve a particular method of setting the price in advance. They are obliged to issue a decision on a particular method to be used if asked by a taxpayer. However, they do not confirm prices used or publish any benchmarks. The approved method could be used for up to five tax periods and could be prolonged for another five tax periods if the conditions of the operations do not change. The tax authorities should cancel or amend their decision if it turns out that the approved method was resolved based on false or inaccurate information provided by the taxpayer or once the conditions had changed. The tax authorities may also cancel or amend their decision based on the request of the taxpayer proving that conditions have changed. In addition, the tax authorities can approve a method for determining the corporate income tax base of a Slovak permanent establishment of a foreign taxpayer. This method is usually based on one of the OECD transfer pricing methods.

For certain related party transactions, such as a sale of certain assets or a business, the Slovak tax authorities will generally accept as the arm's length price the value of the items sold as appraised by an independent, court-approved Slovak valuation expert.

According to the most recent amendment to the Income Tax Act, as of 1 January 2009 Slovak taxpayers will be required to keep specific, detailed documentation on transactions carried out with foreign related parties for transfer pricing purposes. Based on unofficial information, the documentation should consist of a "masterfile" and a "local file". In general, the documentation should include at least the following:

- a description of the company's business activities and strategy;
- the company's organisational structure, and a list of foreign related parties;
- a description of transactions or services provided to foreign related parties, including the ownership and usage of intangible assets;
- any advance pricing agreements (unilateral or bilateral) agreed on with foreign tax authorities;
- an outline of the group's business;
- the group transfer pricing policy;
- a marketing strategy, functional analysis, economic analysis, and financial analysis;

- an analysis of the transfer pricing method used, an explanation of why this method has been chosen to defend the market level of the foreign related party's fees; and
- information on comparable data (benchmarking study).

The minimum extent of the obligatory documentation will be set out by the Ministry of Finance, likely in the second half of 2008. Taxpayers will be obliged to present the transfer pricing documentation to the tax office during a tax inspection, upon its request. As the taxpayers will be obliged to keep this documentation, we expect the tax authorities will not be willing to give long deadlines for presenting the documentation during tax inspections (currently, a deadline of only 30 days is expected). It is therefore important that the documentation be prepared at the same time that the foreign related party transactions are implemented.

### **5903 Value added tax**

Slovak VAT law does not address transactions between related parties and, therefore, no restrictions apply to such transactions.

However, based on the Slovak Act on Tax Administration, in case of transactions for which the principal motive is tax evasion or abuse resulting in decrease of tax base, the Slovak tax office can adjust the tax base accordingly.

### **5904 Other taxes**

In Slovakia, Gift Tax was abolished on 1 January 2004 and Real Estate Transfer Tax was abolished on 1 January 2005.

With respect to Real Estate Tax, the value of the real estate, based on which tax base is determined, should generally be set according to the Appendix to the Real Estate Tax law. In specific cases it should be based on the arm's length price, determined by an independent, court-approved valuation expert who must value the real estate under specific regulations.

### **5905 Customs**

Since its accession to the EU on 1 May 2004, Slovakia has followed the EU Customs Code, based on the transaction value. In cases of sales between related parties, the price applied should approximate the transaction value in sales between buyers and sellers who are not related in any particular case of identical or similar goods.

### **5906 Tax inspection procedures**

Generally, the tax authorities may initiate tax inspections within six years of the end of the tax year. If the tax authorities initiate a tax inspection within this period, another tax inspection can be initiated within a further five year-period, up to a total of 11 years from the end of the tax year at the latest. During any tax inspection, the taxpayer is obliged to prove and support, with sufficient documentation, any facts contained in the inspected tax return; in other words, the burden of proof is placed on the taxpayer.

According to the Slovak Act on Tax Administration, the tax administrator should impose a fixed penalty equal to three times the National Bank of Slovakia's basic interest rate (4.25% in April 2008) on the difference in tax between that shown in the

tax return and that determined by the tax administrator.

In case of late payment of the tax liability declared in the tax return, the tax administrator should impose an interest of four times the National Bank of Slovakia's basic interest rate on overdue tax. This applies to each day of late payment up to a maximum period of four years.

### **5907 Anticipated developments**

As the tax authorities become more familiar with transfer pricing principles and begin to understand the background to transactions between related parties, the importance of having sufficient and technically sound documentation is increasing. The tax authorities recently started to run special transfer pricing tax inspections.

We understand that the tax office continues to train a specialised group of staff to handle transfer pricing audits and has started transfer pricing tax inspections of multinational companies present in Slovakia.

# 60 Slovenia

## 6001 Introduction

Slovene transfer pricing legislation, which generally embraces the OECD Guidelines, applies to both cross-border and domestic inter-company transactions. Supporting transfer pricing documentation has been required since 2005. As of 2006, the transfer pricing documentation for cross-border inter-company transactions must be prepared concurrently; documentation for domestic inter-company transactions needs to be submitted only upon request from the tax authorities in the course of a tax inspection.

The introduction of Slovenia's transfer pricing rules has been accompanied by efforts to train Slovene tax inspectors in transfer pricing analysis using consultants from foreign revenue authorities.

## 6002 Statutory rules

### *Definition of taxable basis between related parties*

The arm's length principle is described in Article 16 of the Slovene Corporate Income Tax Act (CITA), which is valid from 1 January 2005. In establishing a taxable person's revenues and expenses, the pricing of transfers of assets (including intangible assets) between related parties and inter-company services should not be less than the arm's length amount for revenues and not greater than the arm's length amount for expenses.

### *Methods for determining the arm's length price*

Comparable market prices are determined by either one of the methods specified in the OECD Guidelines, or a combination of those methods. The traditional transactional methods specified in the OECD Guidelines include the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method.

Where these traditional transaction methods cannot be applied, the transactional profit methods (transactional net margin method and profit split method) may be used.

The Slovene Ministry of Finance issued Regulations on transfer pricing, which came into force on 1 January 2007. The Slovene Regulations on transfer pricing set out in more detail the application of the five pricing methods in a manner similar to that outlined in the OECD Guidelines.

### *Definition of related parties*

Provisions in Articles 16 and 17 of the new CITA differentiate between the definition of related parties, depending on whether the transactions are cross-border or domestic.

Cross-border controlled transactions are transactions between a taxable person (resident) and a foreign person (not resident), related in such a way that:

- (1) The taxable person directly or indirectly holds no less than 25% of the value or number of shares of a foreign person through holdings, control over

management, supervision, or voting rights; or controls the foreign person on the basis of a contract or terms of transactions different from those that are, or would be, achieved in the same or comparable circumstances between unrelated parties;

- (2) The foreign person directly or indirectly holds no less than 25% of the value or number of shares of a taxable person through holdings, control over management, supervision, or voting rights; or controls the taxable person on the basis of a contract or terms of transactions different from those that are, or would be, achieved in the same or comparable circumstances between unrelated parties;
- (3) The same legal person directly and, at the same time, indirectly holds no less than 25% of the value or number of shares, or participates in the management or supervision of the taxable person and the foreign person or two taxable persons; or they are under his control on the basis of a contract or transaction terms different from those that are, or would be, achieved in the same or comparable circumstances between unrelated parties;
- (4) The same natural persons or members of their families directly or indirectly hold no less than 25% of the value or number of shares, holdings, voting rights, or control over the management or supervision of the taxable person and the foreign person or two residents; or they are under their control on the basis of a contract or transaction terms different from those that are, or would be, achieved in the same or comparable circumstances between unrelated parties.

Domestic inter-company transactions are transactions between two taxable resident persons. Residents shall be related parties if:

- (1) They are related in terms of capital, management, or supervision by virtue of one resident directly or indirectly holding no less than 25% of the value or number of shares, equity holdings, control, supervision, or voting rights of the other resident; or controls the other resident on the basis of a contract in a manner that is different from relationships between non-related parties; or
- (2) The same legal or natural persons or their family members directly or indirectly hold no less than 25% of the value or number of shares, holdings, control, supervision, voting rights, or control the residents on the basis of a contract, in a manner that is different from relationships between non-related parties.

Related parties are also taxable and natural persons performing business, provided that this natural person (or his family members) holds no less than 25% of the value or number of shares or equity holdings; or participates in the management, supervision, or voting rights of the taxable person; or controls the resident on the basis of a contract in a manner that is different from relationships between non-related parties.

Notwithstanding the above provisions, the tax base may be adjusted only in cases when one of the residents: i) shows unsettled tax loss from previous tax periods in treated tax period, ii) pays the tax either at a rate of 0% or one which is lower than 25%, or iii) is exempt from paying the tax.



### *Documentation*

A taxable person shall provide and keep the information about related parties, the sort and extent of business transactions with these entities, and the determination of comparable market prices, as prescribed by the Tax Procedure Act (TPA). The provisions of TPA on transfer pricing follow the EU Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD). Therefore, companies need to prepare a masterfile and country-specific documentation as described below:

- (1) The masterfile should contain at least the description of a taxable person, global organisational structure, and type of relationship, transfer pricing system, general business description, business strategy, general economic and other factors and competitive environment;
- (2) The country-specific documentation should contain information about transactions with related entities (description, type, value, terms and conditions), benchmark analysis, functional analysis, terms of contracts, circumstances that have an influence on transactions, application of the transfer pricing method used and other relevant documentation.

The masterfile must be assembled concurrently, and no later than the submission of the tax return. Ministry of Finance determines what information should be provided upon submission of the tax return.

If the masterfile is not in the Slovenian language, it must be translated on the request of the Tax Authorities, within a minimum of 60 days.

### **6003 Other regulations**

The Slovene Ministry of Finance has issued explanatory Regulations on transfer pricing and Regulations on reference interest rates.

The Regulations on reference interest rates define a methodology for determining a reference interest rate on inter-company loans between related parties, taken into consideration when determining revenues and expenses. A reference interest rate is the sum of a variable part of an interest rate (e.g. EURIBOR, LIBOR-USD, etc) and a mark-up expressed in basis points, which is determined for a particular maturity period and depends on the credit rating of a taxable person (borrower/loan provider).

Regulations on transfer pricing replaced the Regulations on determination of comparable market prices and brought some important changes. The most important changes are provisions on the use of cost contribution agreements and the use of the interquartile range. Regulations on the determination of comparable market prices (valid until 1 January 2007) prescribed the use of the arithmetic mean, while the new Regulations on transfer pricing declare that the interquartile range should be used when determining an arm's length price. Moreover, the use of multiple year data is accepted, which can disclose facts that may have influenced the determination of the transfer price. In addition, the Regulations define business interdependence that can be attained without one party having at least a 25% share in the other party.

The new regulations also pay attention to the loss positions of related entities resulting from inter-company transactions. This approach tests whether comparable unrelated party transactions would be profit-making by considering whether an

independent entity would be in a loss position under the same circumstances.

### *Disclosure*

Entities that have transactions with related parties must supply in the supplement to the tax return certain information on the value of controlled transactions and information on interest rates between related parties.

Supplements to the tax return concerning controlled transactions disclose the names of the entities involved in controlled transactions with the entity that files the tax return, the type of relationship and the cumulative value of the controlled transactions for each related entity separately. A supplement containing information on interest rates between related parties discloses cumulative value of received and granted loans, classified by each related entity, and specifies whether a related entity has an adjusted tax base. The supplement shall only be completed when the cumulative value of received and granted loans in the tax period amount to over EUR50,000 per related entity, as provided by Regulations on the Corporate Income Tax Return, in force as of 29 May 2007.

### **6004 Legal cases**

Slovene tax authorities began to perform tax inspections concerning the fulfilment of transfer pricing documentation requirements in the second half of 2006. Therefore, the conclusion on the tax authorities' approach towards transfer pricing is yet to be accepted.

### **6005 Burden of proof**

Since documentation requirements for transfer pricing came into force in Slovenia, the burden of proof is placed on the taxpayer. Taxpayers must keep specific documentation proving that they apply transfer prices in line with the arm's length principle. If proper transfer pricing documentation is in place, together with the corporate tax return, the burden of proof shifts to the Tax Authority.

When examining transfer prices, the Slovene tax authorities must determine the arm's length nature of inter-company transactions using the method(s) previously applied by the taxpayer, provided that the taxpayer submitted prepared documentation, used one of the recognised methods and that the method used is supported by appropriate calculations.

### **6006 Tax audit procedures**

To date, Slovene tax authorities have raised the transfer pricing issue only in the context of regular tax audits. However, there is a framework in place for transfer pricing-oriented audits to be undertaken.

### **6007 Additional tax and penalties**

Any entity engaged in intra-group transactions must be able to support that prices agreed between related parties meet the arm's length criteria. Failure to comply with these laws may result in significant tax exposure and penalties.

Penalties include adjustment of the tax base, fines of between 20% and 60% of underpaid tax for the legal entity (underpaid tax from less than EUR400 to more than

EUR4,000), additional fines of EUR80 to at least EUR600 for responsible persons and late payment interest.

For taxes not paid in prescribed terms, late payment interest is levied at a daily interest rate of 0.0274%.

If the transfer pricing documentation is not submitted, or is not submitted according to the prescriptions or the terms defined, the penalty is EUR1,600 to 25,000 for the legal entity and EUR400 to 4,000 for a responsible person of the legal entity.

### **6008 Resources available to the tax authorities**

Slovene tax authorities have a specialised group that is trained to perform transfer pricing examinations.

### **6009 Use and availability of comparable information**

Comparable information is required in order to support the arm's length nature of related party transactions and should be included in the taxpayer's transfer pricing documentation. The arm's length nature of transactions with related parties shall be demonstrated by applying one or more of the prescribed acceptable methods. Acceptable methods that can be applied under the CITA include the traditional OECD methods, or any combination of them. The comparable uncontrolled price method is the preferred method as defined in the Regulations on determination of comparable market prices. Additionally, the comparable uncontrolled price method, resale price method and cost plus method are preferable methods compared to the profit split method and transactional net margin method. In practice, it is often not easy to obtain information on comparable uncontrolled prices. In such cases a transactional net margin method is used.

Slovene tax authorities have access to the Amadeus database and local databases containing financial information for Slovene companies, such as GVIN and IBon. In accordance with the Slovenian Companies Act, companies and sole proprietors are required to submit annual reports that are publicly available.

Slovene tax authorities have a preference towards employing local comparable companies for benchmarking purposes, although a Pan-European benchmark may also be accepted.

### **6010 Risk transactions or industries**

Transfer pricing is an area of increasing interest for the Slovene tax authorities. So far, they have not concentrated on any particular industry, but special attention has been directed towards management fees and royalties charged between related parties.

### **6011 Advance pricing agreements (APAs)**

Currently, there is no legal basis for an APA in Slovenia. There are provisions on binding tax rulings in the new tax legislation; however, obtaining a binding ruling for transfer pricing purposes has not been made possible.

### **6012 Anticipated developments in law and practice**

Although the Slovene tax authorities have until now not been considered aggressive, their approach to transfer pricing issues is expected to change. Practical training and

experience of tax auditors have increased and this will raise the profile of transfer pricing issues in tax audits. It is also expected that the tax authorities will have to deal with a higher number of complex transfer pricing issues.

### **6013 OECD issues**

Slovenia is not a member of OECD. However, transfer pricing legislation and the tax authorities have generally adopted the arm's length principle and methods provided by OECD Guidelines.

### **6014 Joint investigations**

There is no evidence of joint investigations.

### **6015 Thin capitalisation**

Debt to equity provisions restricting tax deductibility of interest expenses exceeding a company's equity came into force in Slovenia on 1 January 2005. The tax deductibility of interest payments on loans granted by a related party (a party that owns at least 25% of the shares or voting rights in the taxpayer) is generally restricted (but not for banks and insurance companies), where the amount of loans exceeds four times the value of the shareholder's share in the equity of the taxpayer, referring to the amount and the period of the exceeding loans in a certain tax period.

The loans from third parties (for which the shareholder issues a guarantee) and loans granted by a bank (where loans were granted in relation to the deposit of that shareholder in the same bank) shall be qualified as well. The size of the shareholder's share in the equity of the loan recipient shall be calculated as an average of the subscribed capital, retained net profits and the capital reserves, held on the last day of each month in the taxation period.

Slovenian tax provisions related to thin capitalisation are likely to be less rigorous than in some comparable EU tax jurisdictions.

Transitional provisions apply in respect to the debt to equity (D/E) ratio:

- 8:1 D/E ratio applies for the years 2005, 2006 and 2007;
- 6:1 D/E ratio applies for the years 2008, 2009 and 2010;
- 5:1 D/E ratio applies for the year 2011;
- 4:1 D/E ratio applies for the following years, starting from 2012.

### **6016 Management services**

For companies receiving management services, the general rules on the deductibility of expenses apply. In effect, this means that the payment would be tax deductible where the company received a benefit for the service provided, the payment was connected with the company's trade and the amount was at an arm's length price.

A company providing management services should be remunerated for those services on an arm's length basis. Usually, a company providing services is remunerated on a cost plus basis, to represent a market value for the provision of the services. A service provider may, in general, divide its fee between the recipients of the services by applying a direct charge method or an indirect charge method. The direct charge method is used only when there is a clear connection between services rendered

by the management services provider and the costs resulting from the provision of those services for every recipient within the group. In all other cases, an indirect charge method is allowed.

# 61 Spain

## 6101 Introduction

Over the last few years, there has been a significant increase in the Spanish tax authorities' awareness of and attention to transfer pricing. The legislation enacted in 1995, the statutory regulations approved in 1997 and modifications effective as of 1 December 2006, include the general principles for dealing with transactions between related parties. They also state the procedure to be followed by taxpayers seeking advanced pricing agreements (APAs) and the basic procedure to be followed by tax auditors in the field for re-assessing the transfer price agreed between related parties.

Article 16 of Spanish Corporate Income Tax Law (CITL) was modified by Law 36/2006, which came into force on 1 December 2006 and affects transactions carried out in fiscal years starting after that date. The new legislation provides that transactions between related entities and persons, including domestic as well as cross-border transactions, should be priced at arm's length for tax purposes. It is aimed at bringing Spanish transfer pricing legislation into line with best international practice, as provided in the OECD Guidelines and the European Union Joint Transfer Pricing Forum (JTPF). Previously, any adjustment to arm's length prices was only within the power of the Spanish tax administration. It is important to note that the modifications have been included as part of the Bill of Measures Against Tax Fraud, which highlights the level of importance being given to transfer pricing in Spain.

## 6102 Statutory rules

Spain's legislation concerning transfer pricing is contained in Articles 16 and 17 of Law 36/2006, modifying the CITL, and in Article 41 of Law 35/2006, modifying the Personal Income Tax Law (PITL).

The legislation provides that, for corporate tax purposes, related party transactions should reflect arm's length pricing. The transfer pricing methodologies described in the Spanish transfer pricing legislation largely follow those contained in the OECD Guidelines. The new legislation includes the profit-based method transactional net margin method (TNMM) which was not formally accepted in the previous legislation. Furthermore, this legislation specifies the existence of a transfer pricing methodologies hierarchy and specifies that, where possible, the transactional methods should be used to establish an arm's length price in preference to profit-based methods.

Article 41 of the PITL establishes, as a general principle, that transactions between related persons or entities will be priced in accordance with the arm's length principle. The procedure for establishing the arm's length value and, where necessary, for substituting the value declared in a taxpayer's return is set out in Articles 16 and 17 of the CITL.

The procedure to be followed by tax authorities when seeking to apply the arm's length principle through the course of a tax inspection is stated in Article 16 of the Corporate Income Tax Regulations (CTR). A brief description is as follows. First, if the other party of the related party transaction has also been taxed under the CITL or

PITL, it will be notified by the tax authorities that the transaction has been placed under scrutiny. This notification will express the reasons for the adjustment to the company's profit and the methods, which could be used in determining the normal market value. The related party has 30 days to present any facts or arguments that it believes are pertinent to the matter.

Having examined both related parties' arguments, and immediately prior to preparing the document in which the arm's length value shall be established, the methods and criteria to be taken into account will be made available to the parties. The parties will then have a period of 15 days to formulate additional arguments and whatever documents and evidence they deem appropriate.

Either party has the right to dispute the outcome of the proceedings, in due course. If they do not, the normal market value established by the tax authorities will be effective for all tax periods under assessment in accordance with Articles 16 and 17 of the CITL. If the outcome is indeed contested by either of the related parties, its application will be suspended pending a final decision. In the meantime, tax assessments will be deemed to be provisional.

The Spanish CITL includes provisions dealing with APAs. APAs can be either unilateral or bilateral and normally refer to pricing arrangements. However, APAs can also cover research and development (R&D) expenses, management fees and thin capitalisation. There are separate provisions dealing with contributions made for R&D purposes and management fees.

One additional change included in Spanish law is the introduction of the so-called "secondary adjustments". These adjustments refer to cases where the results of non-arm's length transfer pricing are deemed to have secondary consequences, such as in the case of a local taxpayer whose transfer prices paid to a parent company are deemed to be higher than the market value by the tax administration, with the resulting difference being classified as a dividend. In the case of cross-border transactions, the law contemplates different tax treatments of the secondary adjustments, depending on the characterisation of the excess income, as well as on whether the local or foreign taxpayer is the party benefiting from the excess income generated from non-arm's length transfer prices. Given the level of uncertainty surrounding this adjustment, taxpayers have already made consultations to the tax administration on this matter. In a consultation dated 7 February 2008 the tax authorities advised that any difference between the transfer price and the correct market value will be subject to secondary adjustments, with the additional tax obligation for the local taxpayer depending on the characterisation of the excess payment/income.

### **6103 Documentation**

Documentation will now also be a requirement, with Spanish taxpayers required to produce group-level and taxpayer-specific documentation for each tax year. Until now, no requirement for formal documentation existed, with the exception that during an inspection explanations could be demanded as with any other transaction that influences tax results.

However, the requirement to produce transfer pricing documentation is postponed until such time as the exact documentation contents are established. A draft Decree setting out the content requirements was published in July 2007 and is expected to be finalised later in 2008.

The draft Decree also establishes certain instances in which there is no documentation requirement for related party transactions. These are:

- Transactions carried out within a consolidated Spanish fiscal group;
- Transactions carried out by economic interest groups and temporary business associations; and
- Transactions involving the purchase or sale of publicly traded shares.

At the same time, the draft Decree establishes reduced documentation obligations for (i) related party transactions involving small companies (net revenues for the consolidated group of less than EUR8 million in the previous tax year) and (ii) individual persons. Finally, it should be noted that documentation will be required for transactions with entities, related party or not, resident in tax havens.

### **6104 Legal cases**

Under the former legislation (1978 CITL), the Central Treasury and Tax Court (Tribunal Económico Administrativo Central; TEAC), an administrative body included within the Tax Administration but acting independently of the tax audit authorities), had created a solid administrative doctrine that was consistently applied. It also established some important principles for dealing with transfer pricing issues. These principles are set out below:

#### *Comparable uncontrolled market price*

- (1) The establishment of a comparable uncontrolled market price is extremely difficult and in any event requires that:
  - (a) the same geographical market is used as a reference;
  - (b) similar or identical goods be compared;
  - (c) the volume of transactions compared is identical;
  - (d) the comparison be made at the same stage of the production/distribution process; and
  - (e) the transactions being compared are carried out within the same period of time.

#### *Transfer pricing adjustments*

- (2) Where the above information is not available, transfer pricing adjustments may be made by a tax inspector in accordance with the OECD Guidelines, i.e. using the resale price or cost plus, taking the following issues into consideration:
  - (a) in order to make an adjustment to reported profits successfully, the authorities must prove that the transaction has not been carried out at market value. The fact that the transactions are between related companies does not automatically mean that the transfer price does not accord with the arm's length standard; and



- (b) the legal bases and reasons behind the normal market value proposed by the authorities must be disclosed, otherwise the taxpayer could be deprived of information necessary in order to defend his/her position.

### *Intra-group services*

- (3) Referring to intra-group services, the Ministry of Finance issued some rulings on the matter stating that:
- (a) for valuation purposes, any method included in the 1979 OECD Guidelines could be applied; and
  - (b) the burden of proof lies on the taxpayer's side. The taxpayer is therefore required to prove that:
    - (i) the services have in fact been provided;
    - (ii) the service provider incurred in expenses when rendering such services; and
    - (iii) the service provided added economic value to the related entity receiving such services.

Additionally, under the former legislation there were some legal cases issued by courts of justice, which also followed the above-mentioned principles.

Regarding the current legislation, the Spanish tax authorities and the jurisprudence issued by the Tribunals have widely used the OECD Guidelines in order to apply or interpret the Spanish transfer pricing rules and regulations. In particular, the TEAC is making an extensive and intensive use of the OECD Guidelines. Some interesting TEAC resolutions are mentioned below:

- RTEAC 7 June 1994; RTEAC 22 October 1997; RTEAC 29 January 1999;
- RTEAC 9 March 2000; RTEAC 1 December 2000; RTEAC 26 March 2004; and RTEAC 25 July 2007.

Until recently, there were just a few Spanish sentences pronounced by the Spanish High Court of Justice (STS) regarding transfer pricing issues. In line with the increased interest given to transfer prices since 2007, several sentences have been pronounced by the STS that have ruled against the taxpayer. These sentences (STS 4 December 2007 and STS 6 February 2008) dealt with various related party transactions, including management fees and purchase of active ingredients. In the case of the 10 January 2007 STS sentence, the STS explicitly manifested that the burden of proof falls on the taxpayer, and since the taxpayer had not prepared the necessary justification for its inter-company pricing, the court ruled in favour of the tax administration.

- STS 11 February 2000; STS 15 July 2002.
- STS 10 January 2007; STS 4 December 2007; STS 6 February 2008.

### **6105 Management services and R&D cost sharing arrangements**

The section of the legislation dealing with management services is now included within a more general definition of 'services'. The deduction of expenses for services provided by related parties is subject to the condition that the services provided produce or can produce an advantage or benefit to the receiver.

Where it is not possible to separate the services provided by entity (i.e. directly charging), it is possible to distribute the total price for the services between all beneficiaries of the services in accordance with rational distribution criteria. These criteria need to take into account not only the nature of the service, but also the circumstances surrounding the provision of services as well as the benefits obtained (or that can be obtained) by the beneficiaries of the services.

The deduction of expenses derived from cost sharing arrangements (not only related to R&D) between related parties is subject to the following:

- The participants to the arrangement must be able to access the property (or the rights to the property having similar economic consequences) of the resulting assets or rights being subject of the cost sharing arrangement.
- The contribution of each participant must take into account the anticipated benefits or advantages that each participant expects to obtain in accordance with rational criterion.
- The agreement must contemplate variations in circumstances and participants, establishing compensatory payments and any other adjustments that may be considered necessary.
- The agreement must comply with the documentation requirements to be established at a later date.

Despite the conditions established in the legislation for the deductibility of inter-company services charges, recent developments in Spain would indicate that it will be not be easy for taxpayers to provide the level of evidence needed to justify the charges to the tax administration. A recent court case (STS 4 December 2007) that specifically dealt with the deductibility of a service charge paid by the local taxpayer to its foreign parent company sets down precedence for these types of inter-company transactions. The court ruled that a service charge was not deductible despite the availability, amongst other evidence, of a transfer pricing report in English on the allocation of expenses by the head company (rejected as it was prepared by the parent company and not available in Spanish) and a series of sworn statements by heads of departments in the Spanish taxpayer and parent company that the services were received and beneficial (rejected as they were perceived to be subjective).

### **6106 Burden of proof**

The statutory regulations state that taxpayers should value transactions with their related parties at market prices and also indicate how that value has been calculated (Article 16 of the CITL and Article 41 of the PITL).

This represents an important change to the rules that has been introduced by the new legislation (previously the burden of the proof lay with the tax authorities).

Should any discrepancies regarding the suitability of the transfer prices arise in the course of a tax review, it is in the taxpayer's interest to present as much evidence as possible in support of its prices. Detailed evidence presented by the taxpayer will help reduce the likelihood of the authorities proposing an adjustment and imposing penalties. For these reasons, it is necessary that the taxpayers comply with the obligation to produce documentation, the specific contents of which are expected to be published during 2008.

**6107 Tax audit procedures***Selection of companies for audit*

Spanish tax inspectors operate on three levels: national, regional and local. National and regional specialist units are responsible for all tax affairs dealing with companies or groups of companies, which may deserve close attention for reasons such as size, importance of operations, a distinguished reputation in an economic sector, volume of sales, etc. Such companies and groups are subject to tax audits on a recurring basis. Smaller companies are dealt with at the local level. Transfer pricing issues, until recently, have been considered part of a general tax audit and not the subject of special investigation. However, with the new legislation, transfer pricing audit activity has increased significantly. Already audits have been launched where the scope is limited to an analysis of the arm's length nature of inter-company prices.

The provision of information and duty of the taxpayer to co-operate with the tax authorities

In principle, the tax authorities are empowered to collect all the information and data necessary to conduct a tax audit. In general, taxpayers are obliged to provide the tax authorities with such information. Failure to present the accounting registers and documents, which companies are required to keep by law, or failure to provide any data, reports, receipts and information relating to the taxpayer's tax situation, may be considered as 'resisting or hindering' the tax audit.

In general terms, all taxpayers are obliged to present, by law or under a specific request by the tax authorities, any relevant information for tax purposes they may have with respect to third parties, in connection with business, financial or professional relationships held therewith. Any information presented to or obtained by the tax authorities is considered to be confidential and can only be used for tax purposes and may not be disclosed to third parties, except in those cases stated by law.

**6108 The audit procedure**

Each inspector is assigned a Personal Confidential Tax Audit Plan for the period, which includes all the taxpayers to be audited by his/her team.

Each taxpayer is entitled to be informed upon commencement of a tax audit the nature and scope of the audit about to take place as well as its rights and obligations during the course of such proceedings. The tax audit proceedings must be concluded within 12 months although, under certain circumstances, this period may be extended to an additional 12 months.

Inspections are normally conducted either at the company's main offices or at the tax authorities' offices.

The procedure is deemed to be completed when the tax auditor considers that all the necessary information required to put together a reassessment proposal has been obtained. Prior to the tax auditor drawing up his/her proposal, the taxpayer is given the opportunity to formulate allegations. A tax inspection will usually conclude with a reassessment proposal, which the taxpayer can either accept or reject in part or in whole.

Under the draft Decree, which is expected to be adopted in 2008, tax inspectors must file a separate transfer pricing assessment, distinct from any assessments related to other income tax obligations. The contents of the transfer pricing

assessment must include a justification of the arm's length value as determined by the tax inspector and an explanation of how the arm's length value was determined.

### **6109 Revised assessments and the appeals procedure**

In the event that the taxpayer does not accept the inspector's proposal, a writ of allegations may be presented to the inspector's superiors. Based upon this writ and the tax inspector's extended report, the superior officer can confirm, modify or cancel the additional assessment.

If the taxpayer is dissatisfied with this decision, an appeal may be filed with the office or directly with the TEAC. At this stage of the procedure, the additional assessment must be paid or guaranteed. An appeal against the decision passed by the TEAC may be filed with the ordinary courts of justice.

### **6110 Additional tax and penalties**

With regard to the new requirement of documentation, the provision of incomplete, inaccurate or false documentation, or where the declared values do not coincide with the values derived from the documentation would imply penalties.

The penalty applied depends on whether the tax administration assesses a transfer pricing adjustment or not:

- If there is no adjustment, there will be a penalty of EUR1,500 for each missing, inaccurate or false data item, or EUR15,000 for a collection of missing, inaccurate or false data item.
- If there is an adjustment, there will be a penalty of 15% of the adjusted amount with a minimum of double the penalty that would have been assessed if no adjustment had been made.

The transfer pricing specific penalty regime, however, will not enter into force until the draft Decree is approved. In the interim, the failure to value at arm's length is subject to the general tax penalty regime, such that a penalty of 50-150% of the additional tax can be applied. Penalties are not tax deductible and interest for late payment is charged.

However, prior to imposing a penalty under the general regime, the tax authorities must prove that the taxpayer has behaved in a negligent manner. The taxpayer is considered to have acted with due diligence when he/she presents a reliable and full statement and makes the relevant self assessment under a reasonable interpretation of the regulations, including compliance with the documentation requirement,

A special procedure exists for imposing penalties, which is independent of the normal tax audit procedure. Such a procedure may either be commenced by the tax inspector or by a special officer assigned by the Chief Tax Inspector. The tax inspector must provide all relevant data or proof in order to justify the penalty being imposed. The taxpayer may formulate allegations and present its consent to, or disagreement with, the proposed penalty. The penalty will be automatically reduced by 30% if the taxpayer agrees with the penalty proposal.

The taxpayer may appeal against the proposed penalty without necessarily paying or guaranteeing the amount of the penalty being imposed.

**6111 Resources available to the tax authorities**

Currently, a specialist unit dealing with transfer pricing issues is being established. The regional and national tax offices, which are responsible for the larger companies or multinational companies normally deal with transfer pricing issues during the course of a general tax audit.

In addition, significant resources are being made available to improve inspectors' ability to successfully undertake audits and active training is taking place. Tax inspectors currently act on their own, although this does not rule out the possibility that they could receive assistance from in-house experts. Additionally, tax inspectors are able to exchange information under the principles established in the OECD Model Tax Convention and in the European Directive 2004/56 on Mutual Assistance.

**6112 Use and availability of comparable information**

The new transfer pricing legislation, for the first time, explicitly recognises the transactional net margin method as an accepted method for justifying the arm's length nature of prices.

*Availability*

Annual accounts (including the notes to the accounts and directors' report) are officially registered and therefore publicly available. Databases containing detailed financial information of Iberian companies are available. In certain industries (e.g. the pharmaceutical industry), more detailed information concerning product pricing and profit margins may be obtained. Spanish tax authorities have a natural tendency to employ local comparable companies for benchmarking purposes.

The tax authorities have confirmed their use of databases such as AMADEUS and SABI (the Bureau Van Dijk database containing companies located within the Iberian peninsula).

Tax authorities have also confirmed that they do not use secret comparables although very often they will request information from other companies that operate in the same sector. This information may be requested individually for specific transactions, or in a general manner. Such information has been used by the authorities in some cases, with the aim of justifying a transfer pricing re-assessment.

**6113 Risk transactions or industries**

Transfer pricing is an area of increasing interest for the Spanish tax authorities. So far they have not concentrated on any particular industry, although emphasis has been placed on the automobile, computer/software and pharmaceutical industries.

Special attention has been directed towards management fees and royalties. In addition, the Spanish tax authorities are quite sensitive to so-called 'business transformations' and may assert that a permanent establishment (PE) exists of a foreign party to which significant business functions and risks have been transferred.

Regarding management fees, and as noted, the Spanish tax authorities will expect to see the application of rational and continuous cost allocation criteria, and actual evidence of the benefits received from the services.

### **6114 Limitation of double taxation and competent authority proceedings**

In principle, when a transfer pricing adjustment affects transactions between a Spanish company and a non-resident, the mechanisms laid down in the relevant double taxation treaty should be applied. Where the non-resident is within the EU, the provisions of the Arbitration Convention relating to the elimination of double taxation (EC Directive 90/436) can be applied. In relation to MAP proceedings arising from the mechanisms laid down in the double taxation treaties or the provisions of the EU Arbitration Convention, the draft Decree establishes different regimes (and the phases within each regime), depending on whether the procedure is initiated by the Spanish or the foreign competent authorities and depending on which tax administration (Spanish or foreign) has made (or makes) the assessment.

In relation to MAPs, Law 36/2006 also introduces a remarkable development, which is the possibility of suspending all payments while the MAP is under way, provided that adequate guarantees are secured. The draft Decree regulates the procedure to follow in order to allow for the suspension of the tax payments when a MAP is initiated.

### **6115 Advance pricing agreements (APAs)**

Spanish law provides taxpayers with a statutory right to seek advance pricing agreements. The regulations are contained in paragraph seven of Article 16 and are due to be supplemented with further guidance in due course. The expected changes are set out in the draft Decree published in mid-2007 and are designed to provide greater flexibility during APA negotiations allowing for a quicker resolution.

However, until such time as the draft Decree is formally adopted, the APA requirements are contained in Articles 17–29 of the CTR, which are also applicable to contributions to R&D expenses, management support services and even in respect to the thin capitalisation rules. Both unilateral and multilateral APAs are possible in Spain.

The tax inspection department of the Agency (AEAT) is the administrative body in charge of dealing with APA requests. Basically, the procedure is devised in what could be described as a two-step approach. First, a pre-filing step must be followed lasting one month after which the taxpayer will be informed of the basic elements of the procedure and its possible effects. Next, the actual filing will take place. This second stage will last approximately six months in the case of unilateral APAs.

The information provided to the tax administration in both the pre-filing and filing stages will be exclusively used within the context of the APA and will only be applicable for such purposes. The final resolution will be effective for the period of time decided in the agreement but with the limit of not more than four years. Additionally, it can be determined that the APA affects the operations of the year in which the APA is agreed as well as the operations of the prior year as long as the time limit for the tax return/declaration has not been passed.

If the taxpayer's proposal is not approved, the taxpayer has no right to appeal against the decision. Often, an alternative APA will be filed after negotiating any points of contention of the initial proposal with the tax authorities.

The Spanish tax authorities have shown a positive response in the processing

and ruling of APAs. Furthermore, providing that no significant changes in the underlying conditions of the APA occur, a taxpayer may request an APA renewal.

### **6116 Anticipated developments in law and practice**

The tax authorities have expressed their concerns with respect to transfer pricing and have already begun to pay more attention to transfer pricing issues during tax audits. In order to progress in this area, a select group of tax inspectors are attending advanced specialisation courses (for transfer pricing and other international tax topics) every year.

The Spanish tax authorities have signed their revision of the transfer pricing legislation with the publication of the Laws 35/2006 and 36/2006. The publication of this legislation follow the need to respond to the international developments and to answer more cooperatively to widely accepted new international developments in transfer pricing (i.e. the conclusions obtained by the JTPF in the field of European documentation model).

The most significant development, likely later in 2008, is the formal adoption of the draft Decree setting out the specific contents required in taxpayers' documentation. Three months after publication, Spanish taxpayers will be required to prepare transfer pricing documentation. The draft Decree is also expected to modify APA procedures as well as making other refinements to the regulations.

### **6117 Liaison with customs authorities**

In practice, there is little communication between the income tax and the customs authorities, despite the fact that there is nothing to prevent an exchange of information. Interestingly, transfer pricing adjustments for income tax and corporate tax purposes do not necessarily need to be reflected in returns filed for customs or for any other indirect taxes.

The Laws 35 and 36/2006 has also introduced some points related with the Value Added Tax. Concerning this tax, it is necessary to evaluate the operations according to the arm's length standard when there is a Directive which provides this. These laws also provide for the liability in cases of collaboration in fraud.

### **6118 OECD issues**

Spain is a member of the OECD and endorses the OECD Guidelines. The actual endorsement of the OECD Guidelines is shown with Law 36/2006 which has now included the transactional net margin method in the Spanish legislation. This method was informally accepted before the new legislation in some specific cases, given appropriate justification; however, it is now formally accepted as a transfer price method.

For the first time ever, the introduction of Law 36/2006 explicitly states that the domestic legislation should be interpreted in accordance with the OECD Guidelines.

### **6119 Joint investigations**

There is nothing in Spanish law to prevent the authorities from joining with authorities of another state to establish a joint investigation of a multinational company or group. In fact, on more than a few occasions the Spanish authorities have followed such procedures.

### 6120 Thin capitalisation

Financial transactions are included within the general transfer pricing regime. Additionally, there are rules concerning thin capitalisation as explained below:

On 31 December 2003, the Official Bulletin of the State published a change to Article 20 of the Spanish CITL. This Article previously established that accrued interest would be considered as dividends when a Spanish entity's debt with foreign related entities exceeded three times the Spanish entity's net worth.

In particular, the CITL stated that when a company's direct or indirect net interest-bearing borrowings from non-resident related individuals or legal entities, excluding financial institutions, are greater than three times the company's 'fiscal capital', the interest accruing in respect of the surplus should be regarded as dividends. When applying this rule, the average net interest-bearing borrowings and the fiscal capital over the fiscal year under review shall be used. The fiscal capital consists of the company's net worth, not including the profits/loss for the year.

The changes to the Spanish CITL indicate that effective 1 January 2004, Article 20 will not apply when the foreign related entity is a resident in an EU Member State, unless the territory is classified as a tax haven.

These changes stem from the ruling passed by the European Court of Justice on the Lankhorst-Hohorst case, which concluded that thin capitalisation rules such as those outlined in Article 8 of the German Corporate Income Tax Code (similar to Article 20 of the Spanish CIT Law) discriminate against non-country residents who are EU residents and thus are inconsistent with the EU Treaty (Article 43, Freedom of Establishment).

#### *Rulings*

With respect to the thin capitalisation rules, a few relevant rulings are mentioned below:

- The thin capitalisation rules are also applicable to indirect loans where the related entity, although it is not the lender in itself, assumes the risk arising as a consequence of possible insolvency of the borrower (DGT 24 March 1998).
- Another ruling (DGT 7 July 1998), dealing with thin capitalisation rules within a group of companies subject to a tax grouping regime, stated that for determining both the net interest-bearing borrowings and the fiscal capital, each entity should be considered on a stand alone basis (i.e. it is not possible to aggregate such magnitudes considering the group as a whole).
- Finally, an interesting binding ruling dated 4 September 2001 refers to a request by a company, resident in Spain, which has received a loan from its headquarter in the United States re-lending part of the loan to a wholly owned affiliate company, also resident in Spain.

Interpretation of the law leads tax authorities to understand that the provision applies only to indebtedness between a resident and a non-resident company. Therefore, the expression 'net remunerated indebtedness – direct or indirect' should be understood between the resident company and the non-resident company, regardless of how the former uses that loan.



This means that for purposes of determining whether thin capitalisation rules apply, the resident company cannot use as a measure of 'net remunerated indebtedness' the difference between the loan received from its headquarters and the part of that loan that was re-lent to its subsidiary.

Also, from the Tax Administration's perspective, there is an indirect indebtedness between the resident affiliate and the headquarter. Therefore, the conditions of thin capitalisation would also apply to the affiliated company that received part of the loan. Consequently, the effects of recharacterisation of interest of the affiliated company will take place in the inquiring resident company that re-lent part of the loan to its subsidiary, because it is the one that is actually paying interest to its non-resident headquarters.

#### *Net interest-bearing borrowings*

The law refers to net interest-bearing borrowings. This means that if a company's balance sheet reflects both interest-bearing liability balances and interest-bearing asset balances with related entities over the year, then the level of borrowings to be compared with the average fiscal capital for the year will consist of the net balance (i.e. assets less liabilities). It is evident that there are few cases in which a Spanish company requires financing from its group in order to carry on its business and at the same time provides financing to other related companies abroad.

#### *Proposal to the authorities for a higher ratio*

Taxpayers may submit a proposal to the tax authorities for the application of a ratio other than the 3:1 ratio mentioned above (i.e. via an APA). This proposal must be based on the financing that the taxpayer would have been able to raise from non-related persons or entities in arm's length conditions. This option will not be applicable to the operations made with or by persons or entities residing in countries or territories considered as tax heavens by the Spanish local regulations.

#### *Accrued interest*

The CITL provides that accrued unpaid interest relating to the surplus net interest-bearing borrowings is to be regarded as dividends for tax purposes. This implies that the interest accrued, but not mature, which relates to this surplus, will not be deductible even though it has not been credited to the lender's particular account but merely recorded in accrual accounts.

# 62 Sweden

## 6201 Introduction

On 1 January 2007 the Swedish legislation dealing with transfer pricing was extended substantially. The statutory rule of the Swedish Income Tax Act (SITA) adopting the arm's length principle for transactions between related enterprises was supplemented by formal documentation requirements. Parallel to this legal framework, two cases established, during the 1990s, some important principles for dealing with transfer pricing issues. They concern in particular the areas of thin capitalisation and the circumstances in which transfer pricing adjustments may be made.

It is worth noting that, in general, the Swedish Tax Agency (STA) is becoming more interested in transfer pricing, using the regular tax audit as an opportunity to investigate transfer pricing issues. Even though the activities of the STA until now have been constrained by a lack of resources, the last few years have shown an increased focus on transfer pricing related issues through a number of detailed standard questions in tax audits, including questions about what comparable transactions or companies have been used as a basis for determining the transfer prices. Furthermore, a number of new cases concerning the provision of central support services show an increased focus on transfer pricing. A highly-skilled specialised team has also been established within the STA, which is continuously developing the general awareness within the transfer pricing area. This team assists the general tax auditors of the STA with transfer pricing issues, and performs its own targeted audits towards large companies.

## 6202 Statutory rules

Sweden has only one statutory rule on transfer pricing. Originally included in the tax code in 1929, it is now found in Chapter 14 Section 19 SITA. This section adopts the arm's length principle for transactions between related enterprises and authorises an increase in the taxable income of a Swedish enterprise equal to the reduction of income resulting from non-arm's length transactions. Beside the arm's length rule, Chapter 19 Section 2b of law 2001:1227 introduced documentation requirements for all corporations registered in Sweden that conduct cross-border controlled transactions. It is now compulsory to prepare written documentation on all cross-border transactions with associated companies. The statutory addendum came into effect as of 1 January 2007.

## 6203 Other regulations

In connection with the documentation requirement, administrative guidelines (SKVFS 2007:1) were issued by the STA on 14 February 2007. Moreover, the STA published regulations that provide further details as well as examples related to the transfer pricing documentation requirements. Guidelines and regulations are applicable retroactively as of 1 January 2007 and are further commented below. Generally, the documentation requirements cannot be considered to be over-demanding on the taxpayers in an international comparison.

### 6204 Legal cases

Over the last few years relatively few transfer pricing cases have reached the lower courts and the Court of Appeal. However, there have been two important cases from the Supreme Administrative Court that should be noted. The first, *Mobil Oil* (1990), concerned thin capitalisation and the second, *Shell* (1991), concerned the pricing of crude oil and freight. The tax authorities lost both cases.

The principle established by the *Mobil Oil* case is that, generally, thin capitalisation cannot be challenged in Sweden using the arm's length rule.

The *Shell* case clearly demonstrates three points. First, that the STA bears the full burden of proof in transfer pricing matters. Secondly, that consideration of whether an arm's length price has been charged should not be restricted to the facts arising in a single year, but rather, a span of years should be considered. Finally, if a transfer pricing adjustment is to be justified, there must be a deviation from arm's length pricing that is significant in size. Moreover, the *Shell* case was the first case in which the courts referred to the principles laid down in the OECD Guidelines on transfer pricing.

As a consequence of the increased focus of the STA on various transfer pricing issues, there are currently a number of interesting cases in the lower administrative (tax) courts. One of these cases from an Administrative Court of Appeal concerns incorrect pricing of interest payments on intra-group loans. The outcome of this case is that for intra-group loans, the interest rates used and their consistency with the arm's length principle need to be well documented. Otherwise, companies may have the interest rate adjusted to an average banking interest rate (equal to an average of Swedish banks interest rate on loans to non-financial companies).

Other cases concerning support services and interests on loans, usually provided from the parent company to the benefit of subsidiaries, have also been ruled by Swedish courts. This large amount of cases – by Swedish standards – in a short period of time again points out that the STA have received additional resources and have increased their focus on transfer pricing issues.

### 6205 Burden of proof

The STA bears the full burden of proof when trying to establish that a transfer pricing adjustment is necessary. To support the adjustment the STA must show that:

- (1) the party to whom the income is transferred is not liable to taxation in Sweden on that income;
- (2) they have reasons for believing that a community of economic interests exists between the contracting parties;
- (3) it is clear from the circumstances that the contractual conditions have not been agreed upon for reasons other than economic community of interest;
- (4) the adjustment does not depend upon consideration of the facts applying to one year in isolation; and
- (5) there has been a significant deviation from the arm's length price, sufficient to justify an adjustment.

## 6206 Documentation requirements

According to the new requirements in force since 1 January 2007, transfer pricing documentation has to provide for the following information:

- General description of the company, the organisation and its activities;
- Information about the nature and extent of the transactions;
- Functional analysis;
- Description of the transfer pricing method chosen; and
- Benchmark analysis.

Companies entering into transactions of limited value can benefit from simplified documentation requirements. Transactions of limited value are defined as intra-group transactions of goods for a value of less than approximately SEK25 million (approx EUR2.69 million) per company within a multinational enterprise, and for other transactions, a value of less than approximately SEK5 million (approx EUR.54 million). The “other transactions” does not cover the transfer of an intangible asset. If such a transfer occurs, no simplified documentation requirement applies. The simplified documentation requirement consists of the following information, in a summary or schematic form and at a general level:

- Legal structure of the group;
- Organisation and operations of the tested party;
- A short description of the counterparties to the transactions including their main activities;
- Actual transactions – nature, extent, value – together with the transfer pricing method applied;
- How the arm’s length principle is met; and
- Comparable transactions, if appropriate and if any are identified.

The EU Code of conduct and the EUTPD are explicitly accepted in Swedish legislation.

## 6207 The audit procedure

### *Selection of companies for audit*

The 250 largest Swedish multinational groups are on average audited every five years. A few hundred foreign-owned companies are audited more regularly. Transfer pricing is currently given a high priority in Sweden and the audits present an opportunity for the authorities to focus on the companies’ transfer pricing policies.

During the course of the audit, the STA may examine all inter-company transactions. The audits are always conducted at the company premises, with key personnel being interviewed. The conduct of the taxpayer during the examination is likely to affect the outcome of the audit and the early assistance of a competent tax advisor is therefore highly recommended. Where the STA believes that the arm’s length standard has not been applied, it might sometimes be possible to achieve a negotiated settlement.

### *The provision of information and duty of the taxpayer to co-operate with the tax authorities*

The STA may request copies of any information that is kept on the premises of the taxpayer, and it has the power to search the premises if it considers this to be necessary.

### **6208 Revised assessments and the appeals procedure**

There is an appeals procedure available to the taxpayer, but it is time consuming. The procedure on tax cases in the first instance of the Administrative Courts will normally take two to three years, and perhaps just as long again in the Administrative Court of Appeal.

### **6209 Additional tax and penalties**

Penalties will normally be levied at a rate of 40% of the additional tax due. Penalties paid are not tax deductible. The documentation requirements do not include specific penalties.

### **6210 Resources available to the tax authorities**

The resources of the tax authorities to conduct transfer pricing audits have historically been limited. A specialised transfer pricing team has now been established in the STA which is continuously recruiting more inspectors and acquiring new competence within the transfer pricing area. This is also clearly shown in the increased number of cases brought before the courts. This specialised team will assist the general tax auditors in the STA with transfer pricing issues as well as perform its own targeted audits towards large companies.

### **6211 Use and availability of comparable information**

In accordance with the legislation, the determination of an arm's length price has to be based upon prices that would be agreed between unrelated parties in a comparable situation. In determining the relevant price, the STA prefers the traditional transactional methods but with no preferred order of use. If none of these methods can be used, then a transactional profit method may be used. The STA considers that the transactional net margin method (TNMM) will be the most used of these methods to test the arm's length character of transfer prices.

The financial statements of all Swedish companies are publicly available in Sweden. Databases containing this information exist, and may be accessed in the search for comparables. The STA has also gained access to the most common databases used for comparability searches such as the European database AMADEUS and various royalty databases. In recent tax audits the STA has prepared extensive lists of questions regarding the audited company's comparable data.

### **6212 Risk transactions or industries**

All industries and related party transactions can be audited. The most common questions about intra-group transactions still relate to loans and payments for services such as management fees. Questions related to product sales and payments (such as royalties) for intangible property are, however, becoming more common in tax audits. With the implementation of documentation requirements, an audit will without doubt imply a scrutiny of the complete documentation.

### **6213 Limitation of double taxation and competent authority proceedings**

Initially it can be said that there is, currently, no regulation in Swedish law that automatically relieves a company from economic double taxation caused by an adjustment of its transfer prices. The problem with double taxation is, instead, usually handled through tax treaties. Swedish tax treaties are usually based on the OECD Model Tax Convention. Some older agreements existing between Sweden and developing countries are based on the UN Model Tax Convention.

Sweden has entered into bi-lateral tax treaties with the majority of countries in which Swedish multinationals conduct business. These agreements provide a good basis for the elimination of economic double taxation for both Swedish multinationals, as well as for foreign multinational companies conducting business in Sweden.

The competent authority procedure functions fairly well in Sweden. According to the Ministry of Finance, full or partial relief has historically been obtained in more than 90% of cases where competent authority relief has been claimed. The competent authority responsibility and the Mutual Agreement Procedures (MAPs) were recently transferred to the STA. However, one problem with competent authority claims is the time taken to settle each case. After the transfer of responsibility for the MAPs to the STA the effectiveness in these procedures has increased considerably. Delays in current processes are often the result of delays in the other countries. The normal handling period for the competent authority procedures is usually about two years.

Sweden has signed the EU Arbitration Convention which applies from 1 November 2004. The EU Arbitration Convention constitutes a powerful incentive for the STA to make every effort to ensure that the administrative process is more efficient, and to reach a mutual agreement in relation to all MAPs within the set time limit of two years.

### **6214 Advance pricing agreements (APAs)**

Currently, there is no formal APA procedure in Sweden. Rulings are available from the Board of Advance Tax Rulings, but this procedure concerns legal matters and is hardly applicable to transfer pricing.

Unilateral APAs concluded in other countries, such as the US, may be accepted informally and thus become bi-lateral APAs in practice. This possibility exists only when the relevant tax treaty includes a MAP similar to the one provided by article 25 of the OECD Model Convention. There is, however, no guarantee that a unilateral APA concluded in another country will be accepted. Moreover, even if it is technically possible to conclude an APA on the sole basis of the MAP included in the relevant tax treaty, an administrative framework is desirable in order to organise the procedure.

Therefore, the Swedish Ministry of Finance asked the STA to investigate the possibilities of launching an APA program in Sweden. The STA issued a proposal to an APA programme in late 2007. The proposal includes neither unilateral APAs, nor a simplified procedure for SMEs. It requires an exchange of information provision in the relevant tax treaty, or a possibility to obtain information through other means. The procedure follows indications of the OECD Guidelines as well as Guidelines for APAs in the European Union. Moreover, the proposal states that APAs should, in principle, be concluded for future transactions over a period of three to five years. However, roll-backs may be available in exceptional cases. Swedish Parliament is expected to enact the APA programme during 2008. The STA suggests the APA programme enters in force on 1 January 2009.

**6215 Anticipated developments in law and practice**

The current documentation guidelines provide for a general framework. The guidelines regulations issued by the STA clarify certain aspects of the legislation, but there still are certain areas that may lead to conflicts of interpretation. It may then be up to case-law to solve those conflicts.

**6216 Liaison with customs authorities**

We are currently not aware of any co-operation between Customs and the STA, since they are separate government bodies.

**6217 OECD issues**

Sweden is an OECD member country. There was a Swedish representative on the OECD Transfer Pricing Task Force, and Sweden has signed up to the OECD Guidelines.

**6218 Joint investigations**

The STA has taken part in simultaneous audits from time to time and is particularly likely to join with other Nordic countries in such audits. There have also been a few simultaneous audits by the STA and the US and German tax authorities.

**6219 Thin capitalisation**

A principle established by the *Mobil Oil* case is that the arm's length principle cannot be used to challenge a taxpayer on the grounds of thin capitalisation. Furthermore, there are no rules dealing specifically with thin capitalisation and no set permissible debt-to-equity ratios. Interest paid to a foreign associated entity is deductible for tax purposes without any restrictions as long as arm's length interest rates are applied. However, in special situations with unique circumstances, interest deductions may be challenged and therefore, even if the tax authorities have not yet successfully challenged any instances of thin capitalisation, taxpayers should remain cautious in this area.

# 63 Switzerland

## 6301 Introduction

Switzerland is of the opinion that transfer pricing matters cannot be addressed by legislation and therefore has no plans to issue any domestic provisions on transfer pricing in the near future. There is, however, an increasing awareness of the issue and concern on the part of the Swiss tax authorities that taxpayers may transfer profits without economic justification to countries with strict transfer pricing rules and documentation requirements in order to avoid challenges by the respective local tax authorities. In this context Swiss tax authorities take an increasing interest in a company's transfer pricing position in order to defend their own position. In addition, some cantonal tax authorities have begun to particularly focus on low risk/low profit entities located in Switzerland.

Switzerland follows the OECD Guidelines as closely as possible and recognises the arm's length principle based on interpretation of actual legislation. To clarify transfer pricing issues, Switzerland offers an informal procedure for agreeing pricing policies in advance.

## 6302 Statutory rules

Whilst Swiss tax law does neither contain a definition of the arm's length principle, nor does it specifically address the issue of transfer pricing between related parties, there is some legal authority for adjusting the profits of a taxpayer on an arm's length basis. This legal authority is found in Article 58 of the Federal Direct Tax Act as well as in Article 24 of the Harmonisation of the Cantonal Tax Laws Act, which both define the calculation of a taxpayer's taxable net profit. Importantly, Articles 58 and 24 deny a tax deduction for expenditure that is not commercially justifiable and this provides the basis for an adjustment to profits for non-arm's length terms.

## 6303 Other regulations

### *Services*

Other regulations deal with the requirement for Swiss subsidiaries and permanent establishments (PEs) of foreign companies to include a profit mark up when recharging the cost of performing services to a foreign related company. No mark up is required, however, where there is evidence that the marked up price would be substantially different from the price that would have been paid in a comparable uncontrolled situation. In addition, an Instruction issued in Circular Letter No. 4 on 19 March 2004 provides guidance on the treatment of certain services that do not require a cost plus methodology, e.g. certain financial services and general management services, and encourages a review of the methods and margins (or prices) charged for rendering such services when evaluating whether such charges were made on an arm's length basis. Nevertheless, in most cases, the past practice of charging cost plus 5–10% should meet the third party comparison test and remain acceptable to the tax authorities under the new regulations.



It should be noted that, since the cantonal authorities are not bound by the instructions of the Federal Tax Administration when assessing taxes, there is some room for differences in approach between cantons. Therefore, it is possible that the cantonal authorities may adopt different methods of calculating the base of costs to be marked up.

### *Interest payments*

There are Swiss regulations concerning permitted tax deductible interest rates on loans. The Federal Tax Administration regularly issues Instructions on the permitted maximum and minimum interest rates as set by reference to the prevailing interest rates in the Swiss market. If a loan is in a foreign currency, the relevant market interest rates apply. This is effectively an application of the arm's length principle. In practice, there is an interdependence of permissible interest rates and the permissible amount of debt in the context of thin capitalisation.

### **6304 Legal cases**

There are several cases on transfer pricing before the Swiss courts especially concerning the interpretation of 'costs, which are not commercially justifiable' (e.g. non-arm's length transactions of management services, licence fees or excessive interest rates on loans made by a shareholder to a company), the use of company assets by the shareholder on privileged terms, and the restructuring of sister companies by means of non arm's length transactions.

### **6305 Burden of proof**

The burden of proof within Switzerland lies with:

- the taxpayer regarding the justification of tax deductible expenses; and
- the tax authorities regarding adjustments, which increase taxable income.

This effectively means that a taxpayer has to prove to the Swiss tax authorities that the price it has paid for its tangibles, intangibles and any services it has received from a related party satisfies the arm's length principle (i.e. justifies their tax deductibility). On the other side, the Swiss tax authorities' responsibility is to prove that the compensation for any services rendered by the taxpayer or any tangibles or intangibles transferred to a related party does not reach an arm's length level. However, if a taxpayer fails to produce the documents required by the tax authorities, this burden of proof also reverts to the taxpayer. Therefore, it is recommended that Swiss taxpayers maintain appropriate documentation to justify all income and expenses resulting from related party transactions. This is specifically also true with regard to licence fees charged to a Swiss entity or support and defence of low profits in connection with limited risk type entities.

### **6306 Tax audit procedures**

In general, the attitude of the Swiss tax authorities towards transfer pricing in the course of tax audits is not aggressive but it should be noted that the awareness of the tax authorities regarding transfer pricing issues has risen in recent years.

### *Selection of companies for audit*

Companies can be selected for investigation if relevant profit level indicators (e.g. gross margin, net margin or return on capital) differ significantly from what is considered reasonable, or if the company is thinly capitalised.

### *Provision of information and duty of the taxpayer to cooperate with the tax authorities*

The tax authorities may request any information that is relevant for properly assessing a company's profits. If the taxpayer does not comply, fines may be imposed and the burden of proof moves from the tax authorities to the taxpayer.

### **6307 The audit procedure**

The normal tax audit procedures are performed by the cantonal tax authorities in respect of cantonal and federal taxes. It is normal in Switzerland for the outcome of such an investigation to be decided as a result of negotiation but if no agreement can be reached, an adjustment is imposed. In practice, the conduct of the taxpayer during the investigation can significantly affect the size of any adjustment and cooperation is more likely to lead to success.

It has been noticed, however, that the Federal Tax Department is becoming more aggressive and is intensifying audit procedures, in particular regarding withholding tax in connection with hidden distribution of profits based on non-arm's length transactions and with respect to Swiss value added tax (VAT).

### **6308 Revised assessments and the appeals procedure**

If the taxpayer disagrees with the assessment, he/she is entitled to make a formal appeal to the tax authorities. If the appeal is partly or entirely dismissed, then the taxpayer has the right to appeal to the Cantonal Tribunal and ultimately to the Swiss Federal Supreme Court.

### **6309 Additional tax and penalties**

Penalties will apply where an adjustment is required as a result of a transfer pricing investigation in connection with a criminal proceeding (e.g. in the case of tax fraud). These penalties are not tax deductible. The level of penalties imposed depends on the extent to which the taxpayer has defaulted and can be set as a multiple of between one and three times of the additional tax revenue.

No penalties will apply on transfer pricing adjustments during a normal tax assessment.

### **6310 Resources available to the tax authorities**

The resources available to the Swiss tax authorities depend to a great extent on the canton involved. Zurich, for example, has its own experts, while small cantons are largely dependent on the experts within the Federal Tax Administration.

### **6311 Use and availability of comparable information**

If challenged by the Swiss tax authorities, it is necessary to demonstrate that any transfer prices were based on sound economic and commercial reasoning.

Documentary evidence such as board minutes detailing the assumptions made and the expectations of the pricing policy would normally be required. Furthermore, there is generally no publicly accessible information on which to base a comparables study. Information on comparable types of operations is, in practice, easily accessed by the tax authorities ('secret comparables').

A pan-European benchmarking analysis generally supports the defence of transfer prices in Switzerland.

### **6312 Risk transactions or industries**

All transactions between related companies are equally likely to be challenged, as noted above, loans are more frequently examined. There does not appear to be any single industry sector or type of entity, with exception of low risk/low profit entities as mentioned above, which is more likely to be targeted than any other.

### **6313 Limitation of double taxation and competent authority proceedings**

Switzerland's competent authority under the tax treaties is the Federal Tax Administration and the competent authority process is well-established. Once a decision is final under Swiss law, competent authority procedures are the only means for a taxpayer to avoid double taxation.

### **6314 Advance pricing agreements (APAs)**

No formal procedure for agreeing pricing policies in advance with the tax authorities exists in Switzerland. The APA procedure is therefore informal in its nature. APAs are available to all industries (unilateral and bilateral).

### **6315 Anticipated developments in law and practice**

Since the Swiss Tax Authorities are of the opinion that transfer pricing issues cannot be resolved through the provisions of domestic legislation, no significant changes to the existing statutory rules are expected. Indeed, the Swiss approach to transfer pricing issues is to follow the OECD Guidelines as closely as possible.

The Swiss Tax Authorities have improved the competence and understanding of Swiss tax officers regarding transfer pricing issues and use the possibilities for tax adjustments granted under the existing Swiss tax legislation. This may have particular implications on costs related to the provision of services, licence fees and costs for tangible goods charged to Swiss companies, since the burden of proof in justifying the deductibility of expenses lies with the Swiss taxpayer.

We also perceive that tax authorities in certain cantons are increasingly insisting in an arm's length remuneration for assumed IP's transferred in connection with a transfer of business opportunities – similar to the German discussion.

### **6316 Liaison with customs authorities**

The customs authorities both assess customs duties and levy VAT on imported goods (the ordinary VAT rate is 7.6 percent). Consequently, there is a regular exchange of information between the customs and the VAT authorities. Since the VAT authorities themselves form a sub-department of the Federal Tax Authorities, there is also an

increasing trend towards exchange of information between the VAT and the income tax authorities.

Consequently, transfer pricing adjustments should be considered for income tax as well as VAT purposes. An adjustment to the returns made for customs duty purposes is generally not required, since Swiss customs duty is based on weight and not on monetary value (although there are a few exceptions).

### **6317 OECD issues**

Switzerland is a member of the OECD and has accepted the OECD Guidelines on transfer pricing without reservation.

In an Instruction issued on 4 March 1997, the Director of the Federal Tax Administration informed the cantonal tax authorities about the contents of the OECD Guidelines on transfer pricing and asked the authorities to observe these guidelines when adjusting profits or when assessing multinational enterprises in the canton.

### **6318 Joint investigations**

The Swiss authorities would not join with the tax authorities of another country to participate in a joint investigation.

### **6319 Thin capitalisation**

As noted above, the Federal Tax Administration frequently issues Instructions in connection with minimum and maximum permissible interest rates. Where the interest rates charged do not come within the specified range, then the rate may be adjusted. In conjunction with this, there is also specific legislation on permissible debt to equity ratios. At the Federal level, an Instruction was released in June 1997 according to which the debt/equity ratio has to be determined based on the fair market value of a company's assets. The Federal Tax Administration believes that the amount of available borrowings should be determined depending on the category of assets (receivables, participations, loans, property, installations, machinery, intangibles). Regarding finance companies, the safe harbour ratio is 6:1. The same rules apply to Cantonal Tax Law based on Article 29, (a) of the Act on Harmonisation of Cantonal Tax Laws.

There is some flexibility in the application of these rules, particularly where they interact with the Instructions on permissible interest rates. Thus, where the combination of a modest interest rate with excessive indebtedness results in an interest charge that is arm's length, given the amount of debt that would normally be permissible, it is unlikely that any adjustment would be made to the actual interest paid. Obviously, an excessive interest rate on a high amount of debt would not be acceptable.

### **6320 Management services**

The charging for management services by Swiss service companies and PEs is subject to instructions from the Federal Tax Administration. There are guidelines on both the costs to be recharged and the method of calculating an appropriate profit element. Generally, a cost plus approach is deemed appropriate (see Section 6303).

# 64 Taiwan

## 6401 Introduction

Article 43-1 of the Income Tax Act is an anti-tax avoidance provision added when the Act was amended in 1971. In drafting Article 43-1 of the Income Tax Act, Section 482 of the US Internal Revenue Code was consulted along with general tax agreement practices in various countries. However, as the provision failed to explicitly specify standards to determine non-arm's length business operations or transactions and related (tax) adjustment methods, it lacked general rules for taxpayers and collectors to adhere to. As a result, the provision has proved ineffective.

In order to establish an enforceable transfer pricing regime, the Ministry of Finance (MOF) resolved to 'establish a multinational enterprise transfer pricing audit mechanism' in the 40th National Tax Conference report. To implement this resolution, the MOF amended the 'Assessment Rules for Income Tax Returns of Profit-Seeking Enterprises' on 2 January 2004 by adding Article 114-1, which lays down the related methods for adjusting transfer pricing. On 28 December 2004, in accordance to the rules in Article 80, Paragraph five of the Income Tax Act, the MOF promulgated 'Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's Length Transfer Pricing' (referred to below as 'Transfer Pricing Assessment Regulations' or the 'Assessment Regulations'), in the hope of establishing a comprehensive assessment system. For details, see 'A Summary of Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's Length Transfer Pricing' issued by the MOF.

The Transfer Pricing Assessment Regulations consist of seven chapters and a total of 36 Articles.

## 6402 Statutory rules

Article 43-1 of the Income Tax Act requires the taxpayer to apply the arm's length principle when conducting transactions with related parties. If an arrangement with a related party is found to be inconsistent with the arm's length principle resulting in reduction or evasion of tax, an adjustment may be made by a competent tax authority. The adjustment by the tax authority should be in accordance with arm's length principle and subject to the approval of the MOF.

Article 6 of the Transfer Pricing Assessment Regulations also specifically provides that, when a profit-seeking enterprise files its income tax returns, it must self assess in accordance with regulations whether its income from controlled transactions are consistent with arm's length principle, and if not, decide what the arm's length results of its controlled transactions would have been.

When the tax collection authorities-in-charge undertakes adjustments and/or assessments for transfer pricing inconsistent with arm's length principle, it must also adhere to the same guidance.

Where a business enterprise has a subordinate or controlling relationship with another foreign or domestic business enterprise and has not conformed to Article

43-1 of the Income Tax Act, Article 50 of the Financial Holding Company Act and Subparagraph 1, Paragraph 1, Article 42 of the Enterprise Merger and Acquisition Act, the business enterprise will be subject to the Transfer Pricing Assessment Regulations.

### **6403 Burden of proof**

Previously, the burden of proving a transaction was not conducted at arm's length rested with the tax authorities. The tax authorities were required to prove that the taxpayer intended to avoid tax obligation. However, under the Transfer Pricing Assessment Regulations, the taxpayer is obligated to conform to relevant regulations in disclosing information on related party transactions and prepare relevant transfer pricing documentation to comply with the laws and regulations while filing the annual income tax return.

### **6404 Documentation**

When filing income tax returns, profit-seeking enterprises, except for those which have a turnover amount and controlled transaction amount under the disclosing threshold established by the MOF, shall disclose information regarding their related parties, and the controlled transactions between the enterprises and their related parties in prescribed formats. Information required to be disclosed in the prescribed disclosure formats are as follows:

- Related party organisation chart;
- Detailed list of related parties;
- Summary table of related party transactions; and
- Detailed declaration of related party transactions.

In addition, profit-seeking enterprises are required to prepare the following documents when they process their annual income tax declarations:

- A comprehensive business overview;
- A description of organisation structure;
- A summary of related party transactions;
- A transfer pricing report;
- A statement of affiliation (in the case of a subsidiary) and consolidated business report of affiliated enterprises (of a parent company), as stipulated in Article 369-12 of the Company Act; and
- Other documents concerning related parties or controlled transactions that affect pricing.

The transfer pricing report should include the following items:

- Industry and economic analysis;
- Functional and risk analysis of all the participants of the controlled transaction;
- A description of the nature of compliance with the arm's length principle;
- A description of the search for comparables;

- A description of the selection of the most appropriate transfer pricing method and the related comparability analysis;
- Transfer pricing methods adopted by the other related participants; and
- A description of applying the most appropriate transfer pricing method to evaluate whether the result of the controlled transactions is at arm's length and also its conclusion, including selected comparables, difference adjustments and their assumptions, arm's length range, the conclusion of the evaluation, and the transfer pricing adjustment if the controlled transactions are not at arm's length.

Profit-seeking enterprises are required to prepare and submit transfer pricing reports for the 2005 tax year and onward. However, in order to alleviate taxpayers' burden and compliance cost, the MOF established a safe harbour rule on 30 December 2005. Profit-seeking enterprises of which controlled transactions meet the requirements regulated under the safe harbour rule may replace their transfer pricing report with other evidentiary documents which can sufficiently prove that the results of such transactions are at arm's length.

The applied transfer pricing methods specified by the MOF for each type of transaction are as below:

|  | <b>Tangible<br/>asset<br/>transactions</b> | <b>Intangible<br/>asset<br/>transactions</b> | <b>Provision<br/>of services</b> | <b>Use<br/>of<br/>funds</b> |
|--|--|--|----------------------------------|-----------------------------|
| Comparable uncontrolled price (CUP)        | v  |  | v                                | v                           |
| Comparable uncontrolled transactions (CUT) |  | v  |                                  |                             |
| Resale price method (RPM)                  | v  |  |                                  |                             |
| Cost plus method                           | v  |  | v                                | v                           |
| Comparable profit method (CPM)             | v  | v  | v                                |                             |
| Profit split method (PSM)                  | v  | v  | v                                |                             |

If the taxpayer intends to apply a transfer pricing method other than the above-mentioned arm's length transaction methods specified by the MOF, pre-approval by the MOF is required for applying the alternative method.

### 6405 Audit targets

On 2 August 2005, the MOF announced the key criteria for selecting audit targets. These criteria include:

- Profit-seeking enterprises with gross profit margin, operating margin and return on sales ratio that are lower than that of other enterprises in the same industry;

- Profit-seeking enterprises that make a loss or a profit far less than that of other overseas affiliated entities, but the worldwide enterprise group makes a profit as a whole;
- Profit-seeking enterprises whose profitability during three consecutive years are abnormally fluctuated;
- Profit-seeking enterprises that do not disclose controlled transactions in the prescribed forms;
- Profit-seeking enterprises that do not evaluate whether the result of the controlled transactions is at arm's length in compliance with Article 6 of the Transfer Pricing Assessment Regulations, or does not prepare the required evidentiary documents;
- Profit-seeking enterprises that have controlled transactions with related parties but without reasonable consideration price at arm's length;
- The previous and subsequent years of income tax filing of profit-seeking enterprises that do not provide required evidentiary documents of controlled transactions in compliance with Article 22 of the Transfer Pricing Assessment Regulations upon tax authorities' transfer pricing investigation and assessment adjustment ;
- Profit-seeking enterprises that are involved in significant or frequent controlled transactions with affiliated entities located in tax havens or in the countries with low tax rate;
- Profit-seeking enterprises that are involved in significant or frequent controlled transactions with affiliated entities that enjoy tax incentives; or
- Profit-seeking enterprises that are involved in other arrangements that intend to avoid or reduce tax liabilities.

#### **6406 The audit procedure**

When a profit-seeking enterprise is perceived to conduct transactions that are not consistent with arm's length principle with their related parties, the collection authorities-in-charge may initiate an investigation. A profit-seeking enterprise must present the evidential documentation listed in Section 5004 above within one month of receiving a written notice of an investigation from the competent tax authority. Those who cannot present such documentation within the prescribed time period, notwithstanding special circumstances, must apply for an extension before the original due date. The extension may not exceed one month, and is limited to one time only.

Should the tax authority deem it necessary to request additional supporting documents subsequent to its first review, the profit-seeking enterprise should provide them within one month.

#### *Audit procedures, assessment and corresponding adjustments*

The MOF is principally responsible for setting policies and issuing statutory interpretations; the various regional bureaus of the National Tax Administration are tasked with concrete implementation.



The tax authorities may take two different approaches to conduct the investigation based on whether the enterprises being audited provide the transfer pricing documentation as required.

If an enterprise provides adequate transfer pricing documentation, the authorities may assess its taxable income based on such documentation.

If an enterprise fails to provide the mandated documentation, the authorities may assess the taxable income based on the information gathered from internal and external sources.

In either case, the taxable income of the taxpayer is assessed in accordance with the regulations. However, where there is a failure to provide information regarding comparables (e.g. on royalty payments), the authorities-in-charge may assess tax on adjusted taxable income based on the standard profit margins regulated by the MOF.

If an arm's length adjustment, approved by the MOF is made by a collection authority-in-charge, that authority shall make a corresponding adjustment to the taxable income of the counterparty of the transaction if the counterparty is subject to income tax obligation in Taiwan. If the arm's length adjustment is a result from an income tax assessment of a foreign tax jurisdictions under the tax treaty framework, the collection authority-in-charge shall also make a corresponding adjustment to the taxable income of the counterpart which is liable to the income tax obligation in Taiwan if such adjustment is perceived as reasonable by the Taiwanese tax authorities.

Before the issuance of the Transfer Pricing Assessment Regulations, the law did not prohibit tax authority investigations and adjustments on prior-year income tax declarations. Further, the time limit for such investigations and adjustments were within the scope of the Tax Collection Act. However, as a result of the Transfer Pricing Assessment Regulations, when the tax authority seeks to evaluate the consistency of the controlled transactions with the results of arm's length transactions, the responsibility for producing evidence – the burden of proof – may fall on the tax authority.

### **6407 Revised assessments and the appeals procedure**

If a taxpayer refuses to accept the tax authority's decision as final, the taxpayer may attempt to protect its interests by filing for administrative remedy and litigation.

### **6408 Additional tax and penalties**

If an enterprise is engaged in related party transactions, it must determine the transaction results in accordance with Transfer Pricing Assessment Regulations and use them as its basis for the determination of taxable income.

Where a profit-seeking enterprise fails to comply with the regulations thereby resulting in a reduction of tax liability and the collection authority-in-charge has made adjustments and assessed the taxable income of the enterprises in accordance with the Income Tax Act and the Transfer Pricing Assessment Regulations a fine may be imposed. Article 110 of the Income Tax Act stipulates that beginning in year 2005, in addition to the tax liability assessed, a fine will be imposed at two to three times of the tax amount under-reported, depending on the circumstances, for the following:

- The declared price of controlled transaction is two times or more than the arm's length price as assessed by the tax administration; or 50% or lower of the arm's length price;
- The increase in taxable income of the controlled transactions as adjusted and assessed by the collection authority-in-charge is 10% or more of the annual taxable income of the enterprise; and 3% or more of the annual net business revenue.
- The profit-seeking enterprise fails to submit a transfer pricing report, and is unable to provide other documents evidencing that the results of transactions is at arm's length; or
- Other cases where de facto tax shortfall discovered by the collection authority-in-charge, and the amount of omission or under-reporting is significant.

#### **6409 Advance pricing agreements (APAs)**

The Transfer Pricing Assessment Regulations also provide rules for advance pricing agreements (APAs), and specify the following particulars:

- Criteria and time period for applying for an APA;
- Materials that must be provided in an application for an APA;
- Notification of significant changes in conditions, and agreement termination;
- Period for audit and evaluation by the tax authority;
- Signing procedures and applicable period of an APA;
- Content of an APA;
- Submission of annual APA reports;
- Efficacy of APAs;
- Handling of changes in factors affecting prices or profits; and
- Extension of APAs.

A profit-seeking enterprise may apply for an APA if it meets the following requirements:

- The total amount of the transactions, being applied for under advance pricing arrangements shall be no less than NT1 billion; or, the annual amount of such transactions no less than NT500 million;
- No significant tax evasions were committed in the past three years and
- Documentation required for an APA application, such as business overview, relevant information of the related parties and controlled transactions, transfer pricing reports, etc. shall be provided within the time limit.

Taxpayers deemed qualified to apply for an APA should file an application before the end of the first fiscal year covered by the APA. The collection authority-in-charge shall notify the taxpayer in writing whether the application is accepted within one month. Once the application is accepted, the taxpayer must provide all required documents and report within one month from the date the notification is received.

The collection authorities-in-charge shall review and reach a conclusion within a year. Under special circumstances, the evaluation period may be extended by six months, and if necessary, by an additional six months.

The collection authorities-in-charge will carry out discussions with the applicant in the six months following the date the conclusion is reached. An APA shall be signed between the collection authority-in-charge and the applicant upon an agreement being reached between both parties. Once signed, both sides are obligated to follow the terms of the agreements.

During the applicable period of the APA, the applicant must submit an annual report on the execution of the APA to the tax authority during the annual tax filing period, and must retain evidential documentation and reports as required.

### **6410 OECD issues**

Although Taiwan is not a member of the OECD, the MOF nonetheless did consult the legislation and documents of OECD members and other advanced nations while drafting Taiwan's transfer pricing regulations, making those regulations consistent with international trends and thoughts. This does not mean, however, that all OECD member nation laws and regulations are applicable to Taiwan.

### **6411 Special topics**

#### *Custom duties and other taxes*

Profit-seeking enterprises are reasonably expected, to the extent allowed by the law, to reduce their tax burdens. However, if appropriate transfer pricing policy is not applied (especially for cross-border transactions), any attempt to reduce taxes will be worthless if the outcome leads to double taxation or the attraction of other customs duties and/or additional value added tax (VAT) burden. Business enterprises are therefore advised to give this issue considerable attention.

#### *Transfer pricing on permanent establishment*

On 11 January 2007, the MOF issued a ruling which specifies application of Transfer Pricing Assessment Regulations when determining operating profit attributable to Permanent Establishment (PE) of a foreign enterprise in Taiwan in accordance with Double Taxation Agreement (DTA).

- Under the DTA between Taiwan and a foreign country, if an enterprise of the other contracting state has PE in Taiwan and profit attributable to the PE is subject to income tax in Taiwan, the taxable income should be determined in the following manner:
  - (1) The PE shall be deemed as carrying out business transactions with the enterprise of the other contracting state in a capacity of a completely independent enterprise, under same or similar conditions for the same or similar activities. The income attributable to the PE shall be determined in accordance with Transfer Pricing Assessment Regulations. Sufficient documentation proving that the attribution of income to the PE is in compliance with Transfer Pricing rules must be ready for audit by collection authority-in-charge. If the enterprise of the other contracting state attributes

all income from sale of goods or provision of services in Taiwan to its PE, it is not subject to Transfer Pricing documentation requirement.

Where an enterprise of the other contracting state deducts expenses incurred for carrying out the business of the PE pursuant to relevant rules to determine operating income under the DTA, it should apply the Income Tax Law, Profit-seeking Enterprise Income Tax Assessment Regulations, Transfer Pricing Assessment Regulations and other relevant rules.

# 65 Thailand

## 6501 Introduction

While there are no detailed transfer pricing provisions under the Thai tax law, there is a general requirement that companies transact on an arm's length basis. On 16 May 2002, the Revenue Department introduced its Transfer Pricing Guidelines in the form of Departmental Instruction (DI) No. Paw. 113/2545. The purpose of the Transfer Pricing Guidelines is to assist taxpayers in setting arm's length prices for their transactions with related parties and also to assist Revenue Officers in reviewing taxpayers' transfer prices for compliance with the arm's length principle.

Taxpayers are required to self assess and file corporate income tax returns within 150 days of the last day of their accounting period. In order to ensure compliance, the Revenue Department regularly conducts business operation visits/tax investigations to review major issues and comprehensive tax audits. The burden of proof lies with the taxpayers.

During an operation visit/tax investigation, transfer prices may be reviewed. The Thai Transfer Pricing Guidelines set out the information/documents required to be reviewed by the Revenue Officers. Having well-prepared transfer pricing documentation in place reduces the risk of adjustments to prices under the general provisions of the Revenue Code based on what the Revenue Officer considers to be reasonable transfer prices. In the event that an adjustment is unavoidable, transfer pricing documentation can also help mitigate the size of the adjustment.

The latest development in 2007 has been the substantial increase in transfer pricing investigation activity by the Revenue Department. In this effort, the Revenue Department created a specialist transfer pricing group a few years ago. The transfer pricing group actively performs transfer pricing investigations. In late 2007, it introduced a transfer pricing questionnaire for multinational companies in Thailand to provide information regarding their transactions with related parties e.g. amount of each inter-company transaction, principal locations for each activity. In addition to their normal selection of targets for transfer pricing investigation, their strategy is to investigate, simultaneously, competitors within the same industry sector and group companies within the supply chain. Domestic as well as cross-border related party transactions have been challenged by the Revenue Department during their tax investigations.

## 6502 Statutory rules

There are only general provisions under the Revenue Code designed to guard against tax avoidance arising from transactions between related parties conducted at higher or lower than market price.

On the revenue side, the Revenue Code empowers Revenue Officers to:

- make pricing adjustments on the transfer of properties, rendering of services and lending of money without compensation or with compensation below the market price without justifiable reason; and

- make adjustments on the cost price of imported goods by comparison with the cost of the same type of goods imported into another country.

On the expense side, the Revenue Code empowers Revenue Officers to:

- disallow a purchase of goods at a price higher than market price without justifiable reason as a tax deductible expense;
- disallow an expense that is not expended for the purpose of acquiring profits or for the purpose of business in Thailand; and
- disallow an expense determined on and payable out of profits after the termination of an accounting period.

These tax provisions apply to domestic as well as cross-border transactions.

### **6503 Components of the transfer pricing guidelines**

*DI No. Paw. 113/2545 has the following major components:*

- Clause 1 states that a company established under Thai law or under a foreign law must calculate its net profit for the purposes of corporate income tax according to Section 65 of the Revenue Code;
- Clause 2 defines the term ‘market price’ as compensation for goods or services or interest that independent contracting parties determine in good faith in the case of a transfer of goods, provision of services or lending of money, respectively, which is of the same type as the related parties’ transaction on the same date. In this regard, the term ‘independent contracting parties’ is defined as ‘parties without direct or indirect relationships in terms of management, control or shareholding;
- Clause 3 suggests pricing methods for determining market price, namely comparable uncontrolled price, resale price, cost plus and other methods (i.e. transactional net margin method and profit split method);
- Clause 4 lists the documentation that is required to be kept at the office of the taxpayer. This documentation includes ownership structure, budget, strategy and business plan, details of related party transactions, functional analysis, pricing policy, etc. Where a taxpayer can prove through such documentation that the result of their price setting under the selected method is the market price, Revenue Officers are obliged to use the taxpayer’s methods for determining taxable income and expense for the purpose of calculating corporate income tax; and
- Clause 5 allows taxpayers to enter into an Advance Pricing Agreement (APA) with the Revenue Department. To apply for an APA, taxpayers must submit a letter requesting an APA together with relevant documents to the Director-General of the Revenue Department in order to set the criteria, methods and conditions with which the taxpayer must comply.

### **6504 Legal cases**

No legal cases concerning transfer pricing have been decided by the courts since the introduction of DI No. Paw 113/2545. To date, cases involving transfer pricing issues

have been settled during the investigation stage and details are not made available to the public.

### **6505 Burden of proof**

The burden of proof lies with the taxpayer to clear alleged transfer pricing abuses. The Transfer Pricing Guidelines are designed to assist taxpayers in their efforts to determine arm's length transfer prices.

In the event of a dispute, the taxpayer must be able to substantiate, with supporting documents, to the satisfaction of the Revenue Officers, the Board of Appeals, or the courts, as the case may be, that its transfer prices have been determined in accordance with the arm's length principle.

### **6506 Tax audit procedures**

Taxpayers are not required to submit their transfer pricing documentation with their annual corporate income tax returns. They are, however, expected to submit it when requested by a Revenue Officer within one month of the request.

There is no specific transfer pricing audit; it is undertaken as part of the normal tax audit process. However, the Revenue Department begins the investigation process by issuing a letter requesting taxpayers, under their supervision, to provide information and documents on the adopted transfer pricing practices. Targets are selected for investigation based on their analysis of the tax returns submitted, and information obtained from the 'business operation visit', whereby the Revenue Officers pay a visit to companies under their supervision at least once a year to understand the business and ensure tax compliance.

The criteria used by the Revenue Department to select targets for transfer pricing investigation include, but is not limited to:

- low profits compared with competitors;
- no tax payment for an extended period of time;
- decline in profits after tax holiday expires;
- profits in promoted business, but losses/lower profits in non-promoted business;
- drastic fluctuations in profits from year to year;
- varied profitability by product;
- payment of royalties/management fees; and
- significant related party transactions.

The transfer pricing documentation is reviewed by the Revenue Department's transfer pricing team. Based on this review and analysis, the Revenue Officers typically raise questions, and require more detailed explanations and related documents. Depending on how well the transfer pricing practices are documented and the completeness of the supporting documents, the request for additional information and documents could take many rounds.

*The Revenue Department's tax investigation process is as follows:*

- Collect and analyse accounting and tax information/documents;
- Challenge and invite the taxpayer's representative to discuss the transfer pricing (and any other tax) issues identified, and possibly request additional documents;
- Review additional documents and consider explanations;
- Inform the taxpayer's representative of the Revenue Department's opinion;
- The taxpayer is requested to file amended tax returns if in agreement with the Revenue Department's opinion;
- For transfer pricing issues, the Revenue Department issues a summons to audit all taxes if the taxpayer does not accept their opinion; and
- The taxpayer can enter into the appeals process to resolve the dispute if they disagree with the tax assessment.

The Revenue Department generally requires six months to analyse the information/documents and reach a conclusion. After notifying the taxpayer of the outstanding issues, the clarification and negotiation process between the taxpayer and the Revenue Department may take an additional three to 12 months.

In a case where the Revenue Officers accept the taxpayer's explanations and supporting documents, the challenges will be dropped. However, the Revenue Officers will then generally redirect their focus to other tax issues, including corporate income tax, value added tax, withholding tax, specific business tax, etc.

In the event that the Revenue Officers do not accept the taxpayer's explanations and supporting documents, they will advise the taxpayer to voluntarily file amended tax returns to make the required tax adjustments and to pay a surcharge. If the taxpayer disagrees with the opinion of the Revenue Officers, a summons will be issued for a comprehensive tax audit. The comprehensive tax audit covers all taxes under the Revenue Code (i.e. corporate income tax, VAT, and stamp duty). After having completed the audit, the Revenue Department will issue the notification of a tax assessment.

### **6507 Revised assessments and the appeals procedure**

After receiving notification of a tax assessment from the Revenue Department, the taxpayer is required to make an adjustment to the tax return and pay the tax shortfall together with the related penalty and surcharge. In the event that the taxpayer disagrees with the Revenue Department, the taxpayer is allowed to appeal to the Appeals Division of the Revenue Department. The Por. Sor. 6 form must be filled out completely and submitted to the Appeals Division within 30 days from the date of receipt of the notification of the tax assessment.

The Board of Appeals (BOA) will consider the taxpayer's argument and may invite or issue a warrant to the taxpayer or witnesses for questioning or to provide additional testimony or evidence to support the taxpayer's argument. The appeals process generally takes on average three months (not including the waiting period). Upon completion, the BOA's ruling will be mailed to taxpayers.

In the event that the taxpayer disagrees with the BOA's ruling, the taxpayer may



bring the case to the Tax Court within 30 days from the date of receipt of the notice of the ruling. It should be noted that if a taxpayer fails to cooperate with the Revenue Department and does not comply with the summons, the taxpayer is not allowed an appeal with the Appeals Division. Furthermore, the Court will not accept an appeal case if the taxpayer fails to file the appeal with the Appeals Division.

The Tax Court normally takes one to three years to reach a verdict (not including the waiting period). If the taxpayer disagrees with the ruling of the Tax Court, the taxpayer is allowed to appeal to the Supreme Court within one month from the date of the announcement of the Tax Court's judgment. The ruling process at the Supreme Court may take another one to three years (not including the waiting period).

### **6508 Additional tax and penalties**

In the case of a tax assessment resulting from a comprehensive tax audit, the taxpayer is liable to a penalty equal to the additional amount of tax payable. Revenue Officers have the power to reduce the penalty by 50% if they are of the opinion that the taxpayer had no intention of evading taxes and has cooperated fully during the tax audit. The Director-General of Revenue has the power to waive the penalty if the taxpayer can demonstrate that they co-operated fully during the audit and had no intention of evading the tax.

In addition, the taxpayer is liable to a surcharge of 1.5% per month or fraction thereof of the tax payable or remittable exclusive of penalties. In a case where the Director-General of Revenue has granted an extension of the deadline for the remittance of the tax and the tax is paid or remitted within the extended deadline, the surcharge will be reduced to 0.75% per month or a fraction thereof. Unlike the penalty, the surcharge cannot be waived.

There will be no penalty, only a surcharge, if there is tax payable in the case of voluntary filing of an amended tax return (i.e. no comprehensive tax audit).

### **6509 Resources available to the tax authorities**

The Revenue Department has the financial information of all taxpayers. All taxpayers are required to file their audited financial statements together with their corporate income tax returns. The Revenue Department also has access to the Business-on-Line database, which contains key financial data of all companies registered under Thai law.

Other sources of information include other government agencies, such as the Customs Department, the tax authorities from treaty partners through the Exchange of Information Article, disgruntled employees, etc.

### **6510 Use and availability of comparable information**

Comparable information may come from internal as well as external sources. The Revenue Officers use internal data, if and when available, to determine whether the taxpayer's transfer prices are at arm's length.

External comparable information is also used, as internal comparable information may not be available in every case, and even if internal comparable information is available. There is an abundance of potential comparable data, as all companies established under Thai law are required to file their audited financial statements with

the Ministry of Commerce. This information is available to the public, but can currently only be retrieved by photocopying the hard copy documents.

### **6511 Risk transactions or industries**

No particular industry is more at risk of being subject to tax investigation than any other. However, as Thailand is a manufacturing base for automotive makers and electronic goods manufacturers, a relatively greater number of taxpayers in the automotive and electronics industries have been investigated. Taxpayers in other industries, such as pharmaceuticals, petrochemicals, computers, etc, have also been investigated.

The Revenue Department has begun to focus on the following related party transactions as part of their investigation:

- sales and purchases of goods, assets and services;
- transfer and use of know-how, copyrights and trademarks;
- management and administrative fees;
- loan and interest payments;
- research and development expense allocation; and
- commission payments

### **6512 Limitation of double taxation and competent authority proceedings**

Thailand has entered into conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to tax on income with 52 countries. The conventions include Mutual Agreement Procedures, whereby if a taxpayer considers that the tax assessment of one or both of the contracting states results or will result for the taxpayer in taxation not in accordance with the provisions of the conventions, the taxpayer may present the case to the competent authority of the contracting state. The competent authorities shall endeavour to resolve any difficulties or doubts arising by mutual agreement.

It should, however, be noted that most of the treaties that Thailand has with other countries do not allow for correlative adjustment.

In the event that a taxpayer disagrees with a tax assessment of the Revenue Department, the taxpayer is entitled to seek a ruling from the Revenue Department. The ruling process, which normally takes six to 12 months, is expected to take even longer in the immediate future due to the potential change in the process resulting from the recent political turmoil. The mutual agreement procedures between competent authorities will also take much longer than in the past.

### **6513 Advance pricing agreements (APAs)**

Clause 5 of DI No. Paw 113/2545 allows taxpayers to enter into an APA with the Revenue Department. To enter into an APA, the taxpayer must submit a letter requesting the APA together with the relevant documents to the Director-General of the Revenue Department in order to set the criteria, methods and conditions with which the taxpayer needs to comply. In practice, the Revenue Department has yet to provide detailed

guidelines on the APA application procedures, the APA format, and its impact on past years.

There are currently three cases where the Revenue Department is in the process of negotiating bilateral APAs with foreign tax authorities.

#### **6514 Liaison with customs authorities**

The current level of interaction between the Revenue Department and other government departments, such as the Customs Department, is low. However, taxpayers should ensure that information provided to the various government departments is consistent.

#### **6515 OECD issues**

Thailand is not a member of the OECD. However, the tax authorities have generally adopted the arm's length principle and authorise the use of transfer pricing methodologies (e.g. comparable uncontrolled price, resale price method, cost plus method, transactional net margin method, and profit split method) endorsed by the OECD Guidelines in order to determine the market price of a transaction.

The comparable uncontrolled price method, the resale price method, or the cost plus method are preferred over transactional net margin method and profit split method. However, there is no hierarchy of these three methods. Other methods may be used should the three traditional transaction methods were found to be inappropriate. There is also no hierarchy of these other methods.

#### **6516 Joint investigations**

Cross-border cooperation is common in general tax areas. Such cooperation has tended to take the form of foreign tax authorities requesting information from the Thai Revenue Department. However, recently the Revenue Department has increasingly been requesting information support from foreign tax authorities in those countries that have entered into Double Taxation Agreements with Thailand.

#### **6517 Thin capitalisation**

Thailand currently has no thin capitalisation legislation.

#### **6518 Management services**

The Thai Revenue Department is currently increasing its focus on management service fees. The point of concern is whether the management service fees that a taxpayer pays to a related party are for the direct purpose of acquiring profits for the company's business in Thailand and whether the fees paid are commensurate with the benefits received.

##### *Service providers*

All costs related to the services provided must be included in determining the service charge.

*Service recipients*

Generally, service recipients need to substantiate that:

- services are rendered;
- services benefit the service recipient; and
- service fee paid was consistent with the arm's length principle.

The service recipient must have documents to support the above. Contracts and documents showing the costs incurred by the service provider are not sufficient. The service recipient should keep proper documentation in respect of the services rendered, showing that the services were for the benefit of the service recipient. A benchmarking study should also be maintained to demonstrate that the service fee (as well as other transfer prices) was consistent with arm's length principle.

# 66 Turkey

## 6601 Introduction

Until the publication of the 2007 Transfer Pricing Law, Turkish transfer pricing regulations were based on article 17 of Corporate Tax Law, which set out the general principles of transfer pricing in the Turkish legislation, defining disguised profit and its distribution. The article basically required that transactions between related parties be carried out at 'arm's length' prices. No formal policy existed in respect of methodology or documentation before 2007.

Notwithstanding the absence of detailed regulations, throughout the years at various trials, Turkish tax inspectors focused on the subject by turning to case law and by following earlier judicial decisions.

On 21 June 2006, Turkish tax authorities issued Transfer Pricing Law as part of the new Turkish Corporate Income Tax Law (Turkish CIT), Corporate Income Tax Law No. 5520. The new Law contains the adoption of the OECD Guidelines under new transfer pricing principles under the provisions of disguised profit distribution.

The current Turkish transfer pricing (TP) rules aim to improve the Turkish tax system by defining the standards governing transactions between related parties.

## 6602 Statutory rules

The legal framework, which defines the current Turkish transfer pricing implementation methodology, is included under Turkish CIT Law and the related communiqué(s).

The Turkish Transfer Pricing Law is part of the Turkish CIT Law effective as of 1 January 2007. The arm's length principle, which is defined in line with OECD Transfer Pricing Guidelines (OECD Guidelines) and article 9 of the OECD Model Tax Convention, is enacted in the article 13 of Turkish Corporate Tax Law along with a detailed definition of related parties, as well as the introduction of methods to be applied in the determination of the arm's length price. According to the Law, related parties must set the transfer prices for the purchase and sale of goods and services as they would have been agreed between unrelated parties.

After the enactment of the law, the following has been published to specify the transfer pricing regulations:

- General Communiqué on Transfer Pricing No:1 (November, 2007)
- Cabinet Decision on Transfer Pricing (December, 2007)
- General Communiqué on Transfer Pricing No:2 (April, 2008)
- Cabinet Decision on Transfer Pricing (April, 2008)
- Circular on Transfer Pricing (April, 2008)

A comprehensive definition of what constitutes a related party is found in the transfer pricing article under Turkish CIT Law. It includes direct or indirect involvement in the management or control in addition to the existence of shareholder/ownership relationship. In addition to transactions with foreign group companies, it includes

transactions with entities that are based in tax havens or in jurisdictions that are considered to be harmful tax regimes by the Turkish government.

According to the General Communiqué on Transfer Pricing Number 1, related parties are:

- shareholders of the corporations;
- individuals or corporations which are related to the shareholders or corporation itself;
- individuals or corporations which are directly or indirectly under the control of the corporations or its shareholders, in terms of management, audit or capital;
- individuals or corporations, which are directly or indirectly under the ascendancy of the corporations or its shareholders, in terms of management, audit or capital;
- spouses of the shareholders; and
- shareholders' spouses and any of the relatives of the shareholder or the spouse including lineage with third degree kinship by blood or marriage.

The transfer pricing rules define certain methods for the determination of arm's length transfer prices. The methods adopted are comprehensively explained by the OECD Guidelines and are as follows:

- comparable uncontrolled price method;
- cost plus method; and
- resale price method.

The Law states that if the above-mentioned methods cannot be used by the company for certain situations, the taxpayer will be free to adopt other methods. This means companies can also choose other methods such as the transactional profit methods of the OECD Guidelines (namely profit split and transactional net margin method) for the determination of the arm's length price if they can prove that the above-mentioned traditional methods cannot be used.

According to the General Communiqué on Transfer Pricing Number 1, the other methods are defined as the following:

- profit split method; and
- transactional net margin method.

If none of the afore-mentioned methods can be applied, the method determined by the taxpayer can be used as the most appropriate method for the transactions. The definitions of the transfer pricing methods are defined in the General Communiqué Number 1 on Transfer Pricing.

#### *Comparable uncontrolled price method (CUP)*

When applying the comparable uncontrolled price method, if the internal comparables are sufficient to reach an arm's length price, there is no need to find an external comparable. If there is no internal comparable, external comparables should be used after making a comparability analysis and the required amendments.

### *Cost plus method*

In the cost plus method, all the direct costs, indirect costs, common costs related to service or product and operation costs should be considered

If there is a difference between the accounting systems of related and unrelated transaction processes, the required amendments should be done.

### *Resale minus method*

The resale price method evaluates the arm's length character of a controlled transaction by reference to the gross profit margin realised in comparable uncontrolled transactions, and is most useful where it is applied to marketing operations, such as distributors.

### *Profit split method*

The Profit split method is based on the distribution of the operating profit or loss among related parties according to their functions performed and risks assumed.

### *Transactional net margin method (TNMM)*

The TNMM is applied according to net operating profit margin that is found considering the costs, sales or any other appropriate base.

There is also the possibility that the prices to be applied and methods to be used for determination of the arm's length prices can be agreed with the Ministry of Finance in the form of an approval/agreement request in advance. This exercise has been introduced in the 2007 transfer pricing rules for taxpayers who are willing to get advanced certainty with respect to their transfer pricing issues. The Law states that agreements concluded with the Turkish tax authorities in this respect will be valid for a three-year period given that the conditions represented in the request do not change. An announcement regarding the APA programme is expected to be made accompanied by additional explanations from the Turkish tax authorities.

Under TP rules, if arm's length price is not being used for related party transactions, it is regarded as partial or full distribution of the profit in a disguised manner via transfer prices. The outcome will be that disguised profit distribution will be considered as dividend distribution from one party to another (or transfer of proceeds in case of PEs) as at the end of concerned fiscal period. Tax assessments with regard to wrongfully set transfer prices will be done accordingly and corresponding adjustments are made if the counter party is a resident corporate tax payer, correction process is made according to corporate tax exemption for profits from participations (i.e. participation exemption).

## **6603 Tax havens**

In addition to inter-company transactions between related parties, the transfer pricing provisions of Corporate Income Tax Law No. 5520 cover transactions between unrelated parties, where the foreign party is located in one of the tax havens identified by the Turkish Council of Ministers. The Council was expected to release a list of such tax havens by the end of 2007, but no such a list has been published as of 1 April 2008.

Payments for services, commissions, interest and royalties to parties located in a tax haven are subject to a 30% withholding tax under Turkish CIT Law. However, if the transactions involve the import of a commodity or the acquisition of participation shares or dividend payments, the withholding tax is not applicable as long as the pricing is considered to be arm's length.

#### **6604 Deemed dividends**

When it is determined by tax inspectors that the price applied in a related party transaction is not at an arm's length, the outcome is a tax adjustment on corporate tax as well as additional dividend tax on the disguised profit distribution. This requires that if the counter party is a foreign-based taxpayer, individual or any tax-free person, corporate dividend tax should be paid over the deemed profit distribution.

#### **6605 Adjustments**

Any transfer pricing related adjustments deemed necessary by the tax inspectors will be made to the taxpayers' earnings after they pay their respective corporate taxes.

Disguised profit distributions through transfer pricing are not accepted as deductible for corporate income tax purposes. The corporate tax base of the taxpayer will be adjusted and relevant corporate tax will be calculated together with the penalties and late payment interest. Profit that is regarded by the authorities as distributed in a disguised manner through transfer pricing will be deemed as dividends distributed.

#### **6606 Documentation requirements**

The legislation requires documentation as part of transfer pricing rules wherein Turkish taxpayers should keep the documentary evidence within the company in case of any request by the tax authorities. The documentation must represent how the arm's length price has been determined and the methodology that has been selected and applied through the use of any fiscal records and calculations, and charts available at the taxpayer.

The transfer pricing regulations in Turkey has four basic documentation requirements:

- (1) Electronic Corporate Tax Return Form About Transfer Pricing, Controlled Foreign Company and Thin Capitalisation;
- (2) Annual Transfer Pricing Report;
- (3) Transfer Pricing Documentation For Taxpayers during the application of an APA; and
- (4) Annual Report for Taxpayers under an APA.

According to the General Communiqué on Transfer Pricing Number 1, all corporate taxpayers should submit a form as an attachment of their annual corporate tax return. The form constitutes the following parts:

- Information about the taxpayer (tax number, corporate name, taxation period etc.);
- Information about the related parties within the scope of the form (corporate name, country of residence);



- Total amount of transactions that occurred between related parties;
- The methods used for the related party transaction or different transactions;
- Information about the controlled foreign company of the company (corporate name, country of residence, etc); and
- Information about thin capitalisation.

On the other hand corporate taxpayers are obliged to prepare an annual transfer pricing report in line with the format which is stated in the General Communiqué on Transfer Pricing. The Annual Transfer Pricing Report should be prepared until the last day of corporate income tax declaration day, which is the 25 April (for 2007 applications only, the deadline of the report is postponed to 30 June 2008). The report shall compose different level of information depending on:

- (a) Whether the taxpayer is registered to Major Tax Payers tax office or not; and
- (b) Whether the taxpayer is operating in free trade zones in Turkey or not.

According to the above mentioned distinction,

- (a) Corporate taxpayers that are registered to Major Tax Payers tax office shall prepare a report that comprises information about their transactions with their related parties in and out of Turkey;
- (b) Corporate taxpayers that are operating free trade zones in Turkey shall prepare a report that comprises information about their transactions with their related parties in Turkey; and
- (c) All other Turkish corporate taxpayers shall prepare a report that comprises information about their related party transactions with their non-resident related parties.

Disposition of the Annual Transfer Pricing Report is mentioned in the related legislation is as follows:

- I – General Information: Information about the field of activity of the tax payer, economic conditions of this field, market conditions and business strategies.
- II – Information About Related Parties: Information about tax identification numbers, addresses, telephone numbers etc. of the related parties and the field of activity of the related parties as well as economic conditions of this field, market conditions and business strategies, functions they generate, risks they assumed and assets they owned.
- III – Information About The Details Of Related Party Transactions: Detailed information about all transactions and agreements between related parties.
- IV – Information About Transfer Pricing Analysis: Detailed information about comparability analysis, criteria that are used to choose for the comparable transactions. If there are corrections on the determination of the comparability, the detailed information for that correction should be included. Information, documentation and calculation that shows the applied TP method is the most suitable as well as the comparison of the applied method to the other methods. Detailed information about the calculations used to find the arm's length price

or profit margin, if an arm's length price range is determined, the detailed information on this range.

#### V – Conclusion

Taxpayers that will apply for an APA shall prepare application documents and once an APA is concluded with the Revenue Administration, the taxpayer shall prepare a separate annual report that takes transfer pricing into consideration from the APA's point of view. The documents and information required for the annual report of APA is separately defined in the legislation.

The administration can demand additional information and documents for both annual transfer pricing report, APA application and, other corporate taxpayers which have related party transactions when deemed necessary. If the documents are written in a foreign language, their translation to Turkish is obligatory.

#### **6607 Other regulations**

In addition to the specific Transfer pricing regulations there are additional requirements or rules covering transfer pricing contained in other legislation as follows:

- Turkish Tax Procedural Law article with regard to the determination of the market value of goods;
- Turkish VAT Law article stating if the tax base for goods and services is unknown, the market prices based on the nature of the transactions will be the tax base;
- Turkish Income Tax Law article 41 includes partnerships and real persons subject to income within the scope of transfer pricing;
- Case law on excessive number of decisions of Turkish tax courts after cases have been discussed at courts where tax inspectors challenged the transfer prices and eventually the disguised profit distribution of the taxpayer; and
- Case law on tax rulings on the subject.

#### **6608 Legal cases**

During the year 2007, the Turkish Ministry of Finance significantly increased its number of transfer pricing audits against companies, with a particular emphasis on the pharmaceutical sector. In the course of these audits, the Ministry of Finance has focused on the following transfer pricing issues:

- Pricing of raw materials traded among related parties, with the government relying on industrial benchmarking studies that omit relevant risks and functions;
- Continuous losses in previous years by companies that operate primarily through related companies abroad; and
- Management fees and indirect cost allocations.

It is expected that the companies will face different levels of tax audits under the subject of transfer pricing in the coming couple of years as the current rules seem to become a trendy subject to the tax inspectors.

**6609 Burden of proof**

In Turkey, the burden of proof lays with the party making the claim under article 3 of Turkish Tax Procedural Law. Establishing proof includes an examination of the substance of the business event that gives rise to the transaction.

According to the requirements of the Transfer Pricing Law, companies should be ready to provide evidence in order to explain why they chose to implement a specific transfer pricing method. Moreover, responsibility for safe-keeping of the workings/ accounts and sheets for this issue rests with the taxpayers.

In the case of a tax audit, if the tax inspector claims the application of the transfer pricing method by the company is against the Law, the burden of proof will shift to the inspector. If a situation is claimed to be clearly lacking economic commercial and logical justification, the plaintiff is liable to prove his claim.

**6610 Tax audit procedures**

Descriptive legislation regarding transfer pricing became effective as of 1 January 2007. Thus, the Turkish tax authorities have limited experience in the setting of arm's length prices and profit levels. Statute of limitations is five years as imposed by tax legislation. As of 2008, open years for tax inspection begins with 2003.

It is not the practice for the Turkish tax authorities to conduct regular tax audits. Under normal circumstances, the probability of a tax inspection for a Turkish company is around 2-3% although this dramatically increases depending on which industry has caught the attention of the tax inspectors. There is no specific transfer pricing related tax audit procedure. However, during the random tax audits, transfer prices can be questioned by the tax inspectors and it is expected that transfer pricing will draw more attention from the tax authorities not only because it is addressed in the new Turkish CIT Law but also because of its relationship to other tax laws such as VAT and Customs.

**6611 Revised assessments and the appeals procedure**

Assessments are made by the tax inspectors at the end of the tax audit. There is no administrative appeals procedure but a special reconciliation with the tax authority is possible. If parties cannot reconcile at the end of the reconciliation process, the taxpayer is able to go to court. Likewise, the taxpayer can choose not to reconcile prior to the reconciliation process and go to court.

**6612 Additional tax and penalties**

There are no special tax penalties applicable for transfer pricing purposes, but there are generally applied tax penalties that apply to transfer pricing adjustments. Tax penalties are calculated as 100% of the taxes accrued and late payment interest is calculated monthly as 2.5% of the tax accrued.

In terms of the tax audits being performed before or after the effective date of the new transfer pricing rules, the ratification regime did not change in principle except that additional dividend tax will be calculated over disguised profit distributions if challenged after 1 January 2007.

**6613 Resources available to the tax authorities**

During the tax audits, tax returns of the comparable companies may be used by the tax authority. There is no special unit under Turkish General Directorate of Internal Revenue to deal with transfer pricing issues. Local tax inspectors possess a high level of industry-specific knowledge and they may use a variety of sources for benchmarking such as financial data published by listed companies as well as data from other taxpayers. The lack of statistical information for determining the profit margin of specific activities and the lack of local databases directly affect the accuracy of benchmarking studies.

Moreover, as mentioned in section 6606, by using the annual form, inspectors may assess the amount of related party transactions in a year and initiate an investigation accordingly.

**6614 Use and availability of comparable information**

At present there are no available databases or any other information collection centres which systematically provide financial information on Turkish companies.

In addition, due to the lack of information submitted for public usage by companies in Turkey, finding local comparables is difficult. Consequently, taxpayers can use European databases to identify potentially comparable companies and/or transactions. However, no confirmation has been given by the tax authorities yet in this regard. Alternatively, publicly quoted companies' data, comparables within the same group or specific comparables within the sector specific information can also be used as comparable information.

**6615 Risk transactions or industries**

All industries and related party transactions can be reviewed under the scope of tax audits. Intra-group borrowing is one topic of special interest. The amount of debt and the interest calculations may be challenged. There is a recent trend of auditing the transactions (commercial and/or financial) between headquarters and branches/group entities in Turkish Free Trade Zones (FTZs). Payments for services such as management fees have, for some time, been a particular focus for inspectors.

**6616 Limitation of double taxation and competent authority proceedings**

Turkish tax treaties (currently with 68 jurisdictions) contain relevant mutual agreement procedure (MAP) articles. Countries that have signed a DTT with Turkey can in theory pursue competent authority relief as a means of preventing double taxation arising from tax adjustment. However, in practice there are very rare cases where MAP procedures are initiated, meaning the MAP procedure has never been tested by Turkish taxpayers as a means of preventing double taxation.

**6617 Advance pricing agreements (APAs)**

As part of the Turkish transfer pricing legislation, an APA procedure has been introduced for corporate taxpayers who desire to obtain some certainty with respect to their transfer pricing issues. It is stated in the legislation that agreements concluded with the Turkish tax authorities in this respect will be valid for a maximum period of

three years. If the administration identifies that the demand for the agreements interests more than one country and if there are already APAs considering the other country/countries, the administration may give its decision based on these agreements.

The corporate taxpayers that are registered to Major Tax Payers tax office may apply for an APA beginning from 1 January 2008. APA applications are possible for taxpayers that are registered to other tax offices as of 1 January 2009. Moreover, after 1 January 2009, taxpayers that operate in free trade zones in Turkey may apply for their related party transactions with their related parties in Turkey.

The APA application process consists of the following steps:

- (1) Preparation of documentation as specified in legislation,
- (2) Pre-assessment (assessment of documents and the application's completeness),
- (3) Analysis of documentation and arguments presented,
- (4) Approval or rejection of the application,
- (5) Nine months prior to end of the validity of the agreement, taxpayers may apply for a renewal of the agreement.

### **6618 Anticipated developments in law and practice**

The lack of a reliable database that contains Turkish third party comparables may prove to be problematic. It is expected that the Ministry of Finance will invest in training and the establishment of a technical infrastructure to deal with taxpayers' requests and to determine procedural methodology in relation to transfer pricing.

### **6619 Liaison with customs authorities**

The Customs rules in Turkey are not specifically coordinated with the transfer pricing rules. The Customs Authorities have their own legislative guidance for the treatment of inter-company transfers of imported/exported material. Additional TP regulations may create the need to incorporate customs practices into joint legislation. There have been some joint efforts by customs and tax authorities to work on the transactions and to investigate import prices in specific industries and, for example, reports have been written by a customs inspector that challenged import prices.

### **6620 OECD issues**

Turkey is an OECD member country and acknowledges the OECD Guidelines. On the other hand, as Turkey's transfer pricing regulations are new and at the development stage, they have yet to fully incorporate all the principles contained under the OECD Guidelines. The current transfer pricing law provides an impetus for the adoption of improved transfer pricing regulations in accordance with best international practice.

### **6621 Thin capitalisation**

The thin capitalisation issue is re-arranged in the Turkish CIT Law article 12. According to the article, if the ratio of the borrowings from shareholders or from persons related to the shareholders exceeds three times the shareholders equity of the borrower company at any time within the relevant year, the exceeding portion of the borrowing will be considered as thin capital.

The scope of the term 'related parties' consists of shareholders and the persons who are related with the shareholders that own 10% or more of the shares, voting rights or right to receive dividends of the company.

The shareholder's equity of the borrower company is defined as the total amount of the shareholder's equity of the corporation at the beginning of the fiscal year, or the difference between the assets and liabilities of the company. If the company has negative shareholder's equity at the beginning of the year, any borrowings from related parties will be considered as thin capital.

If thin capitalisation exists, the interest paid or accrued, foreign exchange losses and other similar expenses calculated over the loans that are considered as thin capital are treated as non-deductible for corporate income tax purposes. Moreover, the interest paid or accrued and similar payments on thin capital will be re-classified at the end of the relevant fiscal year as distributed dividend and will be subject to withholding tax.

### **6622 Management services**

Although in the past the law did not provide definitive legislation relating to management services, the new transfer pricing article takes the OECD Guidelines as a basis. Through these developments, management services may be subject to greater scrutiny under the transfer pricing regulations.

As per Turkish transfer pricing regulations, management services refer to:

- The services that are performed by the corporate headquarters to other related group companies; or
- The services that are rendered by one group company to another.

These services are usually considered as services that ensure intra-group management, coordination and control functions. The costs of these services are undertaken by the main company, a group member who is responsible for this purpose or another group member (group services centre).

From a Turkish transfer pricing regulations perspective, the following points have to be taken into consideration:

- Whether the service has been actually rendered or not;
- Whether the receiver company(s) needs the service or not; and
- Whether the price of those services are arm's length or not.

The payments that fail the above mentioned points may be criticised from transfer pricing viewpoint and may be non-deductible from a corporate tax point of view.

# 67 United Kingdom

## 6701 Introduction

In recent years, there have been significant changes in the legal framework for transfer pricing in the UK. The most notable change was introduced in the Finance Act 1998, which modernised the UK's rules in line with the introduction of corporation tax 'self assessment'. Self assessment has shifted the onus of compliance from the tax authority to the taxpayer.

The current legislation – contained in Schedule 28AA of the Income and Corporation Taxes Act 1988 (ICTA 88) – is widely drafted and is intended to cover almost every kind of transaction. Since its introduction, there have been major changes to the legislation. With effect from 1 April 2004 the exemption for UK-to-UK transactions was removed and thin capitalisation rules were brought wholly within the transfer pricing regime (see Section 6719).

Further changes affecting the financing of companies were made with effect from 4 March 2005. These changes are aimed at the private equity houses but have wide-ranging effect beyond private equity structures.

Transfer pricing disputes have in the past usually been dealt with informally and resolved by negotiation between the tax authority and the taxpayer. As a consequence, there is (as yet) little case law but a good deal of informal practice that has developed.

In addition to legislative changes there has been a marked increase in the amount of guidance material published by Her Majesty's Revenue and Customs (HMRC) (HMRC, which in 2005 replaced the Inland Revenue is the UK's tax authority) on its interpretation of the law. More recently, the UK government commissioned a review of HMRC's links with large businesses, resulting in a number of changes which impact on transfer pricing enquiries in the UK.

The advent of self assessment for companies has forced companies and partnerships to focus on transfer pricing, regardless of whether or not transfer pricing methodologies (TPM) are the subject of tax authority enquiries.

## 6702 Statutory rules

The UK's current transfer pricing rules – ICTA 88, Schedule 28AA, including later amendments – were enacted in Finance Act 1998 and took effect for all accounting periods ended on or after 1 July 1999.

### *Self assessment*

UK taxpayers are required to self assess their compliance with the arm's length principle in filing tax returns. Companies and partnerships must identify and must themselves make transfer pricing adjustments when submitting their tax returns under self assessment. An important implication of this approach is the potential for penalties and interest for 'getting it wrong'. Penalties are discussed at Section 6709.

The rules apply a 'one-way street' approach. Taxpayers are required to make transfer pricing adjustments where they result in increased taxable profits in the UK but are generally not permitted to make adjustments that result in decreased taxable profits.

A decrease in the taxable profits of the UK party may only be effected through the operation of the competent authority procedures of the relevant double tax agreement (DTA).

### *Control*

The legislation applies to transactions where one party controls the other, or both parties are under common control. The parties exerting control may include companies, partnerships and in certain circumstances, individuals.

'Control' for the purposes of this legislation is defined in ICTA 88, Section 840. It is important to note that control is not confined to situations where one party is the majority shareholder in the other. Effectively, control exists where one party has the power to ensure that the affairs of another party are conducted in accordance with the first party's wishes.

The concept of control set out in ICTA 88, Section 840 is subject to important extensions for transfer pricing purposes under ICTA 88, Schedule 28AA:

- The rules apply to many joint venture companies where two parties each have an interest of at least 40%.
- There are attribution rules to trace control relationships through a number of levels in determining whether parties are controlled for the purposes of the transfer pricing rules.

### *Concept of 'provision'*

The legislation uses the concept of 'provision made by means of a transaction or a series of transactions' to describe the situations to which the legislation applies. Provision is undefined within the legislation, although it is understood that the use of the term is intended to allow the wider consideration of all the terms and conditions surrounding a transaction or series of transactions in deciding whether it has been conducted at arm's length. When introducing the new rules, the UK government said in Parliament in relation to the use of the term 'provision':

*'we chose to use the word 'provision' which means what the transaction provides. That is not a provision in the narrow accounting term... It simply means what the transaction provides for, which has a plain meaning...and, in my view, it needs no further definition'.*

It remains to be seen whether the use of the term will be judicially interpreted as widely as this.

### *OECD Guidelines*

One of the stated objectives of the government was to bring the UK's transfer pricing legislation in line with the OECD Guidelines. This desire has been enshrined in the legislation through the requirement that the new rules be 'construed in such manner as best secures consistency' between the domestic legislation and Article 9 of the OECD's Model Tax Convention on Income and Capital and the OECD Guidelines.

### *Branches and permanent establishments*

Although ICTA 88, Schedule 28AA cannot be applied to dealings between a branch or



permanent establishment and the company of which it is a part, since the two are not separate legal entities, other sections of the legislation as well as the 'Business Profits' Article of the relevant DTA operate to tax the appropriate amount of profit in the UK. In the case of an overseas branch or permanent establishment of a UK company, the profits of the branch will be taxed as part of the profits of the UK company. In the case of a UK branch or permanent establishment of an overseas company, then in accordance with ICTA 88, Sections 11 and 11AA and Schedule A1, income arising directly or indirectly through or from the branch is taxable in the UK. ICTA 88, Schedule 28AA can of course be applied to transactions involving related parties of the legal entity to which the branch or permanent establishment belongs. Hence the overseas associated company of a UK company is also a related party of the overseas branch or permanent establishment of that UK company and ICTA 88, Schedule 28AA could be applied to transactions between the two overseas entities.

### *Secondary adjustments*

HMRC should not make secondary adjustments, such as deemed distributions or deemed capital contributions, as there is no basis in UK law for such adjustments, although there are some provisions in relation to loan relationships but not, since 1 April 2004, for thin capitalisation.

### *Finance Act 2004 – UK-to-UK transfer pricing*

Major changes to ICTA 88, Schedule 28AA were introduced in the Finance Act 2004, and in the Finance (No. 2) Act 2005 as described below.

When it was originally enacted, ICTA 88, Schedule 28AA included an exemption for UK-to-UK transactions, subject to certain restrictions. With effect from 1 April 2004, the government removed the exemption for UK-to-UK (UK-UK) transactions from the transfer pricing legislation. There were two main reasons behind the changes:

- The government was concerned that its existing rules may one day be held to be in breach of the European Treaty (the EU Treaty); and
- The changes would have the effect of counteracting a range of UK tax planning structures, particularly in the Finance and Treasury areas.

Whether current UK rules or documentation requirements breach the European Treaty is an open question and HMRC may have reacted more to the apparent direction of evolving European case law than any settled case.

The main effects of the legislation follow from the two reasons set out above.

HMRC has no great desire to tie up resources investigating UK-UK transactions for no particular purpose but was determined to ensure that it has rules that cannot be challenged under the EU Treaty. Experience of HMRC enquiries since UK-UK rules were introduced has been varied but generally supports this.

As there is no consolidated tax return in the UK, the rules have effect particularly where there is tax at stake, either where tax planning has taken place, or where some more routine aspect of the tax system (such as losses in one company in the group) means that there is tax to be collected. One particular area where the amended rules have an effect is where no charge is currently made, for example, services or the use of assets (including intellectual property).

### *Finance Act 2004 – concessions and exemptions*

In order to mitigate the effect on UK businesses and HMRC, documentation requirements have been relaxed somewhat. There was also a two-year transitional period, which expired in 2006, during which existing penalty rules were not to apply in certain circumstances. Both concessions apply to cross-border transfer pricing as well as UK domestic transactions. In addition, there is a corresponding adjustment mechanism to effect relief on the counter side of a UK-UK transaction for which an adjustment has been assessed.

There are limited exemptions from the transfer pricing rules for 'small and medium sized enterprises' (SMEs), where the definition of SMEs is assessed at a group level. Groups with more than 250 employees, turnover of more than EUR50 million or a balance sheet worth more than EUR43 million will not qualify for the exemption, nor will any SME entering into transactions with a tax haven entity. Because denomination of these thresholds are in Euros, exchange rate movements may have an impact on a given SME group's qualification for exemption from the transfer pricing rules from one year to the next. Also, HMRC has reserved the right to direct that the rules will apply to any medium sized company where it considers that transfer pricing has been manipulated egregiously.

There are also some exemptions for dormant companies.

### *Finance Act 2004 – thin capitalisation*

Until 1 April 2004, thin capitalisation was generally dealt with separately from transfer pricing in UK tax legislation (ICTA 88, Section 209). Although the legislation could apply to payments other than interest, in general interest paid by a UK company on a loan from a related party could be questioned as being at a non-arm's length rate, if either the interest rate or the amount of the loan were excessive. Under these provisions a tax deduction would be denied for the interest deemed to be 'excessive' (i.e. the interest paid in excess of the market rate on the part of the loan that a third party would have been prepared to lend and all interest on loans that would not have been available at arm's length). The excessive interest would then be recharacterised as a dividend and advance corporation tax (ACT) could be payable. ACT was abolished with effect from 6 April 1999. Section 209 is mandatory and applies without the need for a specific direction by HMRC.

With effect from 1 April 2004, the government amended its approach to thin capitalisation to bring the policing of thin capitalisation issues wholly within the transfer pricing regime, so that thin capitalisation issues are governed by ICTA 88, Schedule 28AA.

The changes in the thin capitalisation rules have raised concerns, in particular the removal of the current UK grouping rules, which provided that the entire UK grouping (which includes any UK resident parent and any subsidiary of it) was regarded as a single entity in determining the arm's length amount of debt. By contrast, the amended legislation provides that only the value of shareholdings in direct or indirect subsidiaries of the borrower are taken into account in determining the arm's length amount of debt. The relationship of the borrowing company with its parent is disregarded. This means that the rules affect both inbound investors with respect to external and group borrowings, and UK headed groups with external borrowings. This is mitigated for UK headed groups by a compensating deduction available to a guarantor where a

thin capitalisation adjustment follows from the provision of a guarantee. In this way, tax deductions for interest paid to unconnected lenders may be retained.

#### *Finance (No. 2) Act 2005 – transfer pricing and loan relationships*

Further provisions were introduced by Finance (No. 2) Act 2005 related to the manner through which financing is effected; these provisions are particularly aimed at, but not limited to, private equity financing. These provisions are effective from 4 March 2005, with transitional arrangements for existing financing which expired on 1 April 2007.

The changes restrict interest deductions to an 'arm's length' basis, where parties are 'acting together' in relation to the financing of a company. The relevant provisions apply transfer pricing rules where 'persons' who collectively control a company or a partnership have 'acted together' in relation to the financing arrangements of that company or partnership. The changes have caused a great deal of concern since private equity financing of UK companies has traditionally followed a model agreed with HMRC. Given the widely drawn provisions, a third party bank could be drawn into the rules because it has agreed to provide finance for a deal, though generally such loans are accepted by HMRC as arm's length. Note that there are clearance procedures for companies to obtain certainty with respect to their particular circumstances.

Guidance has been issued by HMRC on what constitutes acting together for the purposes of new Paragraph 4A(1)(c) Schedule 28AA which indicates that 'acting together' can be construed very widely.

### **6703 Other regulations and guidance**

Prior to the issuance of a Consultative Document in October 1997, which preceded the introduction through Finance Act 1998 of ICTA 88, Schedule 28AA, there had been only limited official statements on transfer pricing. These represented guidance only and did not have the force of law.

#### *The Consultative Document and the March 1998 budget announcements*

The Consultative Document, in addition to setting out the proposed new legislation, gave commentary outlining some of the issues considered by the government in developing the 1999 rules. Some of the key issues considered and outcomes of the consultative process are as follows:

- The government considered no *de minimis* provision necessary. The government left it to HMRC to ensure that inspectors balance the quantum of the potential transfer pricing adjustment against the related costs of an enquiry in selecting cases for examination.
- Despite public concern, the government considered it necessary to bring certain joint venture arrangements within the ambit of the legislation even though no 'control' relationship exists. However, as a concession to pre-existing joint ventures, under which it may not be possible to renegotiate prices at short notice, transitional provisions were introduced with the effect of 'grandfathering' these pre-existing joint ventures for up to three years.
- The government decided not to impose a specific transfer pricing disclosure requirement in taxpayers' annual tax returns.

- A decision was made not to legislate provisions that allow secondary adjustments. However, the government indicated in the Consultative Document that it wished to encourage the voluntary restoration of funds.
- Following considerable support during the consultation process for the introduction of a formal APA procedure, the government announced plans to engage in further consultations with taxpayers and then introduced new APA legislation in the following year's Finance Bill.
- Draft documentation guidelines were set out in an appendix to the Consultative Document. These guidelines outlined a list of documents under three different categories: (i) documents expected to be prepared and maintained for transfer pricing purposes; (ii) documents that should be retained if produced for normal commercial purposes; and (iii) documents that taxpayers are not expected to maintain. Following considerable feedback during the consultative process, the government announced that the draft guidance note was to be revised by HMRC and the revised note would place greater stress on establishing broad principles and less on identifying particular types of documents. The revised note was released in October 1998, included in Tax Bulletin issue 37, and is discussed below (see Section 6709).
- Specific transfer pricing penalty provisions were considered but not introduced (see Section 6709). A guidance note on HMRC's practice on penalties was issued in December 1998, in Tax Bulletin 38, and is discussed below (see Section 5109).

### *HMRC manuals*

HMRC manuals are prepared for internal use by the tax authority but are also publicly available, including on-line versions accessible on the HMRC website. In general these manuals provide a detailed description of how the tax authority interprets the existing legislation and a rationale and explanation of its development. They also provide guidance on the factors to be considered by the tax authority when applying the legislation, such as the circumstances indicating the presence of potential transfer pricing issues to address and matters to consider when deciding whether to pursue an enquiry.

HMRC published a new manual – the International Manual – in October 2003, and has periodically updated specific sections on an ongoing basis. The manual contains guidance on the principles of 'double taxation relief', an introduction to DTAs and guidance on controlled foreign companies (CFCs) legislation; guidance on transfer pricing, cross-border financing and thin capitalisation legislation; and practical advice to inspectors on conducting enquiries in these areas. The manual represents a significant revision to, and expansion of, earlier material on transfer pricing, and a departure in style, especially in the detailed and at times controversial practical guidance sections. The International Manual incorporates much of the material published from 1998 in Tax Bulletins on documentation, penalties, case selection and share options and it also provides additional material. The manual is essentially training material aimed in the first instance at HMRC staff in local offices who conduct transfer pricing enquiries.

The practical guidance on transfer pricing covers the following three main areas:

- (1) Conduct of a transfer pricing enquiry including:
  - (a) case selection;
  - (b) evidence the Inspector should collect; and
  - (c) interpretation of transfer pricing reports and comparables.
- (2) Specific lines of attack including:
  - (a) transfer pricing methods used;
  - (b) use of ranges and the way prices are set; and
  - (c) other tax approaches (e.g., permanent establishment, residence etc).
- (3) 'High risk' transfer pricing structures with those including:
  - (a) commissionaire, commission agents;
  - (b) toll and contract manufacturing;
  - (c) transfers of intellectual property; and
  - (d) procurement and research and development (R&D) services.

Taxpayers can glean much from the manuals as to what they can expect in the case of a transfer pricing enquiry or in relation to tax-advantaged structures.

#### *Corporation Tax Reform consultation 2003*

In August 2003 the Inland Revenue issued a consultation document entitled Corporation Tax Reform, which signalled its intentions to amend the UK's transfer pricing rules. In December 2003 the Inland Revenue (IR) released draft legislation on transfer pricing and thin capitalisation together with guidance in a technical note entitled 'Corporation Tax Reform: the Next Steps', including draft guidance on documentation requirements and the enquiry process. The legislation was incorporated in the Finance Act 2004 and became effective from 1 April 2004.

#### *Review of Links With Large Business 2006*

In 2006 Sir David Varney, former Chairman of HMRC, delivered the findings of the Review of Links with Large Business. The review was commissioned by the government to examine the relationship between HMRC and large business. Sir David Varney chaired a consultative committee comprising representatives of business, HMRC and HM Treasury, and wider consultations were included in the review process. The stated focus was on improving the attractiveness of the UK business tax administrative environment.

The report, which was issued in November 2006, makes a series of recommendations and proposals. Some are directly relevant to the UK's transfer pricing environment, whilst others are wider in scope but will have implications for transfer pricing. HMRC has since implemented a series of organisation changes which affect how it resources transfer pricing enquiries and changes in how it conducts transfer pricing enquiries and how it settles enquiries through negotiations and litigation. Further details are provided in Section 6006 and in other sections where relevant, by reference to 'the Varney review' or 'the Varney report'.

### 6704 Legal cases

Very few cases have been brought before the courts on transfer pricing issues in the UK. The case law that does exist, such as *Watson v Hornby* (1942), *Sharkey v Wernher* (1955) and *Petrotim Securities Ltd v Ayres* (1963), establishes the principle of arm's length prices for transactions between related parties as is now embodied in the legislation. However, HMRC's strategy for the conduct of enquiries and settlements has meant that HMRC has invested significant resources in litigating cases; the first such cases are beginning to be litigated at the first level tribunal stage, the Special Commissioners.

There are two more recent cases, which are of importance in the interpretation and application of the legislation which preceded ICTA 88, Schedule 28AA.

#### *Ametalco UK v IR Commrs (1996)*

The facts of *Ametalco* concerned the nature of the transactions to which the transfer pricing legislation could be applied. The UK company had, at the request of its parent, advanced an interest free loan to a related company. Under the provisions of ICTA 88, Sections 770–773, the tax authority claimed the right to impute 'notional' interest on the loan and tax the consequent 'notional' income in the hands of the UK lending company.

The tax authority maintained that the legislation applied to all types of transaction, including loans or advances of money and in their view this type of transaction was covered by ICTA 88, Section 773, as a 'business facility of whatever kind'. Various arguments to refute this were advanced by the taxpayer but these were rejected by the Special Commissioners who decided in favour of the tax authority.

This case was important in relation to the old legislation, since it clarified the position with regard to the applicability of the legislation to loans and interest in general, and interest free loans in particular.

#### *Glaxo Group Ltd v IR Commrs (1995)*

In *Glaxo Group Ltd*, several companies in the Glaxo group had many years of open (unagreed) assessments as a result of unresolved appeals. HMRC suspected that the companies had been engaged in transactions with related parties on a non-arm's length basis and sought to increase the open assessments to reflect transfer pricing adjustments.

Glaxo contended that transfer pricing adjustments had to be effected by raising new assessments and not by amending existing open assessments. There is a six-year time limit on new assessments (except in cases involving fraud or negligence) and this would have limited the adjustments the tax authority could make.

It was held that transfer pricing adjustments could be made to any open assessment. The current status of the law is, therefore, that the tax authority can make transfer pricing adjustments with respect to any 'open' year and, subject to certain conditions, any closed year in the previous six years.

#### *Special Commissioners' decision – Waterloo plc and other v IR Commrs (2001)*

In addition to these court cases, appeals on transfer pricing – which are heard in the

first instance by the Special Commissioners, although not binding precedents – create a rebuttable presumption on the interpretation of the legislation.

In July 2001, the Special Commissioners considered the transfer pricing rules in connection with the costs associated with the operation of international share plans by Waterloo plc (the name of the company was made anonymous in the published judgment). The Special Commissioners held that Waterloo plc should be taxed as if it had charged a fee to its overseas subsidiaries for providing share benefits to their employees, and that an upward adjustment to Waterloo's taxable profits should be made under the transfer pricing rules.

The Special Commissioners decided that providing the ability for the employees of the subsidiaries to participate in the option arrangements was a 'business facility'. The Special Commissioners accepted that the options were remuneration for the employees. The parent company therefore provided some of the remuneration of employees of the subsidiaries, by means of the totality of the arrangements. Provision of remuneration to the subsidiaries was the valuable 'business facility' in question.

The 'business facility' was made directly to the subsidiaries employing the individuals who participated in the option arrangements. ICTA 88, Section 770 as amended by Section 773(4) required a 'giving' of facilities to a recipient – not a clear transaction with a sale and a purchaser – therefore, there was no need to identify a transaction directly between the parent and the subsidiary. The Special Commissioners' decision was that there was a clear, valuable benefit from the share scheme to the subsidiary employing the relevant employees, and the value of that benefit was capable of being calculated. On a wider level, the case provides a presumption that ICTA 88, Section 773(4) allowed HMRC to tax the total facility provided intra-group, and did not require a transaction-by-transaction analysis: 'the phrase 'business facility' is a commercial not a legal term, and ... that where a commercial term is used in legislation, the test of ordinary business might require an aggregation of transactions which transcended their juristic individuality' (paragraph 57 of the published decision).

Following this reasoning, Waterloo plc failed in its argument that ICTA 88, Section 770 did not apply because the transactions took place between persons not under common control (i.e. the share scheme trustee and Waterloo plc).

HMRC published its interpretation of the Waterloo case in Tax Bulletin 63, in January 2003, and in the International Manual. HMRC has subsequently issued guidance on its application of the arm's length principle to share plans in light of the new accounting rules for share-based payments under IFRS, which apply to accounting periods beginning on or after 1 January 2005.

### **6705 Burden of proof**

Under current legislation, the burden of proving that transfer prices are at arm's length falls on the taxpayer's shoulders. The act of submitting the return under self assessment implicitly assumes that the taxpayer has made all necessary adjustments to taxable profits to take account of non-arm's length pricing.

Where the tax authority considers there has been tax revenue lost as a result of negligence, the burden of proving that this was a result of the taxpayer's negligence rather than for the reasons given by the taxpayer, falls on the tax authority.

## 6706 Tax audits

### *The enquiry process*

Under self assessment, a company submits a corporation tax return and its statutory accounts, with a due date for submission normally twelve months after the end of the accounting period to which the return relates. HMRC may commence an enquiry into the return by the issuing of a formal notice by the local tax inspector with responsibility for the company, within specified time limits. Once an enquiry has been initiated the scope may extend to anything covered in the tax return, including transfer pricing. HMRC is not obliged to state reasons for initiating an enquiry.

### *Transfer pricing enquiry governance and management*

HMRC recently revised its practices and procedures in order to achieve the objectives set out in the Varney Report. Specifically, HMRC aim to provide:

- greater certainty,
- implement an efficient risk based approach to dealing with tax matters,
- speedy resolution of issues, and
- clarity through the effective consultation and dialogue.

In relation to transfer pricing, HMRC have stated that they aim to conclude most enquiries within 18 months, with only the most complex cases taking 36 months. The resources available to the transfer pricing team and revisions to practices and processes are intended to assist in delivering this target.

### *Transfer pricing team*

The size and make-up of the transfer pricing team is dependent on the scale and complexity of the enquiry. The team is lead by a Customer Relationship Manager of the business and consist of members from various disciplines, including at least one transfer pricing specialist from the newly formed Transfer Pricing Group (TPG).

The TPG consists of dedicated specialists from the Large Business Services and other specialist areas. The role of the transfer pricing specialist is to support the team as appropriate, from providing specialist advice to hands on involvement.

### *Practices and procedures*

Under the revised procedures, each transfer pricing case will pass through a series of 'stage gates'. The adoption of stage gates in the enquiry process aims to provide a structured and consistent approach in relation to the management and governance of enquiries. Each stage gate centres on a key decision that needs to be made and approved before the enquiry proceeds to the next gate.

The decision at each stage gate is subject to review and approval. The approval process consists of a panel process, though in some instances to aid swift resolution of enquiries a panel member can take a decision without the full panel. The panel comprises representatives of each directorate involved in transfer pricing work. The most important decisions in larger cases will be escalated to the Transfer Pricing Board which is accountable for all HMRC transfer pricing cases.



### *Stage Gate 1: Risk assessment*

A risk assessment typically comprises an evaluation of the quantum risk, behavioural risk and transaction risk.

- Quantum risk relates to the value of tax at stake. In this regard, a transaction is considered 'high risk' if the value of the transaction is such that incorrect pricing could lead to a significant understatement of taxable profits.
- Behavioural risk considers the systems and processes the business has in place in order to manage its transfer pricing issues for compliance.
- Transaction risk is concerned with the nature of the transaction and such issues as its complexity and whether it involves points of principle.

In HMRC's view a risk assessment carried out by HMRC inspectors should ideally include the review the following information:

- Company information readily available to HMRC, including:
  - (a) A review of any transfer pricing documentation.
  - (b) A detailed examination of six years' consolidated group accounts and of accounts of individual UK and appropriate non-UK entities.
  - (c) Consideration of the group structure and identification of tax haven/shelter countries.
  - (d) A review of industry trends, details of the company's position within its market sector, and recent developments within the group (new acquisitions, new locations, etc).
  - (e) A review of databases for multiple year data and potential comparables.
- Information on other jurisdictions, including a review of company returns in other jurisdictions. It should be noted that, to obtain information on other jurisdictions in a multinational group, HMRC would need to ask the company specifically for this or obtain the information via the exchange of information procedures contained in tax treaties or under EU rules.
- Information from other UK government tax functions:
  - (a) Liaison with PAYE office for details of highly paid UK staff.
  - (b) Liaison with Customs and Excise.

The last point essentially prompts tax inspectors to use other government tax departments to obtain information. PAYE (employment tax) is part of the UK's income tax function and they can provide the tax inspector with information not otherwise available, for example on share options reported for highly paid employees and not booked in the local accounts. With regard to Customs and Excise, which collects revenue primarily from value added tax (VAT) and customs duties, the tax inspector may obtain details of VAT registrations and the movement of goods from which they could identify the price of goods moving into and out of the UK. HMRC replaced the former Inland Revenue and Customs and Excise departments with a single department, so that companies should over time expect greater coordination and information sharing between the various tax functions.

As part of the risk assessment, HMRC will normally invite businesses to take part in pre-return and pre enquiry discussions and relevant information would be provided at this stage. However, HMRC cannot require businesses to provide information until an enquiry has been formally commenced.

A company may choose to cooperate or not to cooperate – understanding the potential negative impression that may be created if it chooses not to cooperate with the pre-enquiry process. In the event that businesses are unwilling or unable to take part in these discussions, the decision at this stage gate will be based on information available, such as statutory accounts that accompany tax returns.

### *Stage Gate 2: Business case*

The outcome of the risk assessment would normally be a decision as to whether there are transfer pricing points that would justify further investigation. If there are such cases, the next action would be to develop a business case for opening an enquiry.

The business case is the formal justification for opening an enquiry and normally includes, but is not limited to, the following:

- A description of the issues in point,
- Risks involved in settling the case,
- The resource required to conduct the enquiry, and
- Estimate of the timescale for completing the enquiry.

The business case is an internal HMRC document and will not be provided to the business. Although there is no statutory obligation, HMRC will usually communicate to a business the reason for initiating an enquiry.

### *Stage Gate 3: Timetable and action plan*

HMRC use action plans and timetables, which act as ‘roadmaps’ for the enquiry. An enquiry commences at the time HMRC gives notice of enquiry into a company’s tax return.

Typically information, including contemporaneous transfer pricing documentation, will be requested by letter. The taxpayer’s response will also be written, providing the documentation, data and information requested together with any accompanying analysis to support its position. Subsequent meetings between the tax authority and the taxpayer at which the information provided to the tax authority and areas of particular concern can be discussed further.

In relation to a transfer pricing enquiry, HMRC currently has no statutory right to visit a taxpayer’s premises or interview its staff and such visits should be by taxpayer invitation. Such visits have not been typically performed in the past, although such requests are becoming increasingly common.

The enquiry will be treated as completed at the point at which:

- adjustments to taxable profits are agreed in writing between HMRC and the business,
- it is agreed no adjustment is required, or

- the time at which it is established that no agreement can be achieved and that the enquiry will be subject to formal proceedings.

HMRC aims to conclude enquiries (that is, up to the point when a resolution decision is made) within 18 months. However, a longer timescale (but no more than 36 months) may apply in exceptional circumstances which are both complex and high risk. In this regard, there has been a reduction in the average time taken to resolve enquiries; however, the average age of cases open at the end of March 2008 was 31 months.

#### *Stage Gate 4: Review*

The timetable is reviewed every 6 months during the enquiry. The objective of this stage is to ensure that the enquiry is progressing in accordance with the action plan and to explore whether the enquiry strategy should be revisited.

#### *Stage Gate 5: Resolution decision*

This stage occurs at the point at which sufficient information is available, and sufficient analysis has been carried out, for HMRC to take a view over the acceptability of the pricing under enquiry, and what adjustments, if any, are necessary. The options at this stage are:

- to close the enquiry without adjustment,
- to seek a negotiated settlement, or
- to progress to litigation.

At the end of an enquiry, the inspector must issue a closure notice, which will present conclusions as to the correct amount of tax payable. The taxpayer has 30 days to make any amendment to its tax return (if any amendment is required). Beyond that, the inspector may amend the return within the next 30 days.

#### *Triggers for enquiry*

HMRC have identified particular risk areas that are most likely to trigger a full transfer pricing enquiry. These include:

- The existence of tax haven entities – HMRC will identify groups with entities located in tax havens and assess whether their profitability is commensurate with the level of activities carried out by these entities. For example, limited operations of entities located in tax havens that enjoy healthy profits may give rise to a transfer pricing enquiry.
- Lower returns in the UK than in the group generally – HMRC will identify companies with profit margins that are lower in the UK than in the group generally and assess whether there are reasons to believe that this should not be the case.
- The UK company produces only a routine, low margin profit – HMRC will identify companies that possess the resources to generate high margin profits, yet produce only a routine, low margin profit. To understand the economic reality of a particular entity, the inspector would review if there was, for example, heavy investment in the entity, a highly skilled and remunerated technical or R&D workforce or intangibles (e.g., trade names, know-how, patents, etc.).

- Royalty or management fee payments that do not appear to make commercial sense and which substantially impact on the UK profits. Examples of such payments include:
  - (a) A brand name unknown in the UK.
  - (b) Technology to which significant value has been added by processes carried out in the UK.
  - (c) Nebulous bundles of intangibles.
  - (d) Poor performance over a number of years. Given the other criteria relating to margins, in practical terms this refers most often to losses. Losses attract the attention of HMRC and it will expect evidence that there is the prospect of super profits in later years to justify the risk of continuing losses.
- Changes in the risk profile and hence the reward of the UK group. Examples of this include:
  - (a) Distributor becomes commissionaire (and net profits decrease).
  - (b) Full manufacturer becomes contract manufacturer.
  - (c) R&D activities that once generated royalties move to contract basis.
  - (d) Cost sharing arrangements are introduced.

HMRC concedes that consideration should be given to both the potential tax at risk and the level of difficulty in establishing the arm's length price, although there is no *de minimis* limit in the UK's transfer pricing legislation.

### *Practical issues*

The International Manual provides further detailed practical guidance and examples of HMRC's approach and interpretation of transfer pricing principles.

### **6707 Information powers**

HMRC's powers are currently provided for solely in general law (Section 19A Taxes Management Act (TMA) 1970). The Finance Bill 2008 introduced changes to information powers which will become available to HMRC in dealing with transfer pricing and other tax issues on or after 1 April 2009. It is not expected that this will have significant impact upon HMRC's capacity to carry out transfer pricing audits effectively. In addition to changes to the legislative basis for information powers, HMRC has undertaken to make wider use of its information powers in response to recommendations contained in the Varney report.

The UK tax authority does not have the power to obtain information on non-UK resident parents of UK companies, nor on fellow subsidiaries (in non-UK controlled groups) that are not UK resident. It should be noted, however, that the UK has an extensive DTA network, as a consequence of which the tax authority is able, at least in theory, to obtain a vast amount of information under the 'Exchange of Information' Article in the relevant DTA. If the taxpayer does not provide information in response to the HMRC's requests then, where considered necessary, inspectors may enter a company's premises and inspect documents related to transfer pricing issues under investigation. HMRC also has powers enabling it to obtain information from third

parties where it considers such information would be helpful in progressing enquiries. However, such powers are used rarely and in extreme circumstances, since these powers are viewed by the HMRC itself as controversial and requiring sensitive handling. Failure to provide information as requested is more likely to result in an estimated assessment being raised, for which the company must then provide the evidence to refute.

Under legislation introduced in the Finance Bill 2008, HMRC will have a combination of an inspection power (the right to access and inspect business premises, business assets and business documents) and an information power (the power to require the production of information and documents). HMRC will have the powers to:

- access records before returns are filed;
- turn up unannounced to check the records;
- routinely have access to business premises and assets and have the right to copy or remove documents;
- the records and documents that HMRC will be able to access are very widely defined; and
- there is no right of appeal against an inspection.

Consultation is ongoing but the expectation is that the powers will be introduced and be available to HMRC next year (on or after 1 April 2009).

### **6708 Revised assessments and the appeals procedure**

Where the tax authority and the taxpayer are unable to agree, then either party may take the case to a body of commissioners, although this is typically done by the tax authority. Appeals on transfer pricing issues are heard by the Special Commissioners, who are a tribunal of tax experts.

It is worth noting that an appeal must be made by the taxpayer within 30 days of receiving an assessment, and the grounds for the appeal must be given. Thus, where the tax inspector has made transfer pricing adjustments to an existing 'open' assessment (under the previous regime), or stipulated an amendment to the tax return (under the current regime), it is likely that the formal appeal will have already been made, even though the case will not yet have been put before the Special Commissioners.

It should also be noted that the Special Commissioners may vary the assessment upwards as well as downwards and thus, once the case is heard, it is possible that the assessment could be finalised in an amount greater than that shown on the assessment raised by the tax authority and under dispute.

The taxpayer or the tax authority may appeal against a decision of the Special Commissioners on a point of law (but not a question of fact). This appeal would then be heard by the High Court, with any subsequent appeals being heard by the Court of Appeal and then the House of Lords. If a question of European law is involved, any of these courts can refer the case to the European Court in Luxembourg.

### **6709 Additional tax and penalties**

Specific penalty provisions for transfer pricing have not been formulated. Instead the general rules (found in FA (Finance Act) 1998 Schedule 18 and FA 2007 Schedule 24 for self assessment tax returns) are to be applied.

### *Finance Act 1998*

For return periods beginning before 31 March 2008, penalties may be levied for certain acts or omissions either in a fixed amount or calculated as a tax related penalty, depending on the offence. For example, the failure to make a corporation tax return initially results in a small fixed penalty but becomes a tax-related penalty for a delay in submitting the return of more than six months from the due date.

The penalties of most relevance to transfer pricing are for:

- Failure to provide information or documents under a formal notice to do so (such notices are rare) – this varies between £50 and £300 but, once levied, continued failure incurs further penalties, which are charged on a daily basis.
- Negligently or fraudulently filing an incorrect tax return (or, if an error or mistake later becomes known, failing to report this in a timely fashion). This is subject to a maximum penalty of 100% of the underpaid tax and is the more significant risk for most taxpayers under the self assessment regime.

Interest will normally be charged on tax underpaid and is calculated from the day on which the tax was originally due. The rates at which this interest accrues are published but in general they are close to, but higher than, ordinary bank rates.

Any interest or penalties paid are not tax deductible, although the treatment of interest is amended under corporate self assessment (for accounting periods ending on or after 1 July 1999). In some cases, the professional fees incurred in the course of the HMRC investigation are not tax deductible.

### *Negligence*

Cases of fraud, which might involve criminal sanction, are likely to be fairly rare. The more difficult practical issue is what constitutes negligence. HMRC's guidance on self assessment penalties, within the framework of the current transfer pricing legislation, is in the December 1998 Tax Bulletin and incorporated in the International Manual.

As the Tax Bulletin states, neither the English courts nor HMRC have ever attempted a detailed definition of negligence. Nonetheless, it is clear that there is an obligation on taxpayers to do what a reasonable person would do to ensure that their returns are made in accordance with the arm's length principle. HMRC suggest that this would involve but would not necessarily be limited to:

- Using their commercial knowledge and judgment to make arrangements and set prices that conform to the arm's length standard.
- Being able to show (for example, by means of good quality documentation) that they made an honest and reasonable attempt to comply with the arm's length standard.
- Seeking professional help where they know they need it.

The emphasis is very clear that to avoid any suggestion of negligence the taxpayer must have set and documented a reasonable transfer pricing policy and must in practice apply that policy. HMRC have been at pains to point out that documentation will not in itself free a taxpayer from the possibility of a penalty, if that documentation does not show that it had good grounds for believing its arrangements and prices to be in accordance with the arm's length principle.

### Mitigation of penalties

For return periods beginning before 31 March 2008, HMRC will continue to mitigate penalties in line with its general principles for disclosure, co-operation and size and gravity. The December 1998 Tax Bulletin is silent in this area except that in relation to size and gravity it indicates that the HMRC will take into account all of the following:

- The absolute size of the adjustment.
- The size of the adjustment relative to the turnover and profitability of the business against which the adjustment is being made.
- Where this is possible, the size of the adjustment in relation to the volume and value of the related party transactions giving rise to the adjustment.

Based on experience to date, penalties have rarely been imposed on transfer pricing adjustments.

### Revised penalty regime (FA 2007)

The Government announced changes in the operation of the penalty regime, which take effect for return periods beginning after 31 March 2008 where the return is filed after 31 March 2009. Penalties can be charged where a document is given to HMRC which contains an inaccuracy leading to an understated liability to tax or an inflated loss or repayment claim, and the inaccuracy is either careless or deliberate.

Under the new rules, a maximum and minimum penalty banding has been introduced that reflects the degree of culpability. These bandings are set by the legislation, and HMRC will be bound to apply the bandings where the circumstances dictate. The degrees of culpability and associated penalty ranges are summarised below.

| Description  | Range for 'unprompted disclosure'<br>(% of the potential lost revenue) | Range for 'prompted disclosure'<br>(% of the potential lost revenue) |
|--|--|--|
| Mistake  | 0%   | 0%   |
| Failure to take reasonable care.<br>(failure less than 12 months)  | 0–30%  | 10–30%   |
| Failure to take reasonable care.<br>(failure 12 months)  | 10–30%   | 20–20%   |
| If the inaccuracy is deliberate but the taxpayer does not make arrangements to conceal it.   | 20–70%   | 35–70%   |
| If the inaccuracy and the taxpayer makes arrangements to conceal it (for example, by submitting false evidence in support of an inaccurate figure) | 30–100%  | 50–100%  |

A penalty is payable on the potential lost revenue, which is the additional amount due or payable in respect of correcting the inaccuracy or assessment.

However, the new rules allow for penalties on losses where no extra tax is payable. Where a loss has been wrongly recorded and is used to reduce tax payable, the potential lost revenue is based on the actual tax. However, if the loss is not fully utilised, or not utilised at all, the potential lost revenue is calculated on 10% of the amount of the unutilised loss.

HMRC may suspend all or part of a penalty for a careless inaccuracy if suspension will help avoid further penalties in the future, for example by encouraging improvements in a taxpayer's systems and processes used for recording transactions and preparing tax returns. If HMRC is satisfied at the end of the period of suspension that the conditions of suspension have been complied with, the penalty will be cancelled. However, if, during the period of suspension, the taxpayer becomes liable for another penalty, the suspended penalty becomes payable.

Where inaccuracy resulted in an amount of tax being declared later than it should have been, the potential lost revenue is 5% of the delayed tax per year, or part of a year.

These changes in penalty regime are expected to result in a significant increase in the number of penalties applied in transfer pricing enquiries.

### *Documentation requirements*

Notwithstanding the change in the burden of proof, unlike many other transfer pricing regimes, the UK has not issued specific regulations governing the documents that a taxpayer is required to prepare in order to support transfer pricing. Instead the UK has preferred to rely on the general rule for self assessment that 'requires taxpayers to keep and preserve the records needed to make and deliver the correct and complete return'. This lack of certainty over what documents should be maintained has been a source of some concern. This has been increased by the threat of significant penalties that may be levied against taxpayers who could have been said to have been negligent in preparing their tax returns by failing to have adequate transfer pricing documentation available to support their decisions.

In light of these concerns, in October 1998 HMRC provided guidance in Tax Bulletin 37 on record-keeping requirements. The direct guidance set out in the bulletin covered five areas, indicating that taxpayers should prepare and retain such documentation as is reasonable, given the complexity or otherwise of the relevant transactions (or series of transactions), and which identifies:

- Relevant commercial or financial relations falling within the scope of the legislation.
- The nature and terms of relevant transactions (including transactions that form a series, and any relevant off-setting transactions).
- The method or methods by which the nature and terms of the transactions were arrived at, including any study of comparables and any functional analysis undertaken.
- How that method has resulted in arm's length terms, or, where it has not, what computational adjustment is required and how it has been calculated.



- The terms of relevant commercial arrangements with both third and related parties.

It is clear from this guidance that HMRC expected detailed documentation to be available. Furthermore, there is a strong suggestion that to be able to support the view that the pricing method chosen results in arm's length terms, it is necessary to include in that documentation a study of third party comparables. This will usually mean comparison with comparable third party transactions and/or with profitability earned by third parties. Without this it seems that HMRC will regard any documentation as incomplete. In order to be satisfied that the comparables are truly comparable, or to evaluate the results obtained, it would normally be necessary to carry out a detailed analysis of the risks and functions undertaken by a particular business ('functional analysis').

There has since been some relaxation of HMRC's expectations on documentation, in conjunction with the removal of the UK-to-UK exemption, and further guidance has been incorporated into the International Manual. In particular, whilst HMRC still requires that there be evidence available to support arm's length pricing at the time a tax return is submitted, the material recording that evidence may be prepared and provided to HMRC in response to a specific request, rather than as a matter of course. Failure to respond to such a request within a reasonable time would expose a company to the risk of penalties.

### **6710 Resources available to the tax authorities**

The key resource for transfer pricing enquiries is the TPG (as discussed in section 6706 above). Within the TPG, there is a centralised specialist transfer pricing unit which is part of HMRC's head office (International Corporation Tax (CT)) and this unit has traditionally worked on investigations into the affairs of large multinational groups.

### **6711 Use and availability of information on comparables**

The principles in the OECD Guidelines have been espoused by the UK and are applied generally. To the extent these recommend the use of comparable information, therefore, then this is an acceptable means to justify a transfer pricing policy. Furthermore, the reference to comparables in HMRC's guidance notes on penalties and documentation make it evident that information on comparables will continue to be a crucial element in practice in defending transfer prices in the UK.

The tax authority has access to its own sources of comparable data and HMRC International uses a commercially available database of UK company results (see below).

HMRC has stated that the comparable uncontrolled price (CUP) method should be considered to be the most appropriate pricing method in principle but other methods may be used where the necessary evidence to use the CUP method is unavailable.

#### *Availability*

All UK companies, both public and private, are required to prepare statutory accounts and file these with the Registrar of Companies at Companies House. Certain companies, such as small or medium-sized companies, need only provide abbreviated accounts with a limited amount of detail. Copies of these accounts are publicly available but their usefulness may be limited by the amount of detail given.

There are also several databases available commercially, which contain a summary of each company's financial results for several years, hence facilitating access to potentially comparable information. The usefulness of these databases is limited, of course, by the quality of their source information. Inspectors also have access to and use these databases to study comparables as well.

Both the tax authority and company advisers are bound by confidentiality considerations in respect of information obtained through work on other companies for the purposes of disclosure to third parties. In reality, both parties accrue considerable expertise and knowledge through the consideration of relevant issues, which can be used in future enquiries. However, HMRC does not overtly use 'secret comparables' to challenge taxpayer prices, although it might use them in selecting cases for enquiry.

### **6712 Risk transactions or industries**

There are no transactions or industries that are excluded from the scope of the transfer pricing legislation. If a particular industry or issue has come to the attention of HMRC International CT, the tax authority is likely to use the information and experience gained in dealing with one taxpayer in investigating other similar taxpayers. HMRC's Large Business Service (LBS), which deals with the tax affairs of larger companies and groups, has increasingly established industry specialists within a number of offices to focus on particular industries.

At the local level, all transactions and industries are at risk. There has been a tendency for queries to be raised not in connection with specific industries but in respect of certain inter-company transactions. In particular, focus has been given to transfer prices related to interest, royalties and management fees, rather than the transfer prices of goods. The risk based approach to enquiries explained at section 6706 should govern the focus of HMRC enquiries.

### **6713 Limitation of double taxation and competent authority proceedings**

In connection with the operation of the MAP, the following should be noted:

- HMRC International CT deals with cases presented under the MAP in respect of transfer pricing.
- HMRC may provide a unilateral solution to double taxation, or consult under the MAP to reach agreement with the other country.
- There is no guarantee that a corresponding adjustment will be made since the tax authority is not required to reach a resolution under the MAP.
- If a UK company is considering seeking a corresponding adjustment as a result of an adjustment by foreign tax authorities, a protective claim should be made as soon as possible to avoid a situation where the time limit for a corresponding adjustment has expired.
- The provisions of ICTA 88, Section 815AA clarify the time limits applicable to the MAP. In the absence of a specific longer time limit in a treaty, a time limit of six years from the end of the accounting period to which the adjustment relates, applies for making claims to cases presented to the UK competent authority.

- Section 815AA explains how an agreement reached under the MAP is put into effect in the UK; it also enables consequential claims to be made within 12 months of the notification of a solution or mutual agreement. This allows, for instance, additional loss relief claims to be made even though the normal time limits for a loss claim may have expired.
- Section 815AA makes clear that a case presented under the MAP is not a claim to relief and therefore is not subject to the general rules governing such claims in the UK.
- There is no formal method of making a case under the MAP; the taxpayer should simply apply in writing stating the details of its case including the years concerned, the nature of the case and details of the parties involved.

Secondary adjustments are sometimes made by overseas tax jurisdictions following a transfer pricing adjustment. A secondary adjustment might include deeming a notional dividend or capital contribution to have been paid so as to balance the results of the company for tax purposes applying the (now adjusted) transactions with its financial statements. While this is not generally done in the UK, the question does arise as to whether the UK would recognise a secondary adjustment made in another country and, if so, how it would be treated. In the Consultative Document, the government explained that it decided not to provide in the legislation for the treatment of secondary adjustments in the UK. Nevertheless, it stated that it wishes to encourage the 'voluntary restoration of funds' under these circumstances. Accordingly, in certain cases the tax authority may be prepared to consider an adjustment, for example a deduction for the 'interest' payment by a UK company, due on a constructive loan resulting from a secondary adjustment by another tax authority. Such an adjustment would be considered on the merits of the case.

HMRC aims to keep its position under review, and will consider the need to recommend legislation for secondary adjustments in the future. The decision on whether to legislate will depend on the effectiveness of allowing voluntary secondary adjustments in the medium term.

It is worth noting that the competent authority procedure may take several years to complete, with no guarantee of a satisfactory outcome. However, as the frequency of such proceedings increases, HMRC anticipates that the process will become much quicker. Indeed, regular meetings take place between the UK and certain other tax authorities where the competent authority cases are likely to be most numerous. This is understood to be the case with the US Internal Revenue Service (IRS), the NTA (Japan) and the French tax authority, at least.

Furthermore, as a member state of the EU, the UK tax authority is subject to the arbitration procedures of the EU Arbitration Convention. This Convention came into force with effect from 1 January 1995, applies to EU member states only, and the signatory states agreed to extend it with effect from 1 January 2000. The ratification of the extension protocol was finally completed late in 2004 and the Convention re-entered into force with retroactive effect from 1 January 2000 in November 2004. Where the Convention is invoked by a taxpayer, it provides that where the tax authorities concerned cannot resolve any differences through mutual agreement, they will be subject to mandatory arbitration procedures. The arbitration procedure consists of an advisory commission including independent experts who will give an

opinion within a specified timescale. Both tax authorities must act on this opinion or agree on another course of action.

The expected benefit of the Convention is that it should ensure that the resolution of issues is achieved within a specified timescale. However, in practice the expected benefits of the Convention have not been realised. Few cases have been reported as having been resolved successfully, and the time limits have been interpreted in a variety of different ways.

### **6714 Advance pricing agreements (APAs)**

The UK has had formal APA procedures since 1999. On 31 August 1999, the UK Inland Revenue, issued a Statement of Practice (3/99) (the Statement) to provide guidance on the Revenue's interpretation of Sections 85 to 87 of Finance Act 1999, which establish the APA procedures. In the Statement, the Revenue explains how it will apply the legislation in practice. To date, the APA process has been initiated by a number of companies, and several APAs have been concluded.

#### *Applicants and scope*

UK businesses, including partnerships, may request APAs regarding transactions that are subject to ICTA 88, Schedule 28AA. APAs may also be requested by non-residents trading in the UK through branches or agencies, and by UK residents trading through branches or PEs outside the United Kingdom.

The UK APA process only comes into play to resolve complex transfer pricing issues, or in other cases where there is very significant difficulty in deciding the method to be used in applying the arm's length principle. As the Statement says, '[HMRC] does not regard entering into APAs on less complex matters as a sensible use of resources in the absence of significant doubt as to the manner in which the arm's length principle should be applied. It may therefore decline to accept applications that do not satisfy those criteria.'

APAs may involve transfer pricing methods covering different types of related party transactions or for particular types of transactions only, as well as other, intra-group arrangements, including transfers of tangible or intangible property and the provision of services. APAs may relate to all the transfer pricing issues of the business or be limited to one or more specific issues.

Within the statement of practice, HMRC have expressed their preference for including the tax administration of the related party in the discussions and concluding a 'bilateral APA'. HMRC state that they would be prepared to seek to adapt the bilateral framework to reach agreement on a multilateral basis. However, any multilateral agreement would take the form of two or more bilateral APAs.

#### *Process*

Section 85(1)(c) of Finance Act 1999 provides that the APA process is initiated by a business making an application for clarification by agreement, regarding the application of the statutory provisions. The APA process typically comprises four stages: (i) expression of interest, (ii) formal submission of application for clarification, (iii) evaluation and (iv) agreement. At the expression of interest stage, or at the stage when a formal proposal is submitted, HMRC may exercise their discretion by declining the request for an APA. In that event, HMRC will advise the business of the reasons

for doing so, and will allow the business the opportunity to make further representations. A business may withdraw an APA request at any time before final agreement is reached.

HMRC have stated that it is anticipated that all proposals will need to be supported by most of the following information:

- The identification of the parties and their historic financial data (generally for the previous three years).
- A description of the transfer pricing issues proposed to be covered by the APA and analysis of the functions and risks of the parties, and projected financial data of the parties in relation to the issues.
- A description of the worldwide organisational structure, ownership and business operations of the group to which the taxpayer belongs.
- A description of the records that will be maintained to support the transfer pricing method proposed for adoption in the APA.
- A description of any current tax enquiries or competent authority claims that are relevant to the issues covered by the proposed APA.
- The chargeable periods to be covered by the APA.
- The identification of assumptions made in developing the proposed transfer pricing method which are critical to the reliability of its application.
- A request for a bilateral APA.
- If applicable, any representations from the business that HMRC should exercise its discretion in exchanging information, where the business considers such information to be trade secrets.

Information supplied by a business in relation to an APA will contribute to the pool of information held by HMRC about that business. HMRC explicitly state that the information may be used for purposes other than evaluating the APA request.

### *Nature and term*

An executed agreement between the business and HMRC determines the treatment of the transfer pricing issues for a specified period of time. The terms of a bilateral APA will also reflect the agreement reached between the two tax administrations. If HMRC does not reach an agreement with the business, HMRC will issue a formal statement stating the reasons.

APAs will usually operate prospectively, regarding chargeable periods beginning after the time the application is made. However, a chargeable period to which an APA relates may end before agreement is reached. The legislation allows the APA to be effective for that period.

HMRC expects the minimum term for APAs to be three years and the maximum term five years, commencing from the date of entry into force of the agreement.

HMRC considers that APA information is subject to the same rules of confidentiality as any other information about taxpayers and that the unauthorised disclosure even of the existence of an APA will be a breach of that confidentiality.

### *APA monitoring and renewal*

The APA will identify the nature of the reports that the business is required to provide under Section 86(4) of Finance Act 1999. The agreement will also provide for the timing of the submission of the reports. HMRC anticipate that the reports will be required annually and coincide with the filing date for the tax return.

Reports will address whether the agreed-upon method was applied during the year, the financial results produced by the method, and whether there was a mismatch between prices actually charged and those obtained by applying the arm's length standard under the agreed-upon methodology. The business also must provide details of any compensating adjustments that were made, and an assessment of the continued applicability or otherwise of the critical assumptions used in the APA.

Section 86(5) of Finance Act 1999 gives the Board of HMRC the power to nullify an APA when the business has fraudulently or negligently provided false or misleading information regarding the APA application. When considering using this power, HMRC will also take into account the extent to which the terms of the APA would have been different in the absence of the misrepresentation.

An APA may provide for modification of its terms in specific circumstances. For example, an agreement may provide that when there has been a change that makes the agreed-upon methodology difficult to apply but that does not invalidate a critical assumption, the agreement may be modified with the consent of the parties.

A business may request the renewal of an APA. The request should preferably be made no later than six months before the expiration of the APA's current term; however, HMRC will not rule out requests made before the end of the first chargeable period affected by the renewal. If the transfer pricing issues have changed, or a different method is being proposed, the business will be required to make a new APA application.

### *Penalties and appeals*

A tax-g geared penalty will be imposed when a business has acted fraudulently or negligently in making an incorrect return and tax has been lost as a result. When a return is made in accordance with an APA, and false or misleading information was submitted fraudulently or negligently in the course of obtaining the APA, the agreement is treated as if it had never been made. The business has the right to appeal against the amount of any additions to profits arising as a result of the revocation or cancellation of an APA.

### *Thin capitalisation*

HMRC recognises that thin capitalisation is a difficult area and has introduced the advance thin capitalisation agreements (ATCA). These are unilateral APAs and will be based on the same statutory provisions as other APAs. The process is designed to offer assistance in resolving transfer pricing issues which, for any particular period, have a significant commercial impact on an enterprises profit or losses.

ATCAs may cover either the treatment of a single applicant's financial instrument, or the treatment of the overall debt position of a group, depending on circumstances. HMRC issued guidance in relation to which situations are suitable for ATCAs in a Statement of Practice (04/07). This guidance states that situations suitable for ATCAs include, but are not limited to, the following:

- Intra-group funding outside the scope of treaty applications, e.g. involving a quoted Eurobond or discounted bond;
- financing arrangements brought into schedule 28AA by the 'acting together' rules (see 6702);
- financing arrangements previously dealt with under the treaty route.

While the ATCA will normally act prospectively in relation to chargeable periods beginning after the time the application is made, it is possible that an ATCA may be applied retrospectively or rolled back as an appropriate means for amending a self assessment return or resolving outstanding transfer pricing issues in earlier years.

### **6715 Anticipated developments in law and practice**

No further legislative changes have been announced at the time of writing.

### **6716 Liaison with customs authorities**

In April 2005, the UK government integrated the Inland Revenue and HM Customs and Excise into a single department (Her Majesty's Revenue and Customs, HMRC). The Inland Revenue's Large Business Office (LBO) and Oil Taxation Office and Custom's Large Business Group have also integrated to form a single HMRC Large Business Service (LBS). The Revenue and Customs tax functions within HMRC are able to exchange information freely, and hold meetings in order to compare information on particular groups and industries.

### **6717 OECD issues**

The UK is a member of the OECD and has approved the OECD Guidelines. ICTA 88, schedule 28AA is required to be construed in a manner that best ensures consistency with the Guidelines.

### **6718 Joint investigations**

As a member of the OECD, HMRC could join with other tax authorities to participate in a joint investigation in accordance with the OECD Guidelines. If, however, as part of the joint investigation, there was to be an exchange of information, then generally a DTA with the relevant mutual assistance clause would need to be in place to provide a legal basis for the exchange.

### **6719 Thin capitalisation**

As noted above, the legislation in ICTA 88, Schedule 28AA has included provisions that incorporate financial transactions. Furthermore, there is general legislation to enable the tax authority to challenge the deductibility of interest paid by a UK company on a loan from a related party for which either the interest rate is excessive or the amount of the loan itself is excessive. This domestic legislation compensates for the position existing under many older tax treaties where there is an argument that the tax treaty does not provide the authority for the amount of the loan to be questioned. The measure for determining whether the amount of the loan or the interest rate is excessive is the arm's length principle – that is, whether a third party would have loaned the company that amount of money, or at that interest rate. The legislation

seeks to align the UK position with Article 9 of the OECD Model Tax Convention.

The consequence of a successful challenge by the tax authority is that any interest that is found to be excessive, either by reference to the interest on the part of the loan found to be excessive or by reference to the rate, will not be allowed as a tax deduction.

There is no formal UK safe harbour debt to equity ratio, or acceptable interest cover (profit before interest and tax to total interest payable). However, it is often suggested that a debt to equity ratio of 1:1 and interest cover of 3:1 could generally be considered to be 'safe'. HMRC has explained its tendency to accept these ratios on the basis that they reflect historical averages and that the tax authority's resources are better used examining cases with more extreme ratios.

It is worth noting, however, that each case is examined individually and the acceptability of a ratio could well be influenced by the averages for the particular industry sector, and those may be different from those noted above. Other ratios are increasingly considered, including the ratio of debt to earnings and other forms of interest cover. Other factors that HMRC would consider are factors that a third party lender would consider, such as the consolidated debt to equity ratio of the borrower's group and the ability of the group both to pay interest and repay capital. An acceptable ratio is, therefore, often a matter of negotiation.

HMRC will provide clearance in many cases for loan arrangements, under the ATCA procedure, as described above in Section 5114. This involves the provision of detailed documentation of the loan arrangements and valid projections of the taxpayer's interest cover and/or debt to equity ratio. Guidance is given in the International Manual. This guidance covers how the basic pricing rule under self assessment is more broadly formulated than the previous legislation.

The guidance goes on to cover:

- Factors taken into account by HMRC in determining whether interest is excessive.
- The application of ICTA 1988, Section 209, which recharacterises 'excessive' interest as a distribution, which ceased with effect from 1 April 2004.
- Cases where interest is not recharacterised.
- Circumstances where transactions should be considered together in order to evaluate compliance with the arm's length principle.
- Outward investment and where such loans are interest free or at a low rate of interest, and what factors may be taken into account in recharacterising such loans as equity.
- Interaction of the transfer pricing rules with the UK's legislation on foreign exchange and financial instruments.
- Treatment of funding transactions between UK charities and their affiliates.

### *Guarantee fees*

ICTA 88, Schedule 28AA applies to a 'provision' effected by one or more transactions. So, when a UK company borrows from a bank (transaction 1) and the loan is guaranteed by its parent (transaction 2), there may be a 'provision' between the parent and subsidiary. Between independent parties this will usually result in a fee



from the borrower to the guarantor.

The rules provide that the borrowing capacity of a UK company must be considered without regard to the guarantee. In such a case – for example, where the subsidiary is able to borrow more because of the guarantee – there would be no deduction for the guarantee fee related to the ‘excess’ borrowing, and there would be potential disallowance of interest in excess of what would have been paid in the absence of the special relationship. This is true even though the interest is paid to a third party bank.

Where interest is disallowed for a UK borrower, an affiliated UK guarantor may be able to claim the deduction instead.

There is no UK case law on transfer pricing of guarantees. There is non-binding, non-specific guidance to taxpayers and tax inspectors provided by HMRC.

The value of a guarantee under the arm’s length principle will depend on its terms. The arm’s length fee should be determined based on what would be charged between independent parties under the same or similar circumstances. Where a UK parent provides a guarantee to overseas subsidiaries, in some cases HMRC accept that a guarantee may be ‘equity’ in nature – especially where the borrower is thinly capitalised.

### **6720 Management services**

No specific legislation on management services exists, and thus where a company is paying for management services, the general rules on the deductibility of expenses will apply. In effect this means that the payment will be tax deductible where the company received a benefit for the service provided, and where the payment was connected with the company’s trade and was at an arm’s length price. This is, of course, different from where a company simply recharges costs properly attributable to another group company.

Where a company is providing services, it should be remunerated for those services on an arm’s length basis. This would usually mean that a profit element should be added to the cost of providing the service and invoiced to the companies receiving the benefit of the services (i.e. a cost plus basis) to represent a market value for the provision of the services. The arm’s length value of services can also sometimes be less than the cost of providing them. In such a situation the service should still be recharged at the market price (i.e., less than cost) and this principle is recognised in the OECD Guidelines.

Where services are recharged on a cost plus basis, the amount of the mark up will often be the subject of negotiation with the tax authority. No guidelines have been published as to standard acceptable rates of marking up costs in specified situations. HMRC has typically sought cost plus between 5 and 10% for UK provided services. It has not been unknown for inspectors to look for a higher mark-up according to what they consider the value of the services provided to be.

In support of a lower mark-up, a taxpayer may present information on comparable third party service providers, and it is increasingly possible to persuade the tax authorities to accept a lower mark-up on this basis.

# 68 Uruguay

## 6801 Introduction

In 2007, Uruguay initiated the implementation of a significant and historical tax reform pursuant to approval of Law 18,083, which incorporates, among other concepts, personal income tax (which had been repealed in the early 1970s), the figure of permanent establishment and the concepts of residence and transfer pricing. Notwithstanding, the source principle is maintained as the basic taxability empowerment criteria.

This law was enacted by the Executive Power on 27 December 2006, and was published in the Official Gazette on 18 January 2007.

Until 2007, Uruguayan tax legislation had not given a general legal solution for the issue of transfer pricing, except for certain provisions included in the regulations of business income tax relating to export or import transactions involving merchandise and some other specific rulings. For instance, Article 21 of Title 4 of the 1996 Coordinated Tax Compilation (CTC) and related detailed regulations contained in Article 19 of Decree 840/988 prescribe consideration of the wholesalers price plus certain other connected charges for determining net income of local source related with all export and import transactions made by an enterprise (whether a related party or not). This ruling is extensive to transactions made between Uruguayan free zones and non free zone territory as stated in Article 8 of Decree 733/991.

Law 18,083, Chapter VII of Title 4, incorporates for the first time a specific chapter on transfer pricing under the regulations of Income Tax on Economic Activities (ITEA), which are in force for financial years starting from 1 July 2007.

To date, no further regulations have been issued in this connection.

## 6802 Statutory rules

As a general principle, the regulations on transfer pricing are applicable to international transactions made between related parties. However, Uruguayan legislation has extended the scope of these regulations to transactions carried out with low-tax or nil-tax jurisdictions or regimes (either international or domestic).

### *Transactions between related parties*

Law 18,083 states that transactions between ITEA taxpayers and related parties or individuals will be deemed arm's length for all purposes when the terms and conditions provided therein are in conformity with normal market practices between independent parties, without prejudice to the cases of existing limitations for expense deductions upon computing net taxable income.

The burden of proving that the aforementioned terms and conditions are not in conformity with market values, falls on the General Tax Bureau (GTB- Uruguayan tax authority) except in the case of transactions by the ITEA taxpayer with a company in a country with a low or nil taxation regime or with a company in a Uruguayan Free Zone, which are presumed not to be arm's length.

### *Related parties*

The definition adopted by the law for related parties status is quite broad. Such relationship is configured when both parties are subject, directly or indirectly, to the management or control of the same individuals or legal entities, or due either to their participation in capital interest, the level of their credit rights, their functional or any other type of influence – whether contractual or not, they have power of decision to direct or define the taxpayer's activities.

### *Countries or regimes with low taxation or nil taxation*

The operations undertaken by taxpayers with countries or regimes with low or nil taxation will be perceptively treated as not being in conformity with normal market practices or values between independent parties.

The following operations are included in this category:

- Transactions with non-residents, who are domiciled, organised or located in countries of low or nil taxation.
- Transactions with non-residents who are beneficiaries under a special regime of low or nil taxation.
- Transactions carried out with entities operating in customs havens that benefit from a regime of low or nil taxation. Consequently, domestic transactions with Uruguayan free zones would fall under this category.

The countries and regimes referred to in cases (1) and (2) above will be enumerated taxatively in the detailed regulations.

### *Methodology*

Law 18,083 adopts the best accepted international methodologies and requires that the methods used be the more appropriate ones available considering the type of transaction being made.

The law foresees the application of five methods, apart from others that may be established in the detailed regulations:

- Comparable uncontrolled price method (CUP);
- Resale price method (RPM);
- Cost plus method (CP);
- Profit split method (PSM); and
- Transactional net margin method (TNMM).

### *Exception to the best method rule*

The law prescribes perceptively applying the CUP method in the following cases:

- Imports and exports of goods for which a public and notorious international price known in transparent markets can be determined ('commodities'), in which case such prices should be used, unless there is proof to the contrary.
- Imports and exports of goods through a foreign intermediary other than the final recipient of the goods. These represent transactions between related parties

involving primary farming products, and in general, goods knowingly quoted in transparent markets ('commodities'); in this case the price applied should be the value quoted in such market at the date the goods are laden, whatever the transportation means utilised, and disregarding the price agreed with the intermediary. This method will not be enforced when the taxpayer is able to provide trustworthy evidence that the intermediary fully complies with the following requisites:

- (1) Having residence abroad and actual presence in the foreign territory, having a commercial establishment in such location for managing its business activities and complying with the legal requisites of constitution, registration and filing of financial statements. The assets, risks and functions assumed by the intermediary should be appropriate to the volume of business transactions made.
- (2) Its main activity should be other than generating passive revenue or intermediation in the trading of goods out of or into Uruguay, or with other members of the group economically related to the intermediary.
- (3) Its international trade transactions with other subjects related to the importer, or exporter in the case, should not exceed 30% of the total annual revenue from transactions made under its intervention.

It is worth noting that the GTB may extend the application of this method to comprise other international transactions with the participation of an intermediary other than the final recipient of the goods, provided the GTB is able to produce trustworthy evidence proving that the intermediary is not in compliance with the aforementioned requisites.

#### *Information required*

Although the law per-se does not require mandatory preparation of formal transfer pricing documentation, it does provide that both the Administration and the detailed regulations may require additional information for purposes of control and tax audit. These regulations have not been approved to date but will probably be in the next future. The corresponding rules are the following:

- The taxpayer must submit the information that the forthcoming detailed regulations may require, including the cost allocations, profit margins and other data considered convenient for verifying the transactions.
- The GTB may require filing special tax returns containing the data necessary for the analysis, selection and verification of the prices agreed.

### **6803 Other regulations**

#### *Optional regimes of notional profit assumptions*

Law 18,083 empowers the Executive Power to establish special notional profit regimes (safe harbours) considering the modus-operandi of the transactions and of the type of business activity or exploitation. Such regimes will be optional and for the purpose of determining income of Uruguayan source of those transactions subject to regulations on transfer pricing.

*The rule of wholesaler's price as residual criterion*

In the case of import and export operations not contemplated in the above mentioned Chapter VII of Title 4 in connection with transfer pricing, the Uruguayan source income will be determined considering the FOB or CIF value of the goods being imported or exported.

However, when no price has been fixed or if the price stated does not conform to prices prevailing in the international market, such income will be determined in the form to be established in the detailed regulations.

Such detailed regulations are expected to adopt the criteria followed to date in connection with the wholesaler's price rule. In this event, the reference price would be the wholesaler's price prevailing in the place of origin of the goods in the case of imports and in the place of destination in the case of exports. Should this price not be known to the public, or should there be doubts about its applicability to the same or to similar goods being imported or exported, or some other reason hindering comparison, the calculation base of the profits of Uruguayan source will be based on profit ratios obtained from independent enterprises engaged in identical or similar activities.

**6804 Legal cases**

From year 1988 to date there have been practically no transfer pricing issues submitted to administrative or legal jurisdictions. This trend is expected to change in the future once the tax reform is put into practice.

To date there are only two verdicts of the Court on Administration Matters (CAM) concerning transfer pricing issues.

*Case: Philips Uruguay S.A. (Verdict issued on 19 February 2005):*

The Uruguayan subsidiary had entered into a general services agreement with its shareholder located in The Netherlands, comprising the following services: commercial advisory; accounting advisory; audits regarding financial, fiscal and social matters; for a consideration computed at 1.75% on the local sales revenue. The amounts paid for this concept had been deducted by the taxpayer in its business income tax computation. The GTB questioned such deduction for years 1997 and 1998 alleging that the services lacked adequate documentation support and that they were neither indispensable nor reasonable for generating taxable income. The CAM, however, decided in favour of the taxpayer for various reasons. Regarding the reasonableness of the amount deducted by the taxpayer, the court explicitly recognised the OECD Guidelines as valid criteria for fixing the transfer prices between related parties, in the context of regulations not providing any specific rules on this issue.

*Case: Milagro S.A. (Verdict 688 issued in October 2006):*

In this case the Administration (GTB) questioned the selling price of certain export transactions made by the taxpayer during years 1996 and 1997, on the basis of the wholesaler's price rule- among other rules-, established in the aforementioned Article 19 of Decree 840/988. Applying this rule, the GTB determined the income of Uruguayan source on the basis of the wholesalers price at destination (The Netherlands, in the case), overtaking the prices stated in the custom clearance documentation by prices

indicated in the listings submitted by the Uruguayan Embassy in The Netherlands. Again the CAM favoured the taxpayer in its verdict and while the arguments used as a basis for the decision are not clearly stated, the verdict is the first local jurisdictional precedent of the wholesaler's price rule.

### **6805 Burden of proof**

As a rule, the burden of proof lies with the tax authority (GTB) unless the transfer of profits concerns countries or regimes of low or nil taxation.

The law presumes that international transactions with related parties are made at market values, unless the GTB can provide trustworthy proof that the transactions have not been priced at such values. Conversely, in the case of transactions with countries or regimes of low or nil taxation, (either domestic or international) the law presumes that such transactions do not comply with the arm's length principle and therefore should be adjusted.

However, although the burden of proof starts in theory with the head of the tax administration, it will likely be transferred in practice to the taxpayer, to the extent the latter will be obliged to justify his discrepancies with the tax administration once the GTB consider any price of similar transactions made by similar industry entities (without performing a consistent and complete analysis according to OECD Guidelines) as initial presumptions of non compliance. Some experience in that sense has been noticed.

### **6806 Tax audit procedures**

Near the end of year 2006 and during the year 2007, the GTB launched intense tax audit proceedings in the pharmaceutical sector and on those companies that channel their operations under regimes of low or nil taxation.

Tax audits started on a surprise basis at the taxpayers' domicile. A summons for information was delivered to each taxpayer setting forth a series of questions regarding transactions made with related companies and the policy applied for transfer pricing. While the new regulations on transfer pricing were not applicable until year 2007, the GTB set forth its allegations questioning the structures adopted, on the basis of current regulations on 'economic substance'. Finally, many of these cases were closed under mutual agreement with the GTB, with the corresponding tax amounts being restored plus related fines and interest charges. In some of the cases, the Administration had accepted presentation of the documentation on transfer pricing studies as a form of justifying the pricing policy adopted by the taxpayer in the structures used.

It is worth noting that as a general rule, the taxes are self assessed by the taxpayer, but the GTB has far-reaching authority for fiscal investigation and verification. For example, the GTB may require taxpayers to show their books and records, including documentation files and business correspondence, either of their own or kept for third parties; require the taxpayer's appearance at the Administration's authority to provide information; perform tax audits of real estate and chattel properties held or occupied by the taxpayer.

The proceedings are in writing, both for the presentations made by the taxpayer and the tax auditor. These are documented in minutes which should be signed by both parties.

**6807 Revised assessments and the appeals procedure**

Once the circumstances giving rise to the tax obligation take place, the administration makes the tax assessment through an Act of Determination, which may be appealed by the taxpayer within a term of 10 days after the date the respective notification is served.

The recourses available for the taxpayer are: the Appeal for Reversal submitted to the GTB and the Appeal to Executive Authority submitted to the Executive Power (to which the GTB reports).

Should the Executive Power definitively confirm the Act of Determination appealed, or should it fail to issue a pronouncement within a term of 200 days after the date the appeal is presented, the taxpayer may bring an Action for Annulment at the CAM within 60 days after confirmation (either tacit or expressed). The CAM will proceed to confirm or annul the act impugned by means of a verdict which is definitive in nature.

It is worth mentioning that the CAM is an independent court written in the Constitution of Uruguay, which is competent to judge on the legality of all the acts of the Administration.

The actions of filing, performing proceedings and resolving administrative recourses submitted to executive authority and the action for annulment are not subject to prior payment of taxes or related punitive charges.

**6808 Additional tax and penalties**

With the introduction of the new rules, specific penalty provisions for transfer pricing have not been formulated. Instead, the general rules are also applicable.

In a normal case, when a taxpayer is in default, a fine of 20% of the tax underpaid and interest will be charged on the tax underpaid, calculated from the original due date. The rates at which this interest accrues are published but in general they are close to, but higher than, ordinary bank rates.

Regarding more severe sanctions the Tax Code has the figure of tax fraud both as an infringement (punished with a fine of between one and 15 times the amount of the fraudulent tax omission or attempted omission) and as a criminal act (subject to an imprisonment penalty of between six months and six years). In both cases the behaviour subject to punishment is configured by deceit or deceitful concealment with the purpose of creating an undue fiscal benefit. Any interest or penalties paid are not tax deductible.

**6809 Resources available to the tax authorities**

As mentioned above, the Administration has broad faculties for investigation and therefore can resort to various sources of information.

Law 18,083 introduces changes on the matter of 'secrecy of the Administration's proceedings'. The Tax Code establishes that the Tax Administration and the staff members reporting thereto are obliged to keep secret on all the information resulting from their administrative or judicial proceedings. The secrecy of the proceedings can be lifted only by means of a duly founded resolution of a judge. However law 18,083 has changed the secrecy rule for the area of transfer pricing adding that the secrecy of the proceedings will not be applicable in connection with third party information that may be necessary for determining the transfer prices when the Administration must

offer such information as evidence in cases brought to court or administrative jurisdiction.

In conclusion, the Administration may use secret comparables as a means of proof for justifying the prices it has determined.

### **6810 Use and availability of comparable information**

Following the OECD Guidelines, the use of comparable information is essential for any analysis concerning the transfer pricing issue. Regarding local financial information, these rules should be taken into account:

- Enterprises are obliged to file their financial statements with the Registrar of the National Internal Audit Bureau only when they show total assets in excess of the equivalent of USD400,000 at the financial year-end or net operating revenues during that year in excess of the equivalent of USD1.4 million.

While this information is available for any interested party, its usefulness as comparables is subject to the degree of detail of such information.

- Large taxpayers (classified as such in the Large Taxpayers Division of the GTB and in the CEDE Group) must submit financial statements accompanying their tax returns.

These financial statements must include a professional report issued by an independent accountant when total assets shown are in excess of the equivalent of USD80,000. A full audit report is required for large taxpayers but for taxpayers included in the 'CEDE Group' a limited review report will suffice.

### **6811 Risk transactions or industries**

There are no transactions or industries which are excluded from the scope of the transfer pricing legislation. Taking into account that if a particular industry or issue has come to the attention of the fiscal auditor, the tax authority is likely to use the information and experience gained in dealing with one taxpayer in investigating other similar taxpayers.

### **6812 Limitation of double taxation and competent authority proceedings**

The Uruguayan taxation system continues adopting the source principle as the general criteria of taxability empowerment, and therefore does not recognise taxes paid abroad as creditable against taxes in Uruguay.

Uruguay has signed agreements with Germany in 1987 and with Hungary in 1993, in order to avoid double taxation on income and on equity. Aligned with the OECD Guidelines, both agreements adopt the concept of related parties and the arm's length principle. These agreements foresee the possibility of establishing mutual covenants between the State parties to the agreements, in order to avoid taxation that is not within the scope of the Agreement.

Notwithstanding the open legal possibility, in actual facts this type of agreement appears relatively uncommon to date.



**6813 Advance pricing agreements (APAs)**

Although Law 18,083 does not contain specific regulations on the matter of APAs, it does foresee a series of rulings that would enable taxpayers to apply for a special regime for determining income of Uruguayan source under certain circumstances. However these regimes would likely be of a notional type.

**6814 Anticipated developments in law and practice**

Given the recent approval of the tax reform law, further regulations are expected to be issued shortly, as well as publication of the corresponding GTB resolutions clarifying how the tax reform will be implemented.

While the GTB resolutions are issued for internal use of its own staff, the material is available to the public. These resolutions enable the taxpayer to gain knowledge about the interpretation criteria of the GTB on the current tax legislation.

**6815 Liaison with customs authorities**

Recent experience suggests that exchange of information between GTB and the custom authority does occur. Nevertheless, there is no prescribed approach for the use of certain information of one area in the other area (e.g. transfer pricing analysis for customs purposes).

**6816 OECD issues**

Uruguay is not a member of the OECD. Nevertheless the OECD Guidelines on transfer pricing constitute international points of reference for this subject. Their influence in Uruguay has been significant to the extent that effective from year 2005, the CAM has considered these guidelines as valid directives for quantifying the transaction between related parties.

Law 18,083 does not explicitly mention adoption of the OECD criteria, but the regulations in the law have conceptually followed those guidelines.

**6817 Joint investigations**

In theory, Law 18,083 foresees the possibility of carrying out contemporary tax audits with foreign tax authorities, but these appear hardly probable in practice. Joint tax audits are only contemplated for the few States having bilateral agreements signed with Uruguay providing for sharing information between the respective fiscal authorities.

**6818 Thin capitalisation**

Thin capitalisation is not considered the separate category by Uruguayan internal tax legislation that it is in other legislations. Notwithstanding there are (i) specific regulations on liabilities and interest, (ii) specific dispositions included in the bilateral agreements with Germany and Hungary, and (iii) regulations on the treatment of partners' accounts in partnerships and head office accounts in branches, which regulate the subject.

In general, tax legislation allows companies to be financed through equity or debt without restrictions. However, it contains certain rules (as mentioned) that discourage debt financing in some cases, by way of restraining deductible liabilities for capital

tax purposes and deductible interests for income tax purposes. Particularly, Law 18,083 states that interests paid abroad will be deductible (subject to the mentioned other rules) provided they are taxable under the new income tax on non-residents or under an effective income taxation imposed abroad. Should they be levied under those taxes at an overall rate of less than the ITEA 25% rate, their deduction for local income tax purposes will be proportional.

### **6819 Management services**

Law 18,083 does not include special regulations on the treatment of management services in the area related to transfer pricing. Following the aforementioned legal background the OECD Guidelines would constitute the valid criteria to be considered.

Payments abroad for the concept of management services are good tax deductions provided they are taxable under the income tax on non-residents or under an effective income taxation imposed abroad. Should they be levied under those taxes at an overall rate of less than the ITEA 25% rate, their deduction will be proportional.

# 69 Uzbekistan

## 6901 Introduction

Effective 1 January 2008, the Uzbek tax legislation does not contain any transfer pricing provisions. This legislative change came along with the introduction of the new Tax Code.

While the legislative basis for transfer pricing did exist within the tax system in Uzbekistan prior to 1 January 2008, the provisions were extremely thin. Furthermore, in practice, the tax authorities have not sought to enforce these regulations due to the lack of guidance (instructions) and expertise within the tax authorities.

The customs authorities usually challenge taxpayers from a transfer pricing perspective for customs payments (customs duty, excise and VAT) purposes.

## 6902 Statutory rules

N/A.

## 6903 Other regulations

N/A.

## 6904 Legal cases

There are no known legal cases. Application of court practice in tax disputes is not developed in Uzbekistan.

## 6905 Burden of proof

N/A.

## 6906 Tax audit procedures

N/A.

## 6907 Revised assessments and the appeals procedure

N/A.

## 6908 Additional tax and penalties

N/A.

## 6909 Resources available to the tax authorities

N/A

## 6910 Use and availability of comparable information

There is very limited publicly available information on pricing, except for consumer goods.

**6911 Risk transactions or industries**

N/A.

**6912 Limitation of double taxation and competent authority proceedings**

Uzbekistan has effective double tax treaties with 41 countries. However, Uzbek tax authorities have limited practice in the application of double tax treaties. There are no known cases of treaty application to transfer pricing issues.

**6913 Advance pricing agreements (APAs)**

N/A.

**6914 Anticipated developments in law and practice**

There are no known or expected developments in this area.

**6915 Liaison with customs authorities**

The customs code contains pricing rules that allow the customs authorities to adjust the declared import/export value of cross-border transactions for customs payments (customs duty, excise and VAT) purposes.

These rules are better described and used in practice. There is an instruction of how the adjusted price can be determined for customs purposes. The Uzbek customs authorities may use any of six methods available, including the method of data on comparable goods and services.

**6916 OECD issues**

OECD interpretations are not applied in Uzbekistan due to the lack of practice on application of OECD rules by the tax authorities.

**6917 Joint investigations**

N/A.

**6918 Thin capitalisation**

Current Uzbek legislation does not provide for any thin capitalisation rules.

**6919 Management services**

Due to the absence of transfer pricing practice, pricing of management services is not normally questioned by the tax authorities. However, deductibility of such costs for income tax purposes may be challenged if substance/documentation is questioned.

# 70 Venezuela

## 7001 Introduction

Venezuela experienced a significant tax reform in 2001, especially in the area of transfer pricing. In October 2001, the 1994 Edition Venezuelan Tax Code (COT) was updated. The 2001 COT establishes several transfer pricing principles, including: penalties relating to non-compliance with transfer pricing regulations; specific rules for transfer pricing audit procedures; and the introduction of advance pricing agreements (APAs) to the Venezuelan Tax System. Additionally, on December 2001, Venezuela enacted new transfer pricing regulations under the Venezuelan Income Tax Law. The new Venezuelan transfer pricing rules adopt the arm's length standard for related party transactions, adhere to the OECD Guidelines, eliminate the safe harbour regime established during 1999, impose transfer pricing documentation and filing requirements, and contain APA provisions. With these new transfer pricing rules, Venezuela has taken an important and positive step towards the harmonisation of its tax system with the internationally accepted standards. Moreover, in February 2007, Venezuela introduced thin capitalisation rules to its Income Tax Law.

## 7002 Statutory rules

The new transfer pricing rules came into force on 28 December 2001. Its provisions are applicable to all fiscal years initiated on or after 1 January 2002. The new transfer pricing rules are based on the internationally accepted arm's length standard, and thus eliminate the previous safe harbour approach that specifically aimed at two types of transactions: imports and exports conducted by multinationals with their Venezuelan affiliates.

Related parties are defined as parties that are directly or indirectly managed, controlled or owned by the same party or group of parties; intermediary agents; and any relationship between a Venezuelan taxpayer and entities located in low tax jurisdictions (i.e. a country included in the list of tax havens). The arm's length standard applies to all transactions, including transfers of tangible and intangible property, services and financial arrangements.

A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances.

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

- None of the differences, if any, between compared transactions or 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 2001 Venezuelan Income Tax Law are basically the same as those contained in the OECD Guidelines:

- comparable uncontrolled price method ;
- resale price method;
- cost plus method;
- profit split method; and
- transactional net margin method.

In terms of selection of the method, the taxpayer is required to consider the comparable uncontrolled price as the method of first choice, and that the tax authorities will evaluate whether the method applied by the taxpayer is the most appropriate one, given the characteristics of the transaction and the economic activity performed.

The Venezuelan tax administration (SENIAT) is entitled to make an adjustment if a taxpayer fails to comply with the transfer pricing provisions.

### *Documentation*

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 following the end of the fiscal year. This informative transfer pricing return must illustrate the types of inter-company transactions, the dates on which the transactions were celebrated, 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 inter-company transactions, and the Venezuelan rules also require an extensive list of transfer pricing documentation (background documentation) that includes, among others, the following items:

- an analysis of fixed assets and the commercial and financial risks related to the transaction, including documentation to support the acquisition and use of assets;
- an organisational and functional overview of the taxpayer, 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 shareholdings in group companies;
- an overview of the controlled transactions, including activities carried out, dates, prices paid or charged and the applicable currency;
- information on the main activities carried out by each of the relevant group companies as well as data on any changes affecting the group as a whole, such as capital increases or mergers;
- financial statements for the taxpayer's fiscal year, prepared according to generally accepted accounting principles, including balance sheet, income statement, 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; and
- any other information that may be deemed as relevant or required by the Tax Administration.

### **7003 Legal cases**

No transfer pricing cases have yet been brought to the courts. Transfer pricing audits began in February 2005 and have been expanding since then, both in the number of audits performed and in the scope of their requirements. Initially, the SENIAT visited several taxpayers requiring the transfer pricing support documentation detailed above, and usually gave the taxpayers a three to five day period to submit the required information.

In July 2006, the SENIAT conducted the first extensive transfer pricing audit, to a local subsidiary of an important Japanese automotive company. 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 that such transactions were conducted at arm's length. SENIAT, acting under the guidelines of the 'Zero Tax Evasion Plan', ensured that tax collection in this matter was not reduced due to illicit acts.

By the end of 2006, SENIAT's tax audit manager announced the reinforcement of

the 'Zero Tax Evasion Plan' regarding transfer pricing audits, changing its previous focus on formal documentation compliance (if the taxpayer has it or not) to thoroughly audit the arm's length nature of the inter-company transactions that were detected by SENIAT's computerised system. Moreover, he stated that SENIAT's transfer pricing unit would be expanded and certain tax inspectors would be relocated from the economic studies section to the tax audits management.

Consequently, a few weeks after that announcement, the SENIAT notified the local affiliate of an important oil and gas foreign company a transfer pricing adjustment of USD17.7 million, that was assessed by the transfer pricing unit using its databases, studies and analyses. This was the first transfer pricing adjustment in Venezuela and it relates to certain financial transactions of the Venezuelan taxpayer involving its foreign related parties. Besides, SENIAT's head officer warned that the transfer pricing audits were going to be reinforced and will focus on the oil and gas industry.

In early 2007, SENIAT's tax audit manager once again reemphasised that their focus for 2007 will be transfer pricing, and their goal is to collect as much as possible from companies with this 'issue'.

In April 2007, the local affiliate of the oil and gas foreign company accepted part of the transfer pricing adjustment proposed by the SENIAT and paid USD13.7 million, concluding the first transfer pricing case in Venezuela.

#### **7004 Burden of proof**

The burden of proof lies with the taxpayer. However, a challenge by the SENIAT would require adequate supporting evidence if such a challenge is to be accepted by the tax courts.

Any transaction between Venezuelan taxpayers and entities located in low tax jurisdictions will automatically be presumed to be a transaction with a related party and will also be considered not to take place at arm's length. In such cases, the taxpayer has the burden of proof and it will be necessary to demonstrate that:

- the counterparty to the transaction was an independent third party; or
- if the counterparty to the transaction is a related party, the transaction was carried out at arm's length.

#### **7005 Tax audit procedures**

The COT establishes specific rules for transfer pricing audits:

- When a tax objection is made by the SENIAT during a transfer pricing audit, the taxpayer may either accept the objection and settle with the Tax Administration or start summary proceedings in order to defend its position. The taxpayer has more time to submit the defence documents and call for proofs than in a regular summary proceeding: five months rather than 25 days;
- The taxpayer may name a maximum of two representatives within the first 15 days of the summary proceeding in order to evaluate the information gathered by SENIAT regarding the related party transactions. Such representatives may be replaced once; and



- The period for furnishing proofs is the same as a regular proceeding with SENIAT, which is 30 days at the maximum. SENIAT has a two-year period to make a decision of the transfer pricing audit once the period of negotiation and information exchange is over.

### **7006 Additional tax and penalties**

The COT specifies three types of situations where penalties 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; and
- fraud on the part of the taxpayer. This attracts a jail sentence of between six months and seven years. The sanctions established on the COT are summarised in the table opposite.

### **7007 Resources available to the tax authorities**

At present, the SENIAT has a transfer pricing department and provides transfer pricing training to its tax professionals in order to prepare them for the transfer pricing audits.

### **7008 Use and availability of comparable information**

Comparable information is required in order to support the arm's length nature of related party transactions and should be included in the taxpayer's transfer pricing documentation. However, there is very little reliable financial information publicly available on Venezuelan companies. Therefore, reliance is placed on foreign comparables.

The SENIAT has the power to use third party confidential information. The taxpayer has limited access to this data through its two nominated representatives who are then personally liable to criminal prosecution if the data is disclosed.

| TYPE OF ILLICIT SITUATION       | COT ARTICLE                              | LEGAL ASSUMPTION  | SANCTION   |       |        |        |         |        |
|---------------------------------|--|---|--|-------|--------|--------|---------|--------|
|                                 |  |   | MINIMUM  |       | MEDIUM |        | MAXIMUM |        |
|                                 |  |   | TU   | USD   | TU     | USD    | TU      | USD    |
| FORMAL                          | 103<br>Filing Issues                     | 1. No filing returns that include the determination of taxes.<br>2. No filing other returns or communications.  | 10   | 175   | 30     | 525    | 50      | 875    |
|                                 |  | 3. Late or incomplete filing of returns that include the determination of taxes.<br>4. Late or incomplete filing of others returns or communications.   | 5  | 88    | 15     | 263    | 25      | 438    |
|                                 | 104<br>Control Obstructions              | 10. Not using the methodology established in the Venezuelan Income Tax Law in regard to transfer pricing.   | 300  | 5.251 | 400    | 7.001  | 500     | 8.752  |
|                                 | 105<br>information and appearance issues | 1. Not submitting information in regards to the taxpayer's own transactions or related third parties.   | 10   | 175   | 105    | 1.838  | 200     | 3.501  |
|                                 |  | 3. Submitting false or wrong information<br>Last paragraph: the revealing, divulging, personal use, infringement or adverse use or information submitted by independent third parties, that affect or may affect its competitive position in transfer pricing matters, made by any person, without prejudice of the disciplinary, administrative, civil, or penal responsibility. | 10   | 175   | 30     | 525    | 50      | 875    |
|                                 |  |   | 500  | 8.752 | 1,250  | 21.879 | 2,000   | 35.007 |
| MATERIAL                        | 111<br>Tax Liability Issues              | Illegitimate reduction of the taxable income due to action or omission  | 25% - 200% of the omitted tax                      |       |        |        |         |        |
| SANCTIONED WITH JAIL PUNISHMENT | 116<br>Tax Fraud                         | Inducing in error the Tax Administration by means of cheating, resulting an unjust enrichment higher  | 6 Months to 7 Years                                |       |        |        |         |        |
|                                 |  | Hiding of investments in low tax jurisdictions  | The aforesaid punishment increased from 1/2 to 2/3 |       |        |        |         |        |
|                                 | 119                                      | The revealing, divulging, personal use, infringement or adverse use of confidential information submitted by independent third parties, that affect or may affect its competitive position, made by any person, by any mean, without prejudice of the disciplinary, administrative, civil, or penal responsibility.   | 3 Months to 3 Years                                |       |        |        |         |        |

TU : Tax Unit (approximately USD18)

### 7009 Risk transactions or industries

No substantial basis yet exists for identifying any particular industry sector or type of transaction as being especially at risk. Nevertheless, given the importance of the oil and gas industry in Venezuela, the SENIAT is conducting investigations on some of the taxpayers related to this sector.

### **7010 Limitation of double taxation and competent authority proceedings**

If a relevant tax treaty exists containing provisions for mutual agreement procedures (MAP), it is very likely that these procedures would be used to avoid double taxation.

### **7011 Advanced pricing agreements (APAs)**

The COT enables the Tax Administration to approve or reject APAs and establishes the formal rules governing the APA application procedure. This includes a list of the various documents that must be provided along with a taxpayer's application.

The taxpayer should present a proposal to the SENIAT for the valuation of one or more transactions, providing evidence that such transactions comply with the arm's length standard. The proposal should be prepared by the taxpayer and should be based on an accepted transfer pricing methodology. The SENIAT can determine the format of the documents to be provided by the taxpayer in the proposal. The APA proposal can be bilateral in cases involving the territories of tax treaty partners.

The APA process must be concluded by the end of the third year after the year of application. This may be extended if the APA is being negotiated through a competent authority procedure under a double tax treaty.

Either party may terminate the APA application process if commercial or operational changes occur in the assets, functions or risks of the relevant parties.

The SENIAT may terminate the APA if it concludes that fraud was committed or false information was provided in the APA proposal. The SENIAT may terminate an APA in the event of non-compliance with the agreed terms and conditions. If the SENIAT rejects an APA application, a taxpayer cannot seek any of the administrative remedies included in the COT or other law. The only course of action available is to initiate a new APA application.

### **7012 Anticipated developments in law and practice**

In early 2007, the National Assembly approved an 'enabling law' that allows the Government to legislate and speed the reform and implementation of many special laws, including Income Tax Law, Value Added Tax Law, Financial Administration Law, Banking Sector Law and Insurance Sector Law, among others.

### **7013 Liaison with customs authorities**

The SENIAT has the same level of authority as the National Customs Intendant. In some recent custom duties audit procedures, the field examiners requested the taxpayer's information and documentation regarding transfer pricing, and there is an increasing coordination and information exchange between the tax and customs authorities.

### **7014 OECD issues**

Venezuela is not a member of the OECD. In spite of this, the Venezuelan tax authorities have adopted the arm's length standard and the use of the methodologies endorsed by the OECD Guidelines.

**7015 Joint investigations**

Joint investigations with the tax authorities of tax treaty partners are possible. Currently, Venezuela has an important network of tax treaties with countries such as Spain, France, Italy, the United Kingdom, Germany, the Netherlands, Switzerland, Portugal, Sweden, the Czech Republic, Trinidad and Tobago, Norway, Mexico and the United States, among others. Most of the Venezuelan tax treaties follow the OECD model and its Guidelines.

**7016 Thin capitalisation**

On 16 February 2007 the partial reform of the Venezuelan Income Tax Law included the Article 118 to introduce thin capitalisation rules. These rules state that the interest paid directly or indirectly to related parties will be tax deductible only if the amount of the debts with related parties (directly or indirectly received) plus the debts with independent parties does not exceed the amount of the taxpayer's equity. This debt-equity ratio of 1:1 is the strictest in Latin America, where most of the countries requires a 3:1 ratio. Moreover, to determine if a debt was received at arm's length conditions, the tax authorities will consider: (i) the level of debt of the taxpayer, (ii) the possibility that the taxpayer could have obtained the loan from an independent party without the intervention of a related party, (iii) the amount of debt that the taxpayer could have obtained from an independent party without the intervention of a related party, (iv) the interest rate that the taxpayer would have obtained from an independent party without the intervention of a related party, and (v) the terms and conditions of the debt that the taxpayer would have obtained from an independent party without the intervention of a related party.

# 71 Vietnam

## 7101 Introduction

Vietnam has been carrying out economic reforms since 1986 under the “Doi Moi” (Renovation) policy, focusing on market-oriented economic management. This has included: (i) restructuring to build a multi-sector economy; (ii) financial, monetary and administrative reform; and (iii) the development of external economic relations.

One of the most important aspects of economic reform in Vietnam has been the encouragement of domestic and foreign private investment with the introduction of the Law on Foreign Investment in 1987. The first tax law was introduced in the early 1990s. Since then the tax system has been subject to various changes and amendments. Transfer pricing issues have been addressed and dealt with in different forms (such as setting a cap on royalty rates, interest rates, etc). The first proper transfer pricing regulations were introduced only at the end of 2005 and came into force in 2006.

Below is a summary of the historical evolution of transfer pricing regulations in Vietnam which reflects not only the Vietnamese competent authorities’ increasing concerns about transfer pricing issues, but also the progress in their awareness thereon.

The first Vietnamese transfer pricing regulations were promulgated with Circular 95/1997/TT/BTC (Circular 95) dated 29 December 1997 issued by the Ministry of Finance (MOF), which provided the guidelines for the implementation of double tax treaties. Pursuant to related party transactions defined in Article 9. “Associated Enterprises” included in Double Tax Agreements (DTAs) concluded with other countries, Circular 95 allowed Vietnamese tax authorities to make adjustments to transfer prices of related party transactions in order to assure the fairness of the taxable profit under Vietnamese jurisdiction. However, Circular 95 did not specifically stipulate the transfer pricing methods or the documentation requirements.

Four years later, the MOF issued Circular 13/2001/TT-BTC (Circular 13) on 8 March 2001 to provide guidelines on the implementation of the Law on Corporate Income Tax applicable to foreign-invested enterprises. It specified three traditional transfer pricing methods applicable to the determination of the arm’s length nature of related party transactions as follows:

- Comparable uncontrolled price method;
- Resale price method; and
- Cost plus method.

However, Circular 13 did not provide any detailed guidelines on the application of the statutory methods or guidance on documentation requirements.

The Law on Business Income Tax (the BIT Law) issued in 2003 which came into force on 1 January 2004 requires all transactions between related parties to be conducted at market prices (the arm’s length principle).

Pursuant to the BIT Law, the MOF issued Circular 117/2005/TT-BTC (Circular 117) to provide guidelines on related party transactions and disclosure of documents and

information thereof. Circular 117 also specifies five transfer pricing methods applicable to the determination of the arm's length nature of related party transactions as follows:

- Comparable uncontrolled price method (hereinafter referred to as the CUP method)
- Resale price method (hereinafter referred to as the RPM)
- Cost plus method (hereinafter referred to as the CP Method)
- Transactional net margin method (hereinafter referred to as the TNMM)
- Profit split method (hereinafter referred to as the PSM)

There is no preferred method. Taxpayers can select the most appropriate method for the respective transaction.

Circular 117 came into force in 2006 and is applicable to both cross-border and in country related party transactions.

## **7102 Statutory rules**

At present, Circular 117 is considered the most comprehensive transfer pricing guideline in Vietnam.

From a technical viewpoint, the Vietnamese transfer pricing regulations under Circular 117 are modelled on the OECD Guidelines. Indeed, Circular 117 adopts the arm's length principle and the transfer pricing methods set out in the OECD Guidelines. Below is a high level analytical comparison of the Vietnamese transfer pricing guidelines versus the OECD Guidelines.

### **Scope of application (Part A.I and II)**

#### *Persons covered*

The provisions of Circular 117 are applicable to organisations and individuals who are subject to BIT in Vietnam and are carrying out business partly or wholly in Vietnam with related parties.

#### *Transactions covered*

Any transaction which is carried out between related parties (e.g. buying, selling, exchanging, leasing, renting, transferring or concession of goods or services) may come under the scope of Circular 117. However, related party transactions involving products whose price is placed under state control are excluded from the scope of the said Circular.

#### *Definition of related parties*

The definition of related parties in Circular 117 is much broader than that of the OECD Model. First, the threshold of capital participation of 20% either directly or indirectly is much lower than that set out in many other countries. This has meant that a very large number of enterprises are considered related parties under Circular 117. Furthermore, besides a set of criteria to define the related parties based on control, capital contribution and investment similar to the OECD Guidelines, the definition of related parties referred to in Section A.III.4 of Circular 117 also considers two parties related if more than 50% of any one single product of one party is purchased by the

other party or more than 50% of the production materials of any one single product of a party is provided by the other party. This extension would bring many parties which would normally be considered “unrelated” into “related” for transfer pricing purposes.

Under Vietnamese transfer pricing regulations, parties with any of the following management or business relationships would be considered related:

- One party is directly or indirectly engaged in the management, control, contribution of capital to, or investment in the other party;
- The parties are directly or indirectly subject to the management, control, capital contribution or investment in all forms by another party;
- The parties directly or indirectly participate in the management, control, capital contribution or investment in another party;
- Over 50% of any one single product of one party is purchased by the other party or over 50% of the production materials of any one single product of a party is provided by the other party; or
- Two parties have entered into a business cooperation agreement on a contractual basis.

Similar to the OECD Guidelines, Circular 117 also contains guidelines on the following four key subjects: comparability analysis; transfer pricing methods; selection and application of the most appropriate method; and documentation.

### *Comparability analysis*

Part B.I.2 of Circular 117 has detailed guidance with respect to the comparability analysis. When comparing a related party transaction against a comparable unrelated party transaction, a comparability analysis must be carried out and adjustments made (if necessary) to the following four main influential factors:

- Product property/characteristics
- Operational functions
- Contractual terms
- Economic terms in which the transactions take place

The priority given to each of the above factors in the comparability analysis will vary depending on the most appropriate transfer pricing method selected. Under the comparability analysis the factors that are considered to be the main influential factors need to be analysed in detail while the auxiliary factors should be analysed only at a high level.

### *Transfer pricing methods*

Section B.II.2 of Circular 117 sets out five transfer pricing methods to be used for determining the arm's length price. Basically, these methods are a reproduction of the transfer pricing methods specified in the OECD Guidelines.

Further, the Vietnamese transfer pricing guidelines recommend that preference be given to the comparison of the transfer price or profit margin of transactions with related parties against those with unrelated parties of the same taxpayer (internal method).

### *The CUP method*

Similar to the CUP method suggested by the OECD Guidelines, the Vietnamese transfer pricing regulations adopt the direct comparison of the transfer price of related party transactions to the price of comparable uncontrolled transactions.

Under the CUP method, the characteristics of the product and contractual terms are the most important factors for a comparability analysis, while economic conditions and the operational functions of the business establishment are auxiliary factors.

In accordance with Circular 117, two CUP approaches are provided—internal CUP and external CUP. The internal CUP approach compares the price of related party transactions of a company to that of comparable transactions carried out by that same company with unrelated third parties. The external CUP approach compares the price of related transactions of a company against that of comparable uncontrolled transactions carried out by unrelated third parties. Of the two CUP approaches, the tax authorities give preference to the internal CUP approach.

### *The RPM*

Basically, the RPM seeks to determine the price at which a company bought a product from related parties by deducting the gross margin from the price at which the product is resold to unrelated third parties, and any other expenses legally or reasonably included in the purchase price (e.g. import tax, customs duties, insurance and international freight).

For a comparability analysis under the RPM, Circular 117 gives preference to the operational functions of the business establishment while contractual terms, product characteristics and economic conditions are classified as auxiliary.

### *The CP method*

CP method uses the cost (or cost of goods sold (COGS)) incurred by the supplier of goods or services and adds an appropriate cost mark up to determine the arm's length price of the related party transaction.

For a comparability analysis under the CP method, Circular 117 gives preference to the operational functions of the business establishment while contractual terms, product characteristics and economic conditions are classified as auxiliary.

### *The TNMM*

Like the OECD Guidelines, the TNMM provided for by Circular 117 verifies the arm's length nature of a controlled transaction by comparing the ratio of the net profit margin of the controlled transaction relative to an appropriate base such as costs, sales or assets to that established by a comparable unrelated party transaction.

In calculating the net profit margin or earnings before tax (EBT) to be used, interest expense or depreciation of fixed assets should be added in order to eliminate the effect of such expenses on the financial outcome of the related party transaction in question.

For the TNMM comparability analysis, priority is given to the operational functions of the business establishment while other factors such as contractual terms, product characteristics and economic conditions are classified as auxiliary.



### *The PSM*

The PSM allocates profit derived from a controlled transaction realised by more than one related party in accordance with the proportion of their contributions on the basis of the arm's length principle.

For a comparability analysis under the PSM, the assignment of priority is similar to that of the RPM, CP method and TNMM.

Like the OECD Guidelines, Circular 117 also provides for two types of PSM:

- Contribution profit split
- Residual profit split

The first type of PSM consists of allocating the total profit derived from the related transaction to the parties involved on the basis of the contributed capital (or costs) of each of the related parties.

The second type of PSM, known as the residual profit split method, allocates profits derived from the related transaction in two steps. Firstly, each party is allocated an appropriate profit in return for the functions performed by each party (regular profit). Secondly, the residual profit (after deducting the profit distributed in the first step from the total profit) is allocated among the related parties based on the uniqueness or speciality of the contribution of each of the parties (e.g. certain specific contributions like R&D costs or the cost of intangibles or intellectual property used in the production and business in relation to the related transaction in question).

### **Selection and application of the most appropriate method**

#### *CUP selected as the most appropriate method*

In accordance with Circular 117, the CUP method can be considered appropriate under either of the following two main conditions:

- Where no difference in transactional conditions could have a significant material impact on the price of the product; or
- Where any such difference has been eliminated.

In practice, current Vietnamese transfer pricing regulations give preference to the application of the CUP method in the following business situations:

- Where transactions involve a single product in the market;
- Where transactions involve a single service, copyright or loan contract; or
- Where a business establishment carries out business involving the same product with both related and unrelated parties.

#### *RPM selected as the most appropriate method*

In accordance with Circular 117, the application of the RPM can be considered appropriate under either of the following two main conditions:

- Where no difference in transactional conditions could have a significant material impact on the gross profit margin over the net sale; or
- Where any such difference has been eliminated.

In practice, current Vietnamese transfer pricing regulations give preference to the

application of the RPM where the transaction consists of a simple distribution process of goods or merchandise; and this process involves a short business cycle from the time between purchase and resale; and no commercial or industrial activity is carried out to affect/change significantly the product characteristics and add significant value to the product.

#### *CP method selected as the most appropriate method*

In accordance with Circular 117, the application of the CP method can be considered appropriate under either of the following two main conditions:

- Where no difference in transactional conditions could have a significant material impact on the gross profit margin over the COGS; or
- Where any such difference has been eliminated.

In practice, current Vietnamese transfer pricing regulations give preference to the application of the CP method in the following business situations:

- Where the transactions involve manufacturing, assembling, processing or transforming goods in order to be sold to related parties;
- Where the transactions between the related parties involve performance under a partnership or business cooperation contract for manufacturing, assembling, fabricating, processing products, or under contracts for supplying inputs for production and purchasing outputs; or
- Where the transactions involve the provision of services to related parties.

#### *TNMM selected as the most appropriate method*

In accordance with Circular 117, the application of the TNMM can be considered appropriate under either of the following two main conditions:

- Where no difference in transactional conditions could have a significant material impact on the net profit margin; or
- Where any such difference has been eliminated.

As the TNMM is considered to be an expanded version of the RPM and CP method, the preference given to the application of the TNMM is similar to those of the RPM and CP method.

#### *PSM selected as the most appropriate method*

In accordance with Circular 117, the application of the PSM can be considered appropriate where related parties participate in the research and development of new products; or in the development of intangible property to be monopolised; or where related parties are involved in any stage of the manufacturing process from raw materials to finished goods that is associated with the ownership or use of unique intellectual property.

#### *Documentation*

Vietnam is a country where taxpayers are required to record and maintain contemporaneous documentation to submit to the tax authorities on the latter's

request. Basically, transfer pricing documentation under Circular 117 should include:

- General information on the business establishment and related parties;
- The business establishment's transactions; and
- The methods of calculation of arm's length prices.

Further, at year-end, taxpayers are required to disclose related party transactions on a standard form (e.g. form GCN-01/TNDN) which must be attached to the annual BIT return.

The taxpayer is required to use data of at least three continuous fiscal years for benchmarking purposes where transfer pricing methods involve the use of profit margins.

### 7103 Other regulations

In addition to Circular 117 which specifies transfer pricing for tax purposes, the following regulations promulgated by the MOF are also relevant to transfer pricing issues:

In December 2003 the MOF issued a number of Vietnamese Accounting Standards (VAS) including Standard No. 26 "Related Party Disclosures" which sets out general guidelines on the accounting principles and treatment in the financial statements for related party disclosures and transactions between a reporting enterprise and its related parties.

This accounting standard provides a definition of related parties, outlines possible related party transactions and their influences, and specifies required disclosures with regard to related party transactions. Standard No. 26 also provides guidelines on the determination of price for transactions between related parties (i.e. the CUP method, the RPM and the CP method).

In March 2007, the Government also issued Decision 40/2007/ND-CP dated 16 March 2007 providing guidelines on the customs valuation for import duties in the case where buyers and suppliers are considered related parties with respect to capital participation, management, business relationships and family relationships.

Based on this regulation, where the buyer and the supplier are considered to be related parties, the Customs Office will use the following methods to determine the taxable price of goods:

- *Transaction value method with identical goods*: Comparison with the price of identical goods imported into Vietnam within 60 days before or after the date of delivery;
- *Transaction value method with similar goods*: Comparison with the price of similar goods imported into Vietnam within 60 days before or after the date of delivery;
- *Deductive value method*: Calculation of the price of imported goods based on the resale price of similar products after the deduction of reasonable expenses;
- *Computed value method*: Calculation of the price of imported goods based on material costs, production expenses and profits; or
- *Fall-back method*: Combined or modified version of the above methods.

### **7104 Legal cases**

As transfer pricing is relatively new, the Vietnamese tax authorities have not yet conducted a proper transfer pricing audit and therefore there have been no legal cases involving transfer pricing issues as yet.

### **7105 Burden of proof**

In accordance with prevailing regulations in relation to transfer pricing and tax administration the taxpayer is obliged to satisfy the burden of proof by the following:

- Disclosing related party transactions on a standard form accompanied by the annual BIT return; and
- Documenting and reporting information/evidence regarding related party transactions and the relevant related parties in a transfer pricing document showing that the related party transactions are consistent with the arm's length principle set out in the transfer pricing regulations whenever requested.

The recordkeeping and documentation requirements under Circular 117 are onerous. The taxpayer is obliged to present transfer pricing documentation within 30 days from the date of the request. A one time extension of another 30 days may be accepted if it is considered reasonable.

### **7106 Tax audit procedures**

In accordance with prevailing tax administrative regulations under Circular No. 60/2007/TT-BTC issued by the MOF on 14 June 2007, a tax audit can be implemented either at the tax office or the taxpayer's premises. Based on the result of the tax audit at the tax office, the tax authorities may decide to conduct a tax audit at the taxpayer's premises and will then issue the audit decision to the relevant taxpayer.

#### *Tax audit procedure at the tax office (desk review)*

Tax officials examine the tax declaration dossier filed by the taxpayer to verify whether or not the tax amount assessed and declared by the taxpayer is appropriate based on a comparison with relevant data available to the tax authorities. In the case of an abnormality in the declared tax amount or missing information which could point to tax evasion or tax under-declaration, the relevant taxpayer will be required to provide an explanation and additional information/evidence within 10 days from the date of receipt of the authorities' first request. If further information is still required by the tax authorities, the taxpayer will have five days from the date of receipt of the second request of the tax authorities to provide information to justify his/her tax liability assessed and declared in the tax return.

After the second request, if the taxpayer fails to justify the appropriateness of his/her tax liability declared either with or without additional information/explanation, the tax authorities are entitled to:

- Assess the tax liability of the taxpayer in question based on the information/data available to the tax authorities; or
- Issue a decision to carry out a tax audit at that taxpayer's premises if the information/data available to the tax authorities is not considered adequate to issue an assessment of the tax liability as above.

*Tax audit procedure at taxpayer's premises*

The execution of the tax audit must be carried out within 10 working days from the date of the issuance of the decision to perform a tax audit at the taxpayer's premises. However, the decision on such a tax audit shall be cancelled if before the tax audit starts the taxpayer can justify the appropriateness of the declared tax liability or accepts and pays the tax amount assessed by the tax authorities.

The duration of a tax audit at a taxpayer's premises will not exceed five working days. A one time extension of another five days will be permissible if necessary, provided that the taxpayer is notified of the extension at least one day before the first audit period is over.

At the end of a tax audit a report must be issued describing the fact findings and conclusions of the tax auditor team. The taxpayer has the right to make a formal objection to the conclusion of the tax auditor team.

If the result of the tax audit raises concerns about tax evasion or fraud, the case will be reported to the head of the relevant tax authority for further investigation and/or inspection.

*Tax inspection*

In practice, tax inspections are normally conducted on the basis of an annual plan developed by the tax authorities, except where there are signs of tax evasion and/or fraud, or for the purpose of resolving appeals, denunciations, or at the request of the heads of tax administration bodies at all levels or by the Minister of Finance. A taxpayer can be subject to tax inspection not more than once per year.

Where the tax law has been infringed, a tax inspection can only be conducted if the tax authorities have evidence of tax underpayment, tax evasion, or tax fraud but such action is not so serious as to be considered a criminal act.

A decision on tax inspection has to be announced to the taxpayer within 15 days from the date of issuance. The duration of a tax inspection cannot exceed 30 days. A one time extension of another 30 days may be permitted under certain conditions, but the taxpayer in question must be informed of such an extension five working days before the expiration of the first inspection period.

At the end of a tax inspection a report must be issued to document the fact findings including the opinion of each inspection team member. The taxpayer has the right to make a formal objection to the inspection team's observations.

Within 15 working days from the date of receipt of the inspection report, the head of the relevant tax authority must issue a letter specifying the result of the tax inspection. If the taxpayer still disagrees with the conclusion of the tax authorities he/she can file an appeal or suit following the procedure stipulated in the law on appeals and suits.

**7107 The transfer pricing audit procedure**

As there is no audit procedure set out specifically for transfer pricing, a transfer pricing audit could be implemented separately or in conjunction with a tax audit adopting the said procedures.

### **7108 Revised assessments and the appeals procedure**

In the event that the taxpayer considers the administrative action taken by the tax official or the decision issued by the tax authorities (e.g. in relation to tax liability, tax reimbursement, tax exemption/reduction including the conclusion of the tax audit or suit) is a breach of the taxpayer's rights, the taxpayer is entitled to file a suit or appeal against this act or decision.

The authority to resolve appeals follows the administrative hierarchical order from the local office to the MOF. The head of each hierarchical body is responsible for resolving the appeal against the administrative decision issued by his/her office and/or action taken by his/her staff or by him/her.

The appeals procedure is the same as that of the general laws on appeals and suits. In practice, where the taxpayer disagrees, for instance, with the conclusion of the tax inspection of the competent authorities, including the MOF, the taxpayer can file a suit in the administrative court against the conclusion in question. However, there is no tax court in Vietnam.

### **7109 Additional tax and penalties**

Currently, no specific penalty is provided for in the transfer pricing guidelines under Circular 117. However, tax authorities have the right to assess and make appropriate adjustment, as the case may be, to the transfer price, taxable income or tax amount payable where they have evidence that the taxpayer has committed tax evasion or fraud by manipulating transfer prices with related parties. In this case, the adjustment to be made needs to refer to the arm's length range established by transfer prices or profit margins established by unrelated parties. The value of transfer prices or profit margins to be used for tax authorities' assessment is not to be lower than the middle value of the arm's length range.

Further, in accordance with the Law on Tax Administration and its implementing guidelines, non-compliance will be subject to the following categories of penalty:

- Non-compliance with tax filing procedures and/or submission of incomplete returns could be subject to a penalty of up to VND5 million.
- Late payment of tax is subject to interest of 0.05% per day of the outstanding tax amount.
- Under-reporting of tax liabilities could be subject to a penalty of up to 10% of the underpaid amount regardless of whether the taxpayer keeps all related supporting documents and presents them to the tax authorities upon request.
- Tax evasion could be subject to a penalty of up to three times the outstanding tax liability.

### **7110 Resources available to the tax authorities**

For the time being, we understand that the General Department of Taxation (GDT) is planning to organise a network of transfer pricing management nationwide from the central authorities to local tax offices.

At the GDT there is a team to monitor and manage the implementation of transfer pricing regulations at the local tax authorities. This team can conduct transfer pricing audits with assistance from local tax authorities. In an attempt to reinforce transfer

pricing audit capacity at the local level, the GDT has recently organised a number of transfer pricing audit trainings for local tax officials.

At the local level, each provincial Tax Department will have a number of transfer pricing experts who are responsible for information gathering and reporting transfer pricing compliance periodically to the GDT in addition to participating in transfer pricing audits conducted by the GDT team.

With the sponsorship of international organisations, the Vietnamese tax authorities also receive support from other tax authorities in the region such as the Australian Tax Office and the Japanese Tax Administration with respect to transfer pricing coaching.

### **7111 Use and availability of comparable information**

While it is stated in the Vietnamese transfer pricing guidelines that only the databases recognised formally by the Government are acceptable to be used for benchmarking purposes, to date no such recognised databases that are available in Vietnam are suitable to use for benchmarking.

Over the last couple of years, the Vietnamese tax authorities have been gathering information on business dealings in order to establish its own database of comparable information. Once it is ready, this database will be used for tax assessment by the tax authorities.

### **7112 Risk transactions or industries**

Formally, no industry or transactions are classified as particularly high risk from the transfer pricing audit or investigation perspective. However, companies producing high value goods and having significant related party transactions such as in automobile and motorbike production would likely be a high risk industry. In practice, a company which posts chronic losses (e.g. for three continuous years) and/or large companies with significant related party transactions are likely to be challenged by the tax authorities, in particular where the company carries out business with related parties located in a tax haven/harbour.

### **7113 Limitation of double taxation and competent authority proceedings**

Vietnam has more than 50 DTAs concluded with other countries and territorial areas. Most DTAs contain an "Associated Enterprise" Article modelled on the OECD convention. However, a large number of DTAs exclude the provision which permits the respective tax authorities to adjust the profit of an entity where the transaction is judged not to be at arm's length (paragraph 2 of Article 9 of the OECD convention model). On the other hand, there are a number of DTAs that include the previously mentioned provision but exclude the accompanying provisions in the Article requiring one contracting country to reduce the amount of tax charged to offset the increased tax liability imposed by the other contracting country as a result of the arm's length adjustment.

### **7114 Advance pricing agreements (APAs)**

Under the Vietnamese transfer pricing regulations, APAs are not adopted as an alternative method in dealing with transfer pricing matters.

### **7115 Anticipated developments in law and practice**

After the first year of implementation of the transfer pricing regulations under Circular 117, the tax authorities have become more aware of the importance of transfer pricing issues and have attempted to improve transfer pricing compliance management in two ways:

- Improving the transfer pricing knowledge and auditing skill of tax inspectors; and
- Modifying/amending the transfer pricing regulations.

### **7116 Liaison with customs authorities**

In 2002 the customs authorities (the GDC) were merged into the MOF. As a result, the cooperation between the GDT and the GDC has improved significantly. To date, each taxpayer is assigned a unique Tax Identification Number (TIN) which is used for both domestic tax and customs duty declaration.

The GDT and GDC are now working on improving information exchange. The objective of the project is for taxpayers' information to be exchanged automatically on a regular basis between the GDT and the GDC.

### **7117 OECD issues**

While Vietnam is not a member of the OECD, the Vietnamese transfer pricing regulations are essentially analogous to the OECD Guidelines. Indeed, the Vietnamese transfer pricing regulations have adopted the same arm's length principle and transfer pricing methodologies set out in the OECD Guidelines. However, the OECD Guidelines are not formally referred to in the Vietnamese transfer pricing regulations. Also, a transfer pricing policy that is acceptable in an OECD country will not necessarily be accepted in Vietnam (e.g. besides the absence of APA adoption as mentioned above, the Vietnamese transfer pricing regulations do not adopt the safe harbour/haven principle recommended in the OECD Guidelines).

### **7118 Joint investigations**

So far no joint investigation has been implemented by the Vietnamese tax authorities in conjunction with other tax authorities. However, in accordance with the provision of the exchange of information of the DTAs, the GDT has actively participated in information exchange with other tax authorities.

### **7119 Thin capitalisation**

The arm's length principle applies to loans and interest charges. However, at present, there are no rules dealing specifically with thin capitalisation and no set permissible debt to equity ratios.



# Appendix 1

## Functional analysis questions

*This appendix sets out a list of generic questions which might be used in performing a functional analysis of a business to understand its various functions, risks and intangibles. The list is not intended to be exhaustive and would need to be tailored to suit the needs of specific business entities.*

### FUNCTIONS ANALYSIS

#### (1) Manufacturing

##### *(a) Material purchasing*

1. What materials or partly finished goods are purchased?
2. From whom are purchases made?
3. Are any purchases made from related companies?
4. Where and how are raw materials purchased?
5. Who performs the purchasing function?
6. Who plans purchasing schedules?
7. Who negotiates purchasing arrangements?
8. Who approves the vendor as being of acceptable quality?
9. Do purchasing decisions require head office approval?
10. What are the approvals required?
11. Are any purchases made on consignment?
12. What are your major risks?

##### *(b) Inventory*

1. Where is stock held?
2. Who controls the levels of inventory?
3. How are inventory levels controlled? Is there a computer system?
4. Are any purchases made on consignment?
5. How many days of inventory are on hand?
6. Has there ever been a case, for whatever reason, where you were stuck with excess inventory? Who bears the cost of obsolete inventory?
7. What are your major risks?

##### *(c) Production equipment*

1. Who determines the purchasing budget?
2. Who negotiates purchasing?
3. Who maintains the plant?
4. Who has expenditure authority for capital equipment?
5. Who writes specifications for the plant?
6. From whom is production equipment purchased?

7. Are any purchases made from related companies?
8. Do you have discretion over the equipment used? Can you modify the equipment?
9. What decisions require head office approval?
10. What are the approvals required?

*(d) Production scheduling*

1. Who is responsible for production scheduling decisions? What factors enter the decisions? When are the decisions made?
2. Is a computer system used?
3. What decisions require head office approval?
4. What are the approvals required?
5. What are your major risks?
6. Does your distributor always buy what you manufacture?

*(e) Manufacturing and process engineering*

1. What products are produced?
2. Who designed the products and who owns the technology?
3. What is the manufacturing process?
4. Who developed the original process? Have any improvements been made locally?
5. Is it possible to compare productivity between the subsidiaries in the group?
6. Have you ever utilised a third party to produce your products?

*(f) Packaging and labelling*

1. What packaging and labelling is done? Where is it done?
2. Who makes the decisions in relation to packaging and labelling? Have you complete autonomy in relation to such decisions?

*(g) Quality control*

1. What form does quality control take?
2. Who sets finished product quality standards and procedures?
3. Who performs the quality control and who bears the cost?
4. Who provides the equipment and techniques for quality control?
5. How much product is lost because it fails quality control checks?
6. What are your major risks?
7. What decisions require head office approval?
8. What are the approvals required?

*(h) Shipping of products*

1. Who pays freight charges for product in and out?
2. Who arranges shipping of products?

3. Who ships your products? To where? How?
4. Who is responsible for the selection of shippers?
5. Who is responsible for shipping deadlines?
6. What are your major risks?
7. What decisions require head office approval?
8. What are the approvals required?

## **(2) Research and development**

- (a) What research and development do you carry out?
- (b) Is any research and development carried out on your behalf by related companies?
- (c) Do you commission third parties to carry out research and development on your behalf?
- (d) Where are products designed?
- (e) What input do distributors have on manufacturing, product design, or product modifications?
- (f) How important is the development of patents in the industry?
- (g) What patents do you own that create unique products that competitors cannot duplicate?
- (h) What unpatented technical know-how have you developed that might differentiate your products from competitors, create important cost efficiencies, or give you an advantage in increasing your market share?
- (i) What decisions require corporate head office approval?
- (j) What are the approvals required?
- (k) Who formulates the budget?
- (l) Are licence agreements in existence between you and related companies or third parties?
- (m) Is there a cost sharing agreement in force and if so, what are the details?

## **(3) Marketing**

- (a) *Strategic*
  1. Do you carry out your own marketing?
  2. Are market surveys performed? Do you monitor market demand?
  3. What decisions require head office approval?
  4. What are the approvals required?
  5. Who are your competitors?
  6. Who assesses demand in foreign markets?
  7. What are the risks related to demand for your products?
  8. Who formulates the marketing budget?
  9. Does your distributor always buy what your manufacturer produces?
  10. Has your manufacturer ever refused to fill an order?
  11. Do related companies carry out marketing on your behalf?
  12. Are third party distributors used?
  13. Who chooses, authorises and controls third party distributors?

*(b) Advertising, trade shows, etc*

1. What forms of marketing do you utilise?
2. What form of advertising is used? Who pays for it?
3. Are trade shows used and if so, who organises them and who pays for them?
4. Are samples provided to distributors? Who bears the costs?
5. Who produces product brochures, specifications sheets, etc?
6. What marketing assistance do you receive?
7. What decisions require head office approval?
8. What are the approvals required?

**(4) Sales and distribution**

*(a) Sales*

1. How are sales made and who is involved?
2. Who issues the invoice to the customer?
3. Who issues the invoice to you?
4. Who formulates the projections and sets targets?
5. Where are sales orders received?
6. Who is responsible for the achievement of sales targets?
7. Who negotiates sales contracts? Do they operate autonomously?
8. Does your distributor always buy what your manufacturer produces?
9. How much is sold to related companies?
10. Are only finished goods shipped from here?
11. Who are your competitors?
12. What are the risks related to demand for your products?
13. What decisions require corporate head office approval?
14. What are the approvals required?
15. Are products exported? If so, who is responsible for the export function?
16. What are the major risks in selling products in foreign countries?

*(b) Quality control*

1. What form does quality control take?
2. Who sets finished product quality standards and procedures?
3. Who performs quality control and who bears the cost?
4. Who provides the equipment and techniques for quality control?
5. How much product is rejected by customers as below standard?
6. Who bears the loss on defective products?
7. What are your major risks?
8. What decisions require head office approval?
9. What are the approvals required?

*(c) Freight*

1. Who pays freight charges for product in and out?
2. Who arranges shipping of products?

3. Who ships your products? To where? How?
4. Who is responsible for the selection of shippers?
5. Who is responsible for shipping deadlines?
6. What are your major risks?
7. What decisions require head office approval?
8. What are the approvals required?

*(d) Inventory*

1. Do you actually receive the goods and hold stock?
2. Where is stock held?
3. Who controls the levels of inventory?
4. How are inventory levels controlled? Is there a computer system?
5. Are any purchases made on consignment?
6. How many days of inventory are on hand?
7. Has there ever been a case, for whatever reason, where you were stuck with excess inventory?
8. Who bears the cost of obsolete inventory?
9. What are your major risks?

*(e) Installation and after-sales services*

1. Do you install your products?
2. Do you provide after-sales service? If so, describe the service.
3. Are product repairs carried out by any company and who bears the cost?
4. Who bears the cost of installation and after-sales service?
5. Do you provide product guarantees?
6. Who bears warranty costs?

**(5) Administration and other services**

*(a) General administration*

1. Is there a complete administration function?
2. Is any administration performed for you by related companies?
3. What decisions require corporate head office approval?
4. What are the approvals required?
5. Who is responsible for administrative codes of practice?

*(b) Pricing policy*

1. Who determines the product pricing?
2. What is the pricing policy for the various goods and services?
3. What are your major risks?
4. What decisions require corporate head office approval?
5. What are the approvals required?

*(c) Accounting*

1. What accounting functions are carried out? By whom?
2. Where are the financial reports prepared?
3. What decisions require head office approval?
4. What are the approvals required?
5. Is a bank account maintained? For what purpose?
6. Who has cheque signatory authority? What are the authority limits?
7. Do you bear the credit risk on sales to customers?
8. Who pays product liability insurance premiums?
9. Who arranges and pays for other insurance?

*(d) Legal*

1. Who is responsible for legal matters?
2. What decisions require head office approval?
3. What are the approvals required?

*(e) Computer processing*

1. Is computer processing and programming done here? If not, by whom?
2. Who developed the software and is any charge made for it?
3. Who has expenditure authority for capital equipment?
4. What decisions require head office approval?
5. What are the approvals required?

*(f) Finance/loans/credit*

1. Are there any inter-company loans or long-term receivables and if so, is interest charged?
2. What trade credit terms are received and given?
3. Is interest paid or charged if credit periods are exceeded?
4. Who is responsible for borrowing requirements?
5. What are your major risks?
6. What decisions require head office approval?
7. What are the approvals required?

*(g) Personnel*

1. Are there any secondments to or from overseas affiliates? What positions do they hold in the company?
2. What training do you provide to your employees?
3. What is the length of the training period?
4. Is there on-the-job training?
5. Where is management training done?
6. What is the staff turnover rate?
7. Are all employees on your payroll?
8. Who is responsible for the employment of staff?

9. What decisions require head office approval?
10. What are the approvals required?

*(h) Use of property/leasing*

1. Is property owned or leased from affiliates?
2. Do you lease property to affiliates?
3. Who is responsible for this function?

**(6) Executive**

- (a) Does anyone report to the parent company besides the general manager?
- (b) Who is responsible for dealing with government agencies?
- (c) What are the key regulatory requirements?
- (d) Has the parent ever told you to use more procedures than you have developed?
- (e) How does manufacturing site selection occur?
- (f) Where does the initial impetus in relation to corporate decisions come from?
- (g) What decisions require head office approval?
- (h) What are the approvals required?

**RISK ANALYSIS**

**(1) Market risk**

1. What are the market risks?
2. Do you bear the market risks?
3. How significant are the market risks?

**(2) Market risk**

1. Does inventory become obsolete?
2. Who bears the cost of obsolete inventory?
3. Do you provide warranties in relation to finished goods?
4. Who bears the cost of returns/repairs under warranty?

**(3) Credit and bad debt risk**

1. What credit terms are given and received?
2. Do you bear the cost of bad debts?
3. Is this a significant risk?

**(4) Foreign exchange risk**

1. Are you exposed to foreign exchange risk?
2. How significant is the risk?

## INTANGIBLE ANALYSIS

### (1) Manufacturing

#### *(a) Research and development*

1. Have you developed your own products?
2. Have you developed manufacturing processes?
3. How important are these processes to your business? Are they unique?

#### *(b) Manufacturing processing/technological know-how*

1. Do you possess technological know-how?
2. If so, what is its nature?
3. How important to your business is the know-how?
4. Is the know-how unique?

#### *(c) Trademarks/patents, etc*

1. Do you own any trademarks/patents?
2. How significant are their existence to your business?

#### *(d) Product quality*

1. Do you consider that you have a reputation for high quality?

#### *(e) Other*

1. Are there any other manufacturing intangibles?

### (2) Marketing

#### *(a) Trademarks/trade names*

1. Do you own any trademarks/trade names?
2. Do you pay royalties for the use of any trademarks/trade names?
3. Do you charge royalties for others to use trademarks/trade names that you own?
4. How significant are they to your business?

#### *(b) Corporate reputation*

1. Do you consider that you have a corporate reputation?
2. What is the nature of this reputation?
3. Is corporate reputation significant in your business?

#### *(c) Developed marketing organisation*

1. Do you have a developed marketing organisation?



*(d) Ability to provide service to customers*

1. Do you consider that you provide good service to customers?

*(e) Product quality*

1. Do you consider that you have a reputation for high quality?

*(f) Other*

1. Are there any other marketing techniques?

# **Appendix 2**

## **Examples of databases for use in identifying comparative information**

The range of easily accessible information is increasing at a very rapid pace, driven by technological change. Vast quantities of data can be obtained on CD-ROM and DVD, an example being the AMADEUS database of information on European companies. Beyond that, the internet allows the researcher direct access to any information placed in the public domain, either by individual companies or by commercial information providers that make a charge for accessing their databases. These databases are changing day by day but many are built from 'traditional' sources, including some of those listed below.

### **US**

Annual Report and SEC Filings and Forms (EDGAR)  
Dun and Bradstreet's Hoover's (North America)  
Standard and Poor's Compustat North America and Global Vantage  
Thomson's Financial/Disclosure SEC and Worldscope

### **Pan-European**

Dun and Bradstreet's Who Owns Whom (Europe) Europe Top 15,000  
Fortune Top 500 (Non-US) Industrials Forbes Top 500 Foreign Companies Extel  
Kompas Europe  
Moody's International Manuals Directory

Each European country also has individual databases – as an example, the major UK databases are listed below.

### **UK**

Companies House  
Stock Exchange Official Year Book  
Dun and Bradstreet's Who Owns Whom (UK)  
FT Supplement Top Companies  
UK's Top 10,000 Companies  
'Business' 1,000  
McMillan's Unquoted Companies  
Jordan's Top 4,000 Privately Owned Companies  
Kompas  
Extel  
ICC  
OneSource  
Juniper  
Experian Bureau van Dijk – Fame

# Appendix 3

## US – Proposed service regulations

The proposed US regulations will replace the existing rules under Treasury Regulation ('Treas. Reg.') §1.482-2(b) and Treas. Reg. §1.482-4(f)(3). The proposed regulations address the transfer pricing issues related to the provision of inter-company services, and the antecedent economic substance and ownership of intangible property arguments subsumed within such relationships. The proposed regulations represent an attempt by the US to harmonise and coordinate the inter-company services transfer pricing regulations with other sections of the US transfer pricing regime.

### **Benefit test**

An activity provides a benefit if it directly results in a reasonably identifiable increment of economic or commercial value to the service recipient. The proposed services regulations look at benefit primarily from the service recipient's perspective. This is a departure from the existing rules that try to determine if the service renderer would charge for

The proposed regulations permit the sharing or allocation of centralised service activities or corporate headquarters costs only in situations in which there is an identifiable benefit to the recipients attributed to the charged-out costs. The proposed services regulations states that activities that provide only an indirect or remote benefit, duplicative activities, shareholder activities, and passive association are not beneficial services for recipients. Thus, recipients are not liable for such costs under the proposed regulations.

### **Overview of proposed transfer pricing methods**

The proposed regulations require taxpayers to apply the arm's length standard in establishing compensation amounts for the provision of inter-company services. Thus, similar to other sections of the transfer pricing regulations, taxpayers involved in the provision of inter-company services must adhere to the best method, comparability, and the arm's length range requirements of Treas. Reg. §1.482-1. What is new is that the proposed regulations stipulate that taxpayers must apply one of the six specified transfer pricing methods or an unspecified method in evaluating the appropriateness of their inter-company services transactions. The six specified transfer pricing methods include three transactional approaches, two profit-based approaches, and a cost-based safe harbour. The proposed transactional approaches are the comparable uncontrolled services price method (CUSPM), the gross services margin method (GSMM) and the cost of services plus method (CSPM). The two profit-based approaches are the existing comparable profits method (CPM) and the profit split method (PSM). The proposed cost-based safe harbour is the simplified cost-based method (SCBM).

### **The comparable uncontrolled services price method (CUSPM)**

The CUSPM is analogous to the comparable uncontrolled price (CUP), the comparable

uncontrolled transaction (CUT), and the proposed comparable uncontrolled financial transaction (CUFT) methods of the existing Treas. Reg. 1.4823, Treas. Reg. §1.482-4 and Proposed Treas. Reg. §1.482-8 regulations. Under the proposed CUSPM, the price charged in a comparable uncontrolled services transactions form the basis of evaluating the appropriateness of the controlled services transaction. Generally, the CUSPM is applicable in situations where the related party services are similar (or have a high degree of similarity) to the comparable uncontrolled services transactions.

### **The gross services margin method (GSMM)**

The GSMM is comparable to the resale price method (RPM) of the tangible property transfer pricing regulations. Under this method, evaluating the appropriateness of inter-company services pricing arrangements relies on the gross profit margins earned in comparable uncontrolled services transactions as benchmarks. The GSMM is appropriate in situations where a controlled taxpayer provides services (e.g. agency or intermediary services) in connection with a related uncontrolled transaction involving a member of the controlled group and a third party.

### **The cost of services plus method (CSPM)**

The CSPM is analogous to the cost plus (CP) method of the tangible property transfer pricing regulations. Like the CP method, the CSPM evaluates the appropriateness of inter-company services transfer pricing arrangements by reference to the gross services profit mark-up earned in comparable uncontrolled services transactions. The CSPM is appropriate when the service providing entity provides the same or similar services to both related and third parties.

### **The comparable profits method (CPM)**

Like the CPM of the existing transfer pricing regulations, the CPM described in the proposed services regulations relies on profit level indicators derived from the financial information reported for third parties that engage in similar business activities under similar circumstances as objective measures of profitability. The proposed regulations provide a new profit level indicator, the ratio of operating profit to total services costs, a ratio that transfer pricing practitioners have used for years. The arm's length range derived from the operating profit to total services costs ratios earned by third parties engaged in similar business activities under similar circumstances to the controlled services transactions constitutes the basis for evaluating the appropriateness of the controlled services transactions pricing arrangements.

### **The profit split method (PSM)**

The PSM evaluates whether the allocation of the combined operating profit or loss attributable to the controlled services transactions satisfies the arm's length standard by reference to the relative value of each controlled entity's contribution to the combined operating profit or loss. Under the proposed inter-company services regulations, the PSM is appropriate for controlled services transactions that involve high-value services or transactions that are highly integrated, such that it is difficult to reliably evaluate the contribution of each service-providing entity on a separate basis.

The proposed regulations amend the residual PSM; the proposed regulations note that the value of each controlled entity's relative non-routine contribution can serve

as the basis of sharing residual profits. Such non-routine contributions may include contributions of intangible property.

### **The simplified cost-based method (SCBM)**

The SCBM is intended to replace the existing cost safe harbour rules of Treas. Reg. §1.482-2(b), thereby addressing the perceived abuses of the 'non-integral' services tests. Taxpayers can use the SCBM in evaluating the pricing of low-margin inter-company services (e.g., routine back-office services). The price of the controlled services transaction under the SCBM is evaluated by reference to the mark-up on total services costs earned by third parties that engage in similar business activities under similar circumstances. A key benefit of the SCBM is that it precludes the IRS from proposing an adjustment if a taxpayer's transfer pricing results for low-margin controlled services transactions comply with the safe harbour requirements of the proposed regulations. Under the safe harbour requirements, the IRS can only propose an adjustment if the IRS-determined arm's length mark-up on total costs (based on general transfer pricing rules) exceeds the mark-up charged by the taxpayer by at least a specified number of applicable percentage points. If a taxpayer charges only total costs in a controlled services transaction, the applicable number of percentage points is 6%, and the IRS will only propose an adjustment if the arm's length mark-up on total costs is at least 6%. The benefits of the SCBM decrease as the mark-up attributable to the services increases. Thus, the applicable percentage point of 6% drops by one percentage point for every increase of two percentage points in the mark-up on total costs charged by the taxpayer.

To take advantage of the SCBM, a taxpayer must:

- Maintain books and records that permit for the verification of the total costs of providing services; and
- Have a written contract in place that provides for the current compensation of the provided inter-company services.

A taxpayer cannot use the SCBM if:

- The mark-up charged in a controlled services transaction exceeds the arm's length mark-up;
- The taxpayer charged an amount that is less than the total services costs in the controlled services transaction;
- The taxpayer's cost determination, allocation and apportionment method is inconsistent with the methods used by third parties in similar circumstances;
- The service renderer, recipient, or another related taxpayer in the same controlled group renders similar services to third parties (unless such services are rendered on a *de minimis* basis);
- The controlled services were rendered to a recipient that receives controlled services in significant amounts (i.e. in excess of 50% of the total costs of the service recipient during the taxable year);

- The controlled services involve the use of valuable or unique intangibles with the costs associated with such intangibles not reflected in the services costs;
- The controlled services are combined with other types of controlled transactions, such as a transfer of tangible or intangible property;
- The controlled services are in the nature of manufacturing, production, extraction, and construction services;
- The controlled services involve reselling, distribution, or similar activities conducted under a commission or other arrangement;
- The controlled services involve financial transactions, including guarantees and insurance or reinsurance services; or
- The controlled services involve research and development (R&D), experimentation, engineering, or scientific services.

### **Intangibles ownership and enhancements**

In amending Treas. Reg. §1.482-4(f)(3), the proposed services regulations stipulate new rules for establishing the ownership and development of intangibles. Under the proposed regulations, the legal owner of an intangible asset (as determined under the intellectual property law of the relevant jurisdiction) or the holder of licensing rights under a contract is considered the sole owner of such an intangible, unless such ownership is inconsistent with the economic substance of the underlying transaction. If there is no identified legal owner, the proposed regulations consider the taxpayer who 'controls' the intangible as the owner.

The proposed regulations revise Treas. Reg. §1.482-4(f)(4) by providing for an arm's length compensation for the intangibles development or enhancement services provided by a controlled taxpayer for intangibles owned by a related party. However, in situations where the compensation for such contributions is embedded within the terms of a related controlled transaction, the proposed regulations do not allow for a separate allocation. An example is an inter-company intangible licence arrangement under which the licensee renders marketing services that enhances the licensor's intangible asset. In such a situation, the licensor could elect to separately compensate the licensee through a separately stated fee or embed such compensation within the royalty paid by the licensee in the form of a reduced royalty rate. In analysing the appropriateness of the controlled licensing arrangement, such licensee contributions must be considered, especially when the controlled transaction involves an embedded contribution.

### **Contingent payment contractual terms**

The proposed services regulations recognise and respect the incidence of contingent payment arrangements. The IRS will respect a contingent payment arrangement memorialised in a written contract executed prior to the inception of the activity. The proposed services regulations require such a contract to state that payment is contingent on the occurrence of a future benefit, directly related to the controlled services transaction, for the recipient. In addition, the contract should provide for payment on a basis that reflects the recipient's benefit from the provided services and the risks borne by the service renderer. As long as the contingent payment arrangement

is reasonable and consistent with the economic substance of the controlled transaction and the conduct of the controlled parties, the IRS will respect the arrangement. The proposed services regulations allow the IRS to impute a contingent payment contract if a taxpayer spends more than an arm's length amount to improve the value of intangible assets owned by a related party, and that effort results in excess profits.

### **Allocation of costs**

Under the proposed regulations, a 'generalised or non-specific benefit' cannot serve as the basis of allocating costs to a member of a controlled group. The regulations require taxpayers to consider all factors, including total services costs, assets, sales, compensation, space utilised and time spent in making cost allocation decisions. Taxpayers may consider their allocations or apportionments methodologies for other purposes (e.g. management, creditors, shareholders, potential investors, etc) as potential indicators of reliable allocation methods as long as such allocations comply with the requirements of Generally Accepted Accounting Principles (GAAP). However, the IRS may not provide such allocations with any conclusive weight.

### **Conclusion**

The proposed services regulations place a renewed emphasis on economic substance and require consistency with the language contained in a taxpayer's inter-company agreements. If finalised in its current proposed form, the IRS is likely to take a narrow view of the SCBM safe harbour. The IRS is also likely to challenge inter-company transactions that involve intangible assets with an aim of forcing taxpayers to adopt the PSM for such transactions.

# INDEX

*References are to section numbers*

## A

- Accounting services** – see Services
- Accounting systems**
  - policy changes** ..... 620, 624
- Adjustments**
  - mutual agreement procedure 313, 1107
  - secondary ..... 313
- Advisory commission**
  - generally ..... 1109
  - resolution of the problem ..... 1110
- Ad valorem duties and taxes** ..... 1007
- Agreements**
  - cost sharing ..... 523,532
  - inter-company legal agreements 432
  - management services ..... 512
- Anti-dumping duties** ..... 1008
- Arbitration**
  - audits ..... 704
  - procedures ..... 1107
- Arm's length principle**
  - financing transactions ..... 215
  - generally ..... 202, 302
  - guidance ..... 302
  - hybrid intangibles ..... 211
  - manufacturing intangibles ..... 209
  - marketing intangibles ..... 210
  - OECD Guidelines ..... 301
- Assists** – see also Intangible
  - property valuation for customs
  - purposes ..... 1010
- Audits** – see also Tax audits
  - advance rulings ..... 707
  - arbitration ..... 704
  - establishing control of process . 702
  - existing pricing policies, dealing
    - with adjustments ..... 706
  - indirect tax authority, valuation of.....
    - imported goods ..... 1025
  - minimising exposure ..... 703
  - negotiation ..... 704

- preparation ..... 705
- settlements ..... 607

## B

- Barriers to entry** ..... 206
- Berry ratio** ..... 311
- Bonus schemes** ..... 623
- Brokerage and commissions** .....
  - 808,810,819
- Brussels definition of value (BDV)** ..... 1005
- Buy-in arrangements** ..... 530
- Buying commissions** ..... 1010

## C

- Capital stock**
  - financing long-term capital
  - needs ..... 222
- Centralised support activities**
  - restructuring techniques ..... 413
- Comparable profits**
  - method (CPM) ..... 913
- Comparables documentation** .. 434
- Comparable uncontrolled price**..... 303
- Competent authority procedures**
  - see chapter 11
- Computer software**
  - classification difficulties ..... 211
  - valuation for customs
  - purposes ..... 1016, 1020
- Container costs** ..... 1010
- Contract maintenance firms**
  - restructuring techniques ..... 418
- Contract manufacturers**
  - functional analysis ..... 409
- Contract marketing**
  - restructuring techniques ..... 419
- Contract service providers**
  - restructuring techniques ..... 415
- Co-operation between tax**
  - authorities ..... 313
- Cost-accounting method**



- management fees ..... 508
- Cost plus method**
  - capacity adjustments ..... 306
  - generally ..... 305
- Cost sharing arrangements** – see Finance arrangements; Research and development
- Credit risk** .....406
- Customs duties** – see chapter 10
- D**
- Debt** – see Finance arrangements
- Deep discounted loans** .....224
- Defective products and warranty**...406
- Definitions and meanings**
  - arm's length .....202
  - comparable profit method ..... 913
  - control .....1002, 1105
  - functions .....405
  - intangible development area.915,917
  - net adjustment penalty ..... 938
  - provision of services ..... 212
  - related persons ..... 302
  - residual profit split method ..... 914
  - sales of tangible property ..... 203
  - tested party ..... 949
  - transactional net margin method 310
  - transactional penalty ..... 938
  - transfers of intangible property . 206
- Designs** – see Intangible property; Licence fees; Royalty payments
  - costs, customs valuation .... 1021
- Disclosure tax returns** .....619
- Distribution companies**
  - characterisation .....410
- Documentation**
  - comparables ..... 434
  - contemporaneous ..... 426
  - financial analyses ..... 428
  - functional analysis ..... 433
  - generally ..... 427
  - guidelines ..... 313
  - licence arrangements ..... 515
  - management fees ..... 504, 512
  - OECD Guidelines ..... 970
  - policy changes ..... 626
- Double taxation relief** – see Offsetting adjustments
- Dumping ..... 1008
- E**
- Employees**
  - communication of changes to employees ..... 622
  - functional analysis interviews .. 403
  - transfer of ..... 213(4)
- End of year adjustments** .....613
- Engineering risks** .....406
- Exchange rates** – see Foreign exchange rates
- Excise duties** .....1007
- F**
- Fees**
  - management – see Management fees
- Finance arrangements**
  - capital stock ..... 222
  - characterisation of loans ..... 541
  - cost sharing ..... 218
  - deep discounted loans ..... 224
  - financial statements ..... 621
  - flexibility in managing
    - capital needs ..... 225
  - generally ..... 215
  - guarantees of indebtedness ..... 543
  - hybrid financing arrangements .. 224
  - interest rates ..... 215, 542
  - leasing ..... 221, 544
  - loans and advances ..... 540
  - long-term capital needs ..... 219
  - long-term inter-company loans . 223
  - market penetration payments/
    - market maintenance ..... 217
  - mortgages ..... 220
  - short-term capital needs ..... 216
  - swaps ..... 224
  - thin capitalisation ..... 215
- Financial analyses**
  - evaluation ..... 429
  - generally ..... 428
- Financial goals** .....411

- Financial statements** ..... 428, 621
  - Finished goods**
    - sales of ..... 205
  - Foreign exchange rates**
    - arm's length standard ..... 534
    - economic exposure ..... 538
    - generally ..... 533
    - planning opportunities ..... 539
    - transaction exposure ..... 537
    - translation exposure ..... 536
    - types of exposure ..... 535
  - Foreign exchange risk** ..... 406
  - Fourth methods** ..... 307
  - Freight costs** ..... 1010, 1016
  - Fully-fledged manufacturers**
    - functional analysis ..... 409
  - Functional analysis**
    - after-sales services ..... 407
    - business risks ..... 406
    - centralised support activities ..... 413
    - characterisation of businesses . 408
    - comparables search .... 421-425, 434
    - contract maintenance ..... 418
    - contract manufacturers ..... 409
    - contract marketing ..... 419
    - contract service providers ..... 415
    - defective products ..... 406
    - distribution functions ..... 403
    - distribution/selling companies,
      - characterisation ..... 410
    - documentation ..... 433
    - environmental accidents ..... 406
    - evaluation of pricing options .... 420
    - evidence, conclusions reached/
      - adjustments made etc ..... 436
    - financial goals ..... 411
    - foreign exchange risk ..... 406
    - fully-fledged manufacturers ..... 409
    - functions, determination ..... 405
    - generally ..... 402
    - income statements ..... 435
    - information/documents,
      - examination ..... 404
    - intangibles ..... 407
    - interviews ..... 403
    - inventory risk ..... 406
    - manufacturing functions ..... 403
    - manufacturing opportunities .... 412
    - marketing functions ..... 403
    - market prices ..... 401
    - market risk ..... 406
    - product liability risk ..... 406
    - research and development . 416, 417
      - risks ..... 406
    - selling companies ..... 414
    - tax havens ..... 412
    - warranty costs ..... 406
- G**
- Global formulary apportionment**
    - non-arm's length approach ..... 312
  - Global tax charge**
    - active planning ..... 604
  - Goodwill** – see Intangible property
  - Guarantee fees**
    - loans ..... 543
- H**
- Handling costs** ..... 1010, 1016
- I**
- Imports** – see Customs duties
  - Income statements**
    - defensible late adjustment ..... 615
    - generally ..... 428, 435
    - retroactive price changes ... 613, 614
    - year-end adjustments ..... 613
  - Insurance costs** ..... 1010, 1016
  - Intangible property**
    - arm's length royalty rates,
      - determination ..... 516-517, 519
    - assists ..... 1010, 1016, 1018
    - barriers to entry ..... 206
    - corporate reputation ..... 210, 211
    - cost sharing arrangements
      - ownership of intangibles ..... 531
    - customer services/training ..... 210
    - customs value of imports ..... 1004
    - functional analysis ..... 402
    - hybrid intangibles ..... 211
    - manufacturing intangibles. 207, 209
    - marketing intangibles ..... 207, 210

|  |                      |
|--|----------------------|
| modes of transfer .....  | 208                  |
| ordinary intangible .....  | 206                  |
| patents .....  | 209                  |
| software .....   | 211                  |
| super-intangibles .....  | 206,518              |
| royalty rates, valuation .....   | 519                  |
| technical know-how .....   | 209                  |
| trademarks and trade names ....  | 210                  |
| transfers .....  | 206,513-519,911,1016 |
| types of intangibles .....   | 207                  |
| typical assets .....   | 407                  |
| valuation for customs<br>purposes .....  | 1016-1018            |
| <b>Inter-company transfers</b>   |                      |
| financing transactions –<br>see Finance arrangements,<br>intangibles – see Intangible<br>property, provision of services<br>– see Services, tangible property<br>– see Tangible property |                      |
| generally .....  | 201                  |
| types of .....   | 201                  |
| <b>Interest</b>  |                      |
| Inclusion in value of<br>imported goods .....  | 1019                 |
| <b>Inventory risk</b> .....  | 406                  |
| <b>Investigations</b> – see Audits   |                      |
| <b>K</b>   |                      |
| <b>Know-how</b> – see Intangible property  |                      |
| <b>L</b>   |                      |
| <b>Labour and material costs</b> ....  | 1010                 |
| <b>Lease financing</b> .....   | 221                  |
| <b>Leasing</b>   |                      |
| arm's length rental rate .....   | 545                  |
| bona fide leases .....   | 544                  |
| <b>Legal agreements</b> .....  | 432                  |
| <b>Legal services</b> – see Services   |                      |
| <b>Licence arrangements</b>  |                      |
| transferring intangible rights ....  | 515                  |
| <b>Licence fees</b>  |                      |
| customs valuation .....  | 1016-1018            |
| <b>Litigation</b> – see Audits   |                      |
| <b>Loans</b> – see Finance arrangements  |                      |

**M****Machinery and equipment**

|  |      |
|--|------|
| charges for construction,<br>erection, etc ..... | 1010 |
| sales of .....                                   | 204  |

**Management compensation** ... 439**Management fees**

|   |          |
|---|----------|
| analysing the services .....                        | 506      |
| arm's length service charge,<br>determination ..... | 511      |
| central services .....                              | 505      |
| comparable uncontrolled price<br>(CUP) method ..... | 506      |
| cost-accounting method .....                        | 508      |
| cost base for service<br>charges .....              | 507, 509 |
| defensible late adjustments .....                   | 615      |
| direct costs .....                                  | 509      |
| documentation .....                                 | 504, 512 |
| establishing facts .....                            | 504      |
| generally .....                                     | 502      |
| indirect costs .....                                | 509      |
| meaning .....                                       | 501      |
| method for determination .....                      | 506      |
| profit mark-up addition .....                       | 510      |
| shareholder costs .....                             | 505      |
| tax treatment .....                                 | 503      |

**Manufacturing businesses**

|                         |     |
|-------------------------|-----|
| characterisations ..... | 409 |
|-------------------------|-----|

**Market risk** .....
**Monopolies**

|                         |     |
|-------------------------|-----|
| barriers to entry ..... | 206 |
|-------------------------|-----|

**Mortgages**

|  |     |
|--|-----|
| financing long-term capital<br>needs ..... | 220 |
|--|-----|

**Mutual agreement procedure**

|                                 |     |
|---------------------------------|-----|
| corresponding adjustments ..... | 313 |
|---------------------------------|-----|

**N****Negotiation** – see Audits**O****Offsetting adjustments**

– See chapter 11

**Organisation for Economic****Co-operation and Development**

**(OECD)**

- arm's length principle ..... 302
- cost sharing ..... 520
- formation ..... 301
- Guidelines ..... 301, 313
- member countries ..... 313

**P**

**Patents** – see Intangible property;  
Licence fees; Royalty payments

**Planning** ..... 102

**Plant and Machinery** – see  
Machinery and equipment

**Price unbundling** ..... 1013

**Pricing methods alternative** ..... 307

- Berry ratio ..... 311
- comparables search ..... 421-424
- comparable uncontrolled price  
(CUP) method ..... 303, 506
- cost plus method ..... 305
- capacity adjustments ..... 306
- determination ..... 302
- evaluation of options ..... 420
- fourth methods ..... 307
- profit split method (PSM) ..... 309
- rate-of-return method ..... 308
- rental rates ..... 545
- resale price method (RPM) ..... 304
- transactional net margin  
method (TNMM) ..... 310
- transactional profit methods ..... 307

**Product liability risk** ..... 406

**Profit split method (PSM)** ..... 309

**R**

**Rate of return method** ..... 308

**Raw materials**

- Sales of ..... 205

**Reproduction charges** ..... 1010

**Resale price method (RPM)** ..... 304

**Research and development**

- contract arrangements ..... 416, 417
- cost sharing ..... 520-531, 920, 927

**Retroactive price changes** ..... 614

**Returns** – see Tax returns

**Rights of reseller to distribute**

**imported goods** ..... 1010, 1016

**Risks**

- business risks ..... 406
- cost sharing arrangements ..... 527
- foreign exchange rates – see Foreign  
exchange rates
- generally ..... 101
- Royalty payments approval ..... 618
- customs valuation 1010, 1016, 1017
- determination ..... 516, 517

**S**

**Safe harbours** ..... 313

**Sales of inventory** ..... 205

**Sales taxes** ..... 1007, 1010

Selling companies

- characterisation ..... 410
- restructuring techniques ..... 414

**Service charges** – see Management  
fees

**Services**

- accounting ..... 213
- employees, transfer of ..... 213
- legal ..... 213
- offshore affiliate requiring parent  
company expertise ..... 213
- provision of, meaning ..... 212
- shareholder ..... 214
- technical assistance, transfer of  
intangibles ..... 213
- technical in nature ..... 213
- types ..... 213

**Set-offs**

- non-arm's length transactions .. 908

**Settlements**

- tax audits ..... 607

**Shareholder services** ..... 214

**Shareholder costs** –

see Management fees

**Shares**

- financing long-term  
capital needs ..... 222

**Software** – see Computer software

**Stewardship costs** –

see Management fees

**Super-intangibles – see**

Intangible property Swaps ..... 224

**T****Tangible property**

machinery and equipment – see

Machinery and Equipment

sales of ..... 203-205

transfers ..... 910

**Tax authorities**

clearances ..... 618

**Tax havens** ..... 412**Tax returns**

disclosures ..... 619

**Technology – see** Licence fees;

Royalty payments

**Thin capitalisation****Trademarks and trade names – see**

Intangible property; Licence fees;

Royalty payments

**Transfer pricing policy**

audits – see Audits

customs valuation. 1009, 1015, 1022

documentation ..... 426, 427

financial analyses ..... 428, 429

formulae for price determination 431

generally ..... 430

implementation ..... 437

management of policy –

see chapter 6

monitoring ..... 438

OECD Guidelines ..... 301

reasons for ..... 101-106

reviewing ..... 103

theory and practice ..... 104

**V****Valuation of imported goods**

adjustments ..... 1010

ad valorem duties and taxes .... 1007

alternative methods

of valuation ..... 1014

anti-dumping duties ..... 1008

assists ..... 1010

audit by an indirect tax authority 1025

## Brussels definition of

value (BDV) ..... 1005

computed value ..... 1014

computer software ..... 1020

costs and payments,

exclusions/additions ..... 1010

deductive value ..... 1014

design, development, engineering

and similar charges ..... 1021

fixed values ..... 1006

(GATT) Customs Valuation

Code ..... 1002

identical goods, value of ..... 1014

intangible assists ..... 1018

intangibles ..... 1004, 1016

interest ..... 1019

international structure, impact . 1024

licence fees ..... 1017

pricing policy ..... 1015, 1022

relationship between customs

and tax rules ..... 1003

retrospective price adjustments,

impact ..... 1023

royalties ..... 1017

similar goods, value of ..... 1014

specific duties ..... 1006

technical considerations ..... 1009

validation of transfer price ..... 1011

**Value added taxes** ..... 1007, 1010**W****Work in progress**

sales of ..... 205

**Y****Year-end adjustments** ..... 613

Transfer pricing considerations affect every company, large or small, with international affiliates, offering planning opportunities whilst imposing increasingly burdensome compliance obligations. As governments throughout the world implement stringent transfer pricing regulations, those multinationals without a robust, consistent and defensible policy will be exposed to financial penalties exacted by fiscal authorities.

International transfer pricing 2009, now in its eleventh edition, provides companies and their advisors with practical guidance on how to approach the issue of determining defensible transfer pricing across the full range of goods and services, as well as how to prepare for the negotiations in which they must be sustained. This edition has been updated to include fully revised overviews of the position in sixty countries, seeking to provide clear and comprehensive coverage of this complex subject.

The book has been written in the light of extensive knowledge and experience gathered by the global transfer pricing network of PricewaterhouseCoopers. The principal author and editor of the 2009 edition is Nick Raby, transfer pricing principal and leader of the PricewaterhouseCoopers practice in the Western United States.

[www.pwc.com/internationaltp](http://www.pwc.com/internationaltp)