

Chapter 17 Case Study

The Weight Resources group is a multinational group resident in Wonderland, a low-tax jurisdiction. The group is in the business of developing, manufacturing and distributing weight loss supplement products. One of their products is a weight loss pill registered under the trademark "Less is More". It is the crème de la crème of weight loss supplement products, and has proven to be one of the group's best sellers. It contains a secret active ingredient, known as "Minimynox".

Facts:

- The parent company of Weight Resources Group (resident in Wonderland) discovered Minimynox (the active ingredient) at its research facilities. It also developed the Less is More product in its commercial form there, obtained the necessary patents, conducted all trials, invented the technology for the manufacture of the active ingredient, was the first to launch the product outside Wonderland and has developed the worldwide marketing strategy.
- LocalCo is a company resident in the case study country, and a distributor of Less is More. It purchases the product in market-ready form directly from its parent company. There is a licence agreement between LocalCo and its parent company, under which LocalCo pays the parent a royalty (7% of sales) for the exclusive distribution rights in the case study country.
- LocalCo took the lead in acquiring approval of regulatory authorities for bringing Less is More to the local market. It also implemented the marketing strategies established by the parent company and introduced the product on the local market by conducting on-site sales activities using its sales staff. The customer base includes first-tier (upper-end market) shops, private clinics and wellness centres. Regulatory approval was obtained in 2005, and LocalCo began selling the product in 2006.
- Profits for LocalCo are as follows (all figures in millions):

Australia Case Study

Where Wonderland has a tax treaty with Australia

1. *Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?*

The ATO has earmarked the pharmaceutical industry as an area of current focus (see country chapter Australia, at 2.2.). Accordingly, in order to minimize the risk of a transfer pricing audit, LocalCo would need to consider whether to:

- rely on contemporaneous transfer pricing documentation, ensuring that the degree and quality of documentation deliver an appropriate (low) risk rating (see country chapter Australia, at 2.3.2.). Having the right documentation in place from the start could avoid an audit. The preparation of robust documentation will, in most instances, be cheaper and easier than entering into an APA; or
- seek to enter into an APA. The APA may be either unilateral (between the ATO and LocalCo) or (where there is a treaty in place between Wonderland and Australia) bilateral (see country chapter Australia, at 5.1.).

This decision may be a trade-off between certainty, and the upfront cost and time of the process (see country chapter Australia, at 5.6.).

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

As indicated in the country chapter, at 1.1., Division 13 does not prescribe a particular method for determining the arm's length price. While the ATO recognizes the methods set down in the OECD Guidelines and requires the "best method" to be adopted, ^[1] the Australian courts and the Administrative Appeals Tribunal have shown a clear preference for direct transfer methodologies where sufficient information is available (see country chapter Australia, at 3.3.4.). In light of this, the potential methods that could be applied are:

- *CUP method.* This method will be appropriate where reliable, independent comparables are available from internal or external sources. In this case, it is not clear that there is a global market for the product. As LocalCo is the first to sell this product in Australia, it may be difficult to identify comparables from external sources. However, appropriate comparables may be available from internal sources if the Weight Resources Group sells its products to independent third parties (as was the case in *Re Roche* and *SNF*; see country chapter Australia, at 3.3.2. and 3.3.3.);
- *resale price method.* The resale price method is likely to be appropriate in similar circumstances to the CUP method, but where the comparables are not exactly the same (e.g. where the product sold is the same or similar but is marketed under a different brand); and
- *profit-based method.* Subject to the discussion of the concerns raised in the recent cases (see country chapter Australia, at 3.3.4.), it may be appropriate to use a profit-based method in this case because the product in question "is unique or contains out-of-the-ordinary intangibles". ^[2] The most likely option would be the TNMM. The ATO considers the TNMM to be useful in valuing profit attributable to intangibles, in particular in situations involving the licensing of intellectual property. In practice, the TNMM is by far the most commonly applied pricing method. ^[3] However, the ATO has also warned that care is needed where (as in this case) one party owns a manufacturing intangible and the other has developed a marketing intangible. In such cases, the ATO considers that the return on the intangibles needs to be allocated between the different intangible assets that are used. ^[4]

3. Could LocalCo apply for an APA in Australia? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

LocalCo could apply to the ATO for an APA. The fact scenario would appear to be an appropriate one for the ATO to accede to an APA request. LocalCo and the Weight Resources Group would need to determine if a unilateral or bilateral APA is preferred, having regard to the desired level of certainty.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

The process for the ATO in looking into LocalCo's transfer pricing would be:

- a risk review focused on examination of the quality of the taxpayer's documentation and the commerciality of its profit outcome;
- audit of the taxpayer, in which the ATO compares its view of the arm's length price with the view taken by the taxpayer;
- the issue of an ATO position paper (with the opportunity for the taxpayer to respond); and
- if agreement cannot be reached, the issue of an assessment (see country chapter Australia, at 2.3.2.).

¹ TR 97/20, country chapter Australia [note 32](#)

² Id. at Para. 3.52.

³ See the 2008-2009 statistics, "APA 2008-2009 Update", country chapter Australia note 168, at 7.

⁴ TR 97/20, country chapter Australia [note 32](#), at Paras. 3.83-3.87.

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Any dispute would then be dealt with in accordance with the usual dispute resolution process; the taxpayer could object to the assessment or seek review of the decision by the Administrative Appeals Tribunal or appeal to the Federal Court (see country chapter Australia, at 3.2.).

5. *What would be the areas of concern for the Australian tax authorities?*

The ATO will be focused on determining whether the 7% royalty adequately reflects the role of the Australian subsidiary and its contribution to the profit generated by the sale of the "Less is More" product. The ATO's concerns will likely focus on the:

- initial losses;
- average return over the period in question;
- location of the related party, in a low-tax jurisdiction; and
- adequacy of the taxpayer's documentation.

6. *Is it likely that the Australian tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?*

In Australia, the likelihood of the Commissioner making a primary adjustment depends largely on the evidence that LocalCo is able to present to the ATO and whether, based on that evidence, the ATO considers that the transactions provide a "commercially realistic result".

In the event that an adjustment results in an increase in the amount of tax due, a statutory penalty of between 10% and 50% may also be imposed, and interest would be charged.

7. *If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?*

If LocalCo does not agree with the adjustment, it could object against the assessment and, failing resolution, seek review of the adjustment by the Administrative Appeals Tribunal or appeal the ATO's decision to the Federal Court (see country chapter Australia, at 3.2.).

Alternatively, where a treaty exists, LocalCo could seek to engage the MAP, which may be more successful if the treaty provides for arbitration.

Where Wonderland has no tax treaty with Australia

Where no treaty exists between Australia and Wonderland, the Commissioner is still entitled to make a transfer pricing adjustment under Division 13. The key difference is that the Commissioner may not rely on the "Associated enterprises" article of a treaty. There is considerable debate in Australia about whether the Commissioner's powers are the same, or more limited, under Division 13 (see country chapter Australia, at 1.2.).

Another consequence of there being no treaty between Australia and Wonderland would be that there is no agreed MAP procedure (and therefore, no procedure for entering into bilateral or multilateral APAs).

Whether an EU country or not

In practice, it should make no real difference whether Wonderland is located in an EU country. However, where the other state is a PATA member, LocalCo may be able to rely on the more established MAP PATA procedures agreed between participating states (see country chapter Australia, at 4.1.).

Brazil Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

Considering Brazilian transfer pricing legislation, the described fact pattern suggests a classical case for the resale-minus approach (PRL 20% method). But before discussing the specific issues associated with the adoption of PRL 20%, the pros and cons of each transfer pricing method in this present case should be considered.

As discussed in the introduction of the Brazilian chapter, Brazilian law does not impose the best-method rule and therefore taxpayers may choose the method that results in the lowest adjustment possible. Obviously, it is possible to achieve this conclusion if (and only if) the taxpayer actively and timely explores all possibilities and methods.

PIC/CUP method

An initial challenge to adopting this method relates to the concept of "product" under Brazilian law and issues of comparability. As mentioned, there is no clear or conceptual definition of "product" and for the present case, based on the fact that LocalCo imports items in "market-ready form", the first approach would be to consider each different item imported as a single product. This does not mean a transaction-by-transaction test, because the methods should be applied considering the annual average amounts.

In practice, some interesting situations may occur. For example, it is common to see pharmaceutical products that can be sold in different concentrations (100 mg or 50 mg), different presentations (pills or injectable), different package sizes (200 ml or 100 ml) and different "vehicles" (gel or liquid), among others. The difficulty here is to adapt these realities to the definition of "similar products" provided by Ruling 243/02. For the sake of adoption of the PIC method, two products will be deemed to be similar if they meet (cumulatively) three criteria, namely that they (1) present the same nature and function, (2) can replace each other and (3) present similar technical specifications. As one may realize, this definition creates some complex situations, as taxpayers face difficulties in accommodating reality and concepts. Exploring the feasibility of the PIC method and taking into consideration the similarity issue described before, LocalCo will most likely have difficulties adopting this method, considering that "Less is More" is quite unique and patent protected. Also, LocalCo may face compliance difficulties, as different presentations can implicate different "products" for transfer pricing analysis. In practice, this means that "debits" and "credits" among individual products cannot be offset, such that excess profits in relation to the statutory margin in one product cannot absorb insufficient profit from another product. Therefore, LocalCo would need a very precise pricing track record. In summary, most likely the PIC method would be not feasible, either for the taxpayer or for tax auditors, unless LocalCo is able to identify an internal comparable within its affiliated companies—a factor that is unknown under the present fact pattern.

CPL method (equivalent to the cost-plus method)

There are some typical problems with the adoption of this method. First, it must be verified whether the allowed margin of 20% is consistent with the effective margin, specifically for the pharmaceuticals and supplements industries. Second, and more relevant, there is the documentation issue. In the present case, the documentation would involve all production documentation, such as acquisition invoices of raw materials, breakdowns of all costs, allocations, spreadsheets, depreciation, payroll, etc., plus general ledgers and tax returns. Everything must be translated and notarized. Although simple in concept, this method is very difficult to implement in practice. Few taxpayers have seriously tried it and even fewer have succeeded in building a robust case that could withstand a transfer pricing audit. It is always possible and likely that the auditor will ask for more details. This could evolve into an endless discussion. Many other details could also be discussed, such as GAAP differences, exchange effects, existing tax benefits in the production plant, etc., but this is not the primary focus in this chapter. In summary, this method is not the primary option. The authors have never seen a tax auditor push for adoption of the CPL method, but rather the opposite.

PRL 20% 60% method

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The PRL 20% looks like the natural approach to the present fact pattern, as LocalCo is effectively a reseller. Also, taking again into consideration the fact that LocalCo is importing products in "market-ready form", this would mitigate the risk associated with PRL 60%. In fact, even cases in which mere packaging is done locally, such activity could lead to a discussion of the imprecise border between PRL 20% and 60%. The intuitive mathematical reaction is that the 60% option is much worse than the 20%. Although in this case it is most likely true because a finished good does not present relevant local value added, it is worth mentioning that the PRL 60% formula (as stipulated in the law) may result in non-intuitive results. That said, LocalCo would focus its transfer pricing analysis based on PRL 20%, on a product-by-product basis. The PRL 20% does not really require that the overall result be a profit, to the extent that the taxpayer can demonstrate that there is a 20% gross margin per product. In fact, situations exist in which other expenses exceed the gross margin, resulting in a negative bottom line.

Four simulated scenarios of PRL 20% are presented below, which explore the different effects that result depending on different understandings and the indirect effect of VAT in transfer pricing calculations, as well as different approaches to royalties.

First scenario

PRL 20% calculation (1)	2005	2006	2007	2008	2009	2010
net resale price	–	150.0	220.0	270.0	310.0	360.0
taxes on sales	–	56.2	82.4	101.1	116.1	134.8
gross resale price	–	206.2	302.4	371.1	426.1	494.8
margin 20%	–	41.2	60.5	74.2	85.2	99.0
parameter/comparable price	–	108.8	159.5	195.8	224.8	261.0
effective price	–	100.0	150.0	175.0	205.0	240.0
transfer pricing adjustment	–	–	–	–	–	–

Assumptions (1):

1. COGS represents cost of product imported, including taxes (CIF + II). Conservative approach. See controversy explanation.
2. Calculations consider the existence of just one product, based on the product-by-product approach.
3. Sales represent net sales, after VAT.

Second scenario

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PRL 20% calculation (2)	2005	2006	2007	2008	2009	2010
net resale price	–	109.1	160.1	196.4	225.5	261.9
taxes on sales	–	40.9	60.0	73.6	84.5	98.1
gross resale price	–	150.0	220.0	270.0	310.0	360.0
margin 20%	–	30.0	44.0	54.0	62.0	72.0
parameter/comparable price	–	79.1	116.1	142.4	163.5	189.9
effective price	–	100.0	150.0	175.0	205.0	240.0
transfer pricing adjustment	–	20.9	34.0	32.6	41.5	50.1

Assumptions (2):

1. COGS represents cost of product imported, including taxes (CIF + II). Conservative approach. See controversy explanation.
2. Calculations consider the existence of just one product, based on the product-by-product approach.
3. Sales represent gross sales, including VAT.
4. VAT considered as ICMS (18%), PIS/COFINS (9.25%) and IPI (0%) = 27.25%.

Third scenario

PRL 20% calculation (3)	2005	2006	2007	2008	2009	2010
net resale price	–	150.0	220.0	270.0	310.0	360.0
taxes on sales	–	56.2	82.4	101.1	116.1	134.8
gross resale price	–	206.2	302.4	371.1	426.1	494.8
margin 20%	–	41.2	60.5	74.2	85.2	99.0
parameter/comparable price	–	108.8	159.5	195.8	224.8	261.0
f.o.b. price	–	100.0	150.0	175.0	205.0	240.0

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PRL 20% calculation (3)	2005	2006	2007	2008	2009	2010
import duty, freight, insurance	–	10.0	15.0	17.5	20.5	24.0
effective price	–	110.0	165.0	192.5	225.5	264.0
transfer pricing adjustment	–	1.2	5.5	–	0.7	3.0

Assumptions (3):

1. COGS represents f.o.b. amount.
2. Calculations consider the existence of just one product, based on the product-by-product approach.
3. Sales represent net sales. after VAT.
4. VAT considered as ICMS (18%), PIS/COFINS (9.25%) and IPI (0%) = 27.25%.
5. Import duty, freight, insurance estimated as 10% over f.o.b. price.
6. Transfer pricing adjustment considering c.i.f. + II criteria. Conservative approach. See controversy explanation.

Fourth scenario

PRL 20% calculation (4)	2005	2006	2007	2008	2009	2010
net resale price	–	150.0	220.0	270.0	310.0	360.0
taxes on sales	–	56.2	82.4	101.1	116.1	134.8
PRL 20% calculation (4)	2005	2006	2007	2008	2009	2010
gross resale price	–	206.2	302.4	371.1	426.1	494.8
margin 20%	–	41.2	60.5	74.2	85.2	99.0
parameter/comparable price	–	108.8	159.5	195.8	224.8	261.0
effective price	–	113.3	165.4	193.9	226.7	265.2
transfer pricing adjustment	–	4.5	5.9	–	1.9	4.2

Transfer Pricing and Dispute Resolution -

PRL calculation (4)	20%	2005	2006	2007	2008	2009	2010
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Assumptions (4):

1. COGS represents cost of product imported, including taxes (CIF + II). Conservative approach. See controversy explanation.
2. Calculations consider the existence of just one product, based on the product-by-product approach.
3. Sales represent net sales. after VAT.
4. VAT considered as ICMS (18%), PIS/COFINS (9.25%) and IPI (0%) = 27.25%.
5. Royalties added to imported prices/COGS due to royalty limitation in Brazil.

Additional comments and considerations

- *APA*. Because Brazilian law does not provide rules for APAs, this is not a feasible option.
- *International transfer pricing study*. Most likely a study based on economic analysis would not comply with Brazilian rules based on product-by-product formulae. It is advisable to perform a local analysis and not to rely on an international transfer pricing study.
- *Royalties*. Brazilian rules impose fixed rates for specific intellectual-property transactions. For Brazilian tax purposes, and in very broad terms, royalties refer to payments made for intangible rights, such trademarks, patented technology and technical assistance associated with transfers of technology (a contractual arrangement through which know-how is transferred over a period of time). In the present case, the proposed 7% royalty for exclusive distribution rights would represent a significant tax issue for several reasons. First, the case suggests that there is no transfer of know-how to LocalCo or compensation for the trademark, which is deductible up to 1% of associated revenues (the express deductibility provisions, which go as high as 5% for some industries, most likely will not be available to LocalCo, as this case does not deal with the licensing of a patented technology, but rather an exclusive distribution right). Second, the attempt to adopt the 7% rate may result in three situations:
 - (1) the INPI (Brazilian Patent Office) would not even register such a contract, and without registration, it is not possible to remit money from Brazil. Therefore, it is not simply a regulatory or tax issue, but first of all a remittance issue. Also, without registration, no royalty would be deductible if accrued in the financial statements;
 - (2) the INPI agrees with 1% as a trademark royalty and imposes amendment of the contract to reflect exactly that percentage; or
 - (3) the INPI approves of the contract stating 7%, but the tax deduction is limited to 1%.

The following table presents a scenario in which the financial statements are restated because the INPI did not approve the contract:

Possible restatement due to excess royalty from 7% to 1%

	2005		2006		2007		2008		2009		2010	
sales	0		150		220		270		310		360	
COGS	0		100		150		175		205		240	

Transfer Pricing and Dispute Resolution -

	2005		2006		2007		2008		2009		2010	
	0	n/a	50	33.30%	70	31.80%	95	35.20%	105	34.00%	120	33.00%
operating expenses	25		50	33.33%	60	27.27%	70	25.93%	71	22.90%	77	21.39%
royalty expense	0		13.3		15.4		18.9		21.7		25.2	
	-25	n/a	-13.3	-8.90%	-5.4	-2.50%	6.1	2.30%	12.3	4%	17.8	5%
reversal of excess royalty	-		11.8		13.2		16.2		18.6		21.6	
net deductible royalty 1%	-		1.5		2.2		2.7		3.1		3.6	
adjusted profit	(25)	n/a	(1.5)	-1.0%	7.8	3.5%	22.3	8.3%	30.9	10.0%	39.4	10.9%
income tax 34%	-		-		2.7		7.6		10.5		13.4	
adjusted net profit	(25)	n/a	(1.5)	-1.0%	5.1	2.3%	14.7	5.5%	20.4	6.6%	26.0	7.2%

Assumptions:

1. A 7% royalty contract will most likely not qualify for registration with INPI. The excess is non-remittable and non-deductible.
2. Contract most likely amended to 1% for trademark.
3. Financial statements restated to reflect new contract of 1%.
4. Profit before income tax subject to 34% income tax and social contribution taxes.

As a final remark, the above considerations are not affected by the existence (or not) of an income tax treaty between Brazil and Wonderland, nor by whether or not Wonderland is an EU country.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

The PRL 20% method is the natural choice for both the taxpayer and the tax authorities. If the taxpayer adopts a different method, it should be robust enough to convince the tax authorities to not disregard it, as occurs in many

cases. In this case, a tax auditor would try to calculate the PRL 20% himself and replace the original choice, unless the transfer pricing adjustment indicated by PRL 20% is lower than the original one chosen by the taxpayer. It is a matter of controversy whether the tax auditor is obliged to attempt more than one method and adopt the lowest adjustment possible. Predictably, the authorities have rejected such understanding, saying that this burden falls only on taxpayers.

3. Could LocalCo apply for an APA in Brazil? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

Not applicable, as APAs are not available in Brazil.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

Once selected for a transfer pricing audit, the taxpayer will receive a notice indicating the commencement of the audit and the initial documents to be prepared, typically within 20 days. The taxpayer may apply for an extension; the tax authorities have the discretion to extend or not. Very often the documentation request is made in a way that the auditor will be able to perform calculations by himself, regardless of the choices made by taxpayer. From this perspective, the primary focus is *not* to review what the taxpayer did, but to compare transfer pricing adjustments and impose the highest one. Audits are data-intensive and very often most of the information should be provided electronically and according to a certain layout, as it will be checked through proprietary software.

5. What would be the areas of concern for the Brazilian tax authorities?

Typical areas of concern include proper compliance work, extensive data coverage, the risk that not all individual transactions are disclosed, adoption of proper formulae, exchange calculations and cross-checking with accounting and tax data. For example, it is quite common that the auditor starts the audit procedure with the importation/exportation data obtained directly from the Siscomex (the official database that registers all foreign transactions). The focus in this case is to be sure that taxpayer did not "forget" to test any particular product, and therefore the intention is to have 100% coverage of tangible goods imported/exported.

In the case of services, contracts, invoices and exchange transactions are the main source of data. In the case of "imported services" (payment to a non-Brazilian party), there is a natural overlap with the withholding tax test, and in fact the authors have seen transfer pricing audits that developed to significant assessment of taxes due on remittances abroad.

Audits involving "rights" are not that common and demand a more complex analysis, also because royalties are regulated by specific legislation that imposes certain deduction limits. Therefore, royalties were excluded from the scope of transfer pricing legislation. From this perspective, "rights" subject to transfer pricing analysis should be understood as all other intangible property that is not covered by royalty regulations. In practice, the most relevant "right" subject to transfer pricing analysis is software licensing and the related fees, as the domestic concept of royalties does not cover such fees. This is yet another instance of how Brazilian tax concepts differ from those of other countries.

As mentioned, the above considerations are not affected by whether or not there is an income tax treaty between Brazil and Wonderland, or whether or not Wonderland is an EU country.

6. Is it likely that the Brazilian tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

This issue should be dealt with on a case-by-case basis. According to the authors' experience, it is quite common for tax authorities to impose primary adjustments. Some reasons for this include a lack of proper transfer pricing compliance work done in an earlier stage, distortions caused by the product-by-product approach, imposition of statutory margins and exchange effects. The primary transfer pricing adjustment leads to an increase in the income tax and social contribution calculation bases. If the taxpayer is in a profit position, most likely there will be a shortfall of taxes paid and a tax assessment will be imposed. Penalties apply, typically at 75% on top of the unpaid tax, plus interest for late payment. No secondary adjustment is provided for under the law.

As mentioned, the above considerations are not affected by whether or not there is an income tax treaty between Brazil and Wonderland, or whether or not Wonderland is an EU country.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

A specific analysis of the actual case is necessary to distinguish between two main sources of tax assessment, namely (1) fault of taxpayer or lack of proper compliance work or (2) mistakes made by the auditor when performing the audit.

In any event, depending on the particularities of the assessment, and the taxpayer's willingness to dispute it, there may be arguments to be presented in the administrative and judicial court systems, with the aim of reducing the amount of taxes under dispute and penalties.

There is no amicable negotiation procedure to reach a settlement with the Brazilian tax authorities, as there are no mechanisms in place for an agreed solution to the dispute. Once the tax is assessed, the taxpayer is required to either pay it or dispute it.

There is also no mechanism in place to resolve potential double taxation arising from a transfer pricing assessment.

As a consequence, the above considerations are not affected by whether or not there is an income tax treaty between Brazil and Wonderland, nor by whether or not Wonderland is an EU country.

Canada Case Study

From a Canadian transfer pricing perspective, it generally does not matter whether Wonderland is a resident of an EU country. The analyses presented below are typically dependent on Canadian domestic legislation, case law and administrative pronouncements and prevailing practices, and on the relevant tax treaties entered into by Canada; no other special considerations relating to some broader public international legal arrangements between Canada and the European Union are typically considered in similar transfer pricing cases.

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

Usually, the first step involved is the careful planning of the Canadian distribution structure based on the anticipated scope of business activities and operations to be carried out in Canada (i.e. the anticipated functions, risks and assets of LocalCo). At inception, planning considerations are typically influenced by a number of factors, including broad business strategies, operational efficiencies and tax benefits. Considering that Wonderland is a low-tax jurisdiction, one of the tax incentives for the Weight Resources Group could have been to limit the profits at the level of LocalCo through the adoption of a limited-risk distributor structure. On the other hand, the Weight Resources Group might have some reasons to believe that the Canadian market is a strategic market where significant growth is expected and where significant operations are to be conducted in the future, which would rather support a full-fledged distributorship structure.

Irrespective of the structure ultimately chosen by the Weight Resources Group, drafting the relevant intercompany agreements governing the selected structure is a key element in the implementation-and subsequent defence-of the relevant controlled transactions. Those intercompany agreements serve to memorialize the terms and conditions of the controlled transactions, and incidentally provide the basis for the allocation of functions, risks and assets between the related parties. To best support its transfer pricing structure in Canada, the Weight Resources Group should have ensured relevant intercompany agreements were put in place, as these are normally the starting point of the analysis in the context of a Canadian transfer pricing audit.

The Weight Resources Group should also have complied with the Canadian transfer pricing documentation requirements in order to demonstrate that reasonable efforts were made to determine and use arm's length transfer

prices for penalty protection purposes, as discussed above. Such documentation would also need to generally align with the content of the intercompany agreements, which would serve in the demonstration that the actual behaviour of the related parties-in the context of their controlled transactions-generally conforms to the legal substance of the transaction as reflected in the intercompany agreements.

In the context of its transfer pricing documentation, LocalCo must document "the assumptions, strategies and policies that will influence the determination of the transfer price (...) in respect of the transactions" as set out in Sec. 247(4)(a) (vi) of the ITA. That is, LocalCo should ensure that it adequately describes and supports the various strategies justifying losses in the start-up phase of its operations, which are typically more easily justified in a full-fledged distributorship structure (e.g. through a market penetration strategy or start-up period) compared to a limited-risk distributor structure.

The Weight Resources Group could also have considered entering into a bilateral APA between Canada and Wonderland (if there is an applicable treaty) or a unilateral APA with Canada (whether or not there is an applicable treaty) to agree, in advance of launching its operations in Canada, on a transfer pricing methodology governing the relevant intercompany transactions. The general advantages and disadvantages of entering into APAs were discussed earlier in this chapter.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

In applying the arm's length principle, the CRA endorses and follows the methods set out in the OECD Guidelines. For Canadian purposes, the use of the traditional transactional methods is preferable when applying the arm's length principle. The CRA may also recognize transactional profit methods in situations where application of the traditional transactional methods is inappropriate. Ideally, the transfer pricing analysis should be performed on a transaction-by-transaction basis. However, in certain cases, the CRA would find that it is acceptable and practical to combine the related transactions for the purposes of the transfer pricing analysis if these transactions are so closely linked that they cannot be evaluated adequately on a separate basis. ^[5]

There are two main controlled transactions, as structured by the Weight Resources Group, which the Canadian tax authorities will consider in this particular case: (1) the purchase of Minimynox and (2) the 7% royalty. Despite the close link between the two controlled transactions, and given their magnitude, it is likely that the Canadian tax authorities will first consider analysing them as two separate transactions, as opposed to assuming that they should be bundled. In addition, considering that the 7% royalty could potentially be subject to withholding tax under Part XIII of the ITA, it is to be expected that this transaction will be looked at separately at least in instances where Wonderland is a resident of a country with which Canada does not have an applicable treaty that would override Canada's taxing right in relation to the royalty.

It is likely that, under the circumstances, the CRA would first look at whether the CUP method could be applied to each of the controlled transactions. While it is very common for the CRA to test royalty arrangements using comparable uncontrolled transactions, it has also applied the CUP to tangible-goods transactions in practice in a similar industry, including in the *Glaxo* case, at least when the product becomes off-patent. Should the CRA be unable to suitably apply the CUP method to the purchases of Minimynox, it would likely try to perform a gross margin analysis under the resale price method, for which the tax authorities are known to expect rather large gross margins in the case of unique or blockbuster products sold in the Canadian market. Depending on the perceived reliability of the traditional transaction method(s) potentially employed by the CRA, it may supplement its analyses with a TNMM analysis, which under the circumstances would be equivalent to performing a profit-based analysis of the controlled transactions as a bundle.

3. Could LocalCo apply for an APA in Canada? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

⁵ See generally CRA, TPM 06, "Bundled Transactions" (16 May 2005). See also *Hasbro Canada Inc.*, (1999) 1 CTC 2512 (Tax Court of Canada).

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LocalCo could apply for an APA in Canada. If Wonderland is a country with which Canada has an applicable treaty and Wonderland has an APA programme (or is willing to pursue an APA), Canada would prefer that LocalCo pursue a bilateral APA with Wonderland. Canada will also consider an application for a unilateral APA.

If LocalCo wishes to seek a bilateral APA, it must complete a pre-filing meeting within 180 days of the year-end of the first taxation to be covered by the APA. In addition, LocalCo may request that the terms of the APA be rolled back to any taxation year for which an audit has not commenced, provided that:

- a request for contemporaneous documentation has not been issued by the taxation services office;
- the facts and circumstances related to the covered transactions are materially the same for the prior years to be covered by the application of a rollback as for the APA period;
- the foreign jurisdiction, in this case Wonderland, and the relevant taxation services office also agree to the application of a rollback; and
- waivers, in respect of the reassessment period, have been filed in prescribed form as set forth in Sec. 152(4)(a) (ii) of the ITA.

A unilateral APA is purely prospective in nature and becomes effective for the first taxation year for which a return has not yet been filed, once a resolution is reached.

To successfully complete a pre-filing meeting, LocalCo should be prepared to discuss the following issues:

- the parties to the transaction to be covered by the APA and the parties that will participate in the APA process;
- the nature and scope of the transactions proposed to be covered by the APA;
- the extent and nature of the data, documentation and analyses that may be needed;
- whether independent experts should be required;
- proposed transfer pricing methods;
- countries involved, and whether a unilateral, bilateral or multilateral APA is being proposed, and issues that should be given consideration in pursuing a bilateral APA or multilateral APA among the relevant competent authorities;
- the proposed taxation years to be covered by the APA; and
- whether a retroactive application of the APA (rollback) is being requested.

In addition, the tax authorities will discuss with LocalCo, the following aspects of the Canadian APA programme:

- the possible need for waivers;
- the use, disclosure and protection of information obtained or generated during the APA process;
- the estimated cost recovery charge;
- the members of the CRA team;
- the next steps in the APA process, should the CRA and LocalCo decide to proceed;
- terms and conditions of pursuing an APA; and
- coordination and scheduling of the subsequent phases in the APA process.

Following the pre-filing meeting, the CRA will consider the suitability of the proposed transactions to the APA programme and communicate its interest in pursuing the potential APA request. Factors that may be considered include:

Transfer Pricing and Dispute Resolution -

- LocalCo's past filing history and history with the CRA;
- the nature and extent of required information and LocalCo's ability to provide the necessary information; and
- the likelihood that the APA request will result in prospective certainty (e.g. whether transactions exist, which if left uncovered, could undermine the efficacy of the APA).

If the CRA concludes that the proposed transactions are suitable to its APA programme, following a written expression of interest from LocalCo, the CRA will issue its cost recovery letter, which sets forth the terms and conditions of continued participation in the APA programme, any specific information requirements identified during the APA process and the cost recovery amounts.

For example, the cost recovery letter may require that LocalCo annually update financial information and provide an annual confirmation that there have not been any significant changes in the facts and circumstances that would materially affect the APA request. In addition, in LocalCo's case, the CRA may request that the transactions be unbundled and considered separately. Further, in consideration of the royalty transaction, the CRA may request that consideration be given to the price that would be paid by the licensee as well as that required by the licensor. Alternatively or conjunctively, in respect of the royalty, the CRA may also request a residual profit split analysis that gives consideration to the amount of residual profits attributable to the distribution rights as well as the amount, if any, of residual profit attributable to LocalCo for locally developed contributions.

In addition to the specific requirements discussed above, an APA request generally must include the following additional information:

- the organizational structure of the Weight Resources Group and LocalCo;
- the parties, participants, transactions and transaction flows proposed to be covered;
- any transfer pricing, audit and reassessment history, competent-authority history and other related audit issues;
- the reasons for requesting the APA, the countries involved and the nature and extent of previous communications with those tax administrations;
- relevant transfer pricing policies, methodologies, practices and accounting systems and policies;
- the transfer pricing methods contemplated under the APA and the underlying rationale;
- the impact of the proposed transfer pricing methods on taxable income;
- relevant key interpretative or technical taxation issues; and
- the key individuals (including officials or employees of the taxpayer and any experts, advisors or other representatives) who will be involved throughout the APA process.

The CRA will accept LocalCo into the APA programme after reviewing the APA request to ensure its accuracy and completeness. Once accepted, the CRA will begin its process of due diligence (which may include site visits) to form its view of the functional analysis and the relevant facts and circumstances, as well as follow-up queries.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

Prior to selecting a taxpayer and initiating an audit, the CRA will examine the tax filings of that taxpayer. This may include examining the effective tax rate of a taxpayer, comparing the filed T106 form for the year under consideration to other T106 forms that have been filed to identify significant changes in the transaction reported, examining the materiality of intercompany flows reported on the T106 form in both relative and absolute terms, and identifying specific types of transactions, such as those involving intangible property.

If LocalCo were selected for an audit, the CRA would initiate its review with a formal request for contemporaneous documentation. The request for contemporaneous documentation would allow LocalCo 3 months to produce the

requested information. Generally, in Canada requests for contemporaneous documentation are broad sweeping and do not necessarily identify specific transactions. Therefore, in LocalCo's case, where it had numerous transactions in multiple jurisdictions, it may be required to produce all of the contemporaneous documentation for its intercompany transactions.

Following the initial request for contemporaneous documentation, the CRA will likely make additional requests for information, such as trial balances and reconciliations of the amounts reported on LocalCo's filed T106 forms. In practice, these requests for information may accompany the request for contemporaneous documentation, follow the initial request or be issued once the contemporaneous documentation has been reviewed.

Once the auditor in the local taxation services office has had an opportunity to review the information provided, he or she may request a visit to the premises of LocalCo and even the premises of one or more of the foreign members of the Weight Resources Group. These visits typically serve to provide the auditor an opportunity to review the books and records of LocalCo and to conduct interviews of key personnel to validate the functions performed, assets employed and risks assumed by the parties to the transactions, as well as any other relevant facts and circumstances. Additional follow-up queries may follow.

In Canada, should the auditor conclude that further transfer pricing analysis is required, a referral may be made to the CRA headquarters in Ottawa for economic support and the assistance of the Field Advisory Service section assigned to the relevant taxation services office. The Field Advisory Service team will likely consist of an experienced international auditor, an economist and a team leader. The mandate of the Field Advisory Service section is to provide support and advice to the taxation services office. The Field Advisory Service team does not take over the responsibility for the conclusion of the audit, and to the extent that reassessments are issued, they are done so by the taxation services office.

The timing of the referral to the CRA headquarters may vary and will depend upon factors such as the complexity and nature of the transactions under consideration, past involvement and experience of the CRA headquarters' team with LocalCo, the experience level of the auditor and any CRA headquarters' directives, to the extent they exist. The involvement of the CRA headquarters' Field Advisory Service section may result in additional requests for information and analyses as they perform further due diligence.

5. What would be the areas of concern for the Canadian tax authorities?

The primary concern of the Canadian tax authorities would be whether the transfer price appropriately rewards LocalCo for the functions it has performed, assets employed and risks assumed. Specifically, the CRA would seek to validate whether LocalCo's selected transfer pricing method and transfer pricing appropriately reward its efforts in penetrating and developing the market, and for any locally developed intangibles.

To test these results, the CRA is likely to evaluate the transfer price that would have arisen had the transactions been unbundled and the Weight Resources Group been rewarded for the manufacture of the product and separately rewarded for any associated intangibles.

In some cases, the CRA has chosen to impute the cost of goods sold for LocalCo by calculating the transfer price for the manufactured product with the use of a TNMM and markup on the total costs and estimating a royalty for the associated intangibles.

Typically, in establishing the royalty rate, the CRA has expressed a preference for licensing arrangements, internal or external, with appropriate adjustments, rather than a database search of royalty rates in the industry. Factors that may be considered in evaluating the royalty include: the potential market for the "Less is More" product, Weight Resources Group's expenditures in developing the intangible, the overall stage in the product lifecycle and time to expiry of the patent, and the nature of the product in terms of available alternatives.

6. Is it likely that the Canadian tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

To the extent that the analyses described above yield a transfer price that differs from that reported, a reasonable probability exists that the CRA would make a primary adjustment. Where the adjustment exceeds the lesser of 10% of revenue or CAD 5 million, a referral will be made to the Transfer Pricing Review Committee for a decision on the application of a transfer pricing documentation penalty, under Sec. 247(3) of the ITA.

The CRA is likely also to raise secondary adjustments for withholding tax on the deemed dividend that arises as a result of the transfer pricing adjustment ⁶ (in instances where there is no tax treaty with Wonderland, withholding taxes will be raised at the rate specified in the ITA). Where there is an applicable tax treaty and the taxpayer is eligible for treaty benefits, the rate will be reduced to that specified in the treaty. Where the adjustment relates to the payment of a royalty, LocalCo should pay careful attention to any statutory time limitations, as the adjustment is likely to be raised after the allowable statutory time limit for a refund on the original withholding tax applied to the royalty.

Other penalties may apply depending upon, for example, whether prescribed forms were filed, whether there were omissions, whether the forms were filed on a timely basis and whether appropriate tax instalments were paid.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

Following the audit, if an adjustment is to be raised, the auditor will formally communicate the results of his or her review in a proposal letter. LocalCo will be given an opportunity to make representations on the merits of the Canadian tax authorities' position and to present any other factors that should be taken into account. The CRA will review this representation and revise their position where warranted.

In addition, where consideration is to be given to the application of a transfer pricing documentation penalty by the Transfer Pricing Review Committee, the auditor should provide LocalCo with a copy of its referral report and recommendations. LocalCo will also be given the opportunity to make a representation to the Committee on its views in respect of whether or not reasonable efforts were made to determine and use arm's length prices.

Once a reassessment has been raised, should LocalCo disagree with the merits of the CRA's reassessment, it may file a notice of objection within 90 days expressing its view and requesting that the Appeals Division reconsider the reassessment. LocalCo may also file a notice of appeal and request that the matter be considered by the courts, typically first by the Tax Court of Canada and subsequently by the Federal Court of Appeal. Although possible in theory, in practice, cases of this nature are rarely considered by the Supreme Court of Canada. LocalCo may also be required to file notices of objection with the relevant provincial authority, to ensure that the issue may be resolved at the provincial level.

Where there is an applicable treaty between Canada and the other jurisdiction, LocalCo may also wish to file a request for competent-authority assistance to seek assistance in the elimination of double taxation.

As a general rule of thumb, the notice of objection and appeals processes are better equipped to address matters related to whether the action of the CRA was correct under the law, and a request for competent-authority assistance is better suited to the matter of elimination of double taxation. However, in practice, LocalCo may wish to pursue both venues to ensure the availability of all opportunities to resolve the issue. LocalCo would then place one process in abeyance, while pursuing the other.

In choosing the appropriate dispute resolution venue, LocalCo will want to give consideration to the uncertainty of outcomes and the likelihood that following a notice of objection and notice of appeal, an adjustment will still remain requiring the resolution of double taxation. Where LocalCo concurs with a determination of the Appeals division or a decision has been rendered by the courts, the Canadian competent authority will only request relief from the foreign jurisdiction and will not vary the adjustment further.

⁶ The CRA would normally rely on Sec. 214(3)(a) ITA to deem the quantum of the transfer pricing adjustments to be dividends paid to a non-resident which are subject to Part XIII withholding taxes under Secs. 212(2) and 215(1) ITA.

China Case Study

For China, whether or not Wonderland is an EU Member State does not make any difference in this case study. The authors have therefore discussed the following questions only based on the scenario where (1) there is a tax treaty, drafted according to the OECD Model Tax Convention, between China and Wonderland (Scenario 1) or (2) there is no treaty between China and Wonderland (Scenario 2).

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

An APA could be an option, albeit with significant barriers in this case if LocalCo looked back to the beginning. The Chinese tax authorities are reluctant to enter into APA negotiations with a company that is newly established, even though this is not explicitly expressed in the regulations. Under Art. 51.1.2 of Circular 2, APA applicants are required to provide certain information on their financial performance, products and assets for the 3 preceding years, which sets a barrier for concluding an APA with a company that does not have 3 years or more of operating history.

That said, initiating an APA helps to open a dialogue with the tax authorities and to table the issues of the initial losses and market risks that LocalCo faces. While the APA may not materialize eventually, the issues are being registered. The discussion also provides an opportunity for the group to receive feedback from the tax authorities and to decide whether its transfer pricing policies should be revised, such as by converting LocalCo to a limited-risk distributor with guaranteed profitability right from the beginning.

The downside of this approach is that it may prompt an audit if the tax authorities disagree with the approach taken by the group and are confident in upholding their position.

With the relatively small possibility of obtaining advance certainty from the tax authorities at the early stage of LocalCo's operation, it is advisable for the group to prepare adequate analysis and corresponding documentation to devise and support its transfer pricing policies. It should have a procedure in place to monitor the implementation of the policies.

The Chinese tax authorities dislike losses and do not believe that distributors should bear (chronic) losses. The SAT promulgated Circular 363 ⁽⁷⁾ in 2009, stating that so-called single-function entities should be remunerated with a positive return from the beginning. While this "single function" is not clearly defined, it is likely that the tax authorities may seize upon the fact that LocalCo is implementing marketing strategies developed by the parent company, arguing that LocalCo should not bear the risk of market failure because it does not have the right to decide on go-to-market strategies. The tax authorities may strengthen their arguments by also focusing on whether LocalCo has decision rights on product portfolios. Should the tax authorities be able to prove that LocalCo does not make key decisions, LocalCo may fall under the single-function regime and any losses would be disallowed.

It is therefore important for LocalCo to adequately document the commercial rationale underlying the losses, and to perform a functional analysis to sustain its profile as a full-fledged distributor making key decisions and managing business risks.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

The Chinese tax authorities have a preference for a residual profit split when they believe an argument can be made for the presence of local intangibles that are developed and owned by LocalCo. In this case, the focus is on whether taking the lead in obtaining local regulatory approvals and implementing marketing strategies developed by the parent in the Chinese market create local intangibles.

⁷ Guoshuihan (2009) 363.

However, the Chinese tax authorities are very much results-driven. Alternatively, they may be prepared to accept a TNMM with the operating margin as the profit level indicator, but they will try to add on a premium associated with the rapid growth of the Chinese market.

Regardless of which methodology is adopted, the challenge is for LocalCo to argue for the losses in the beginning and to sustain the deductibility of royalty payments. A multiple-year analysis can potentially be used with either method.

3. Could LocalCo apply for an APA in China? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

Under both scenarios, normally speaking, the earliest possible year to apply for an APA is 2009, when it has had operating results for 3 years. Exceptions can of course be made, subject to the consent of the tax authorities. In general, pursuing an APA is a resource-consuming process and demands significant disclosure of taxpayer information. Furthermore, any significant changes in the business model may trigger a premature termination of the audit. Thus, the group should weigh these factors and only seek an APA if it believes its business model has long-term stability.

Bilateral APAs are generally preferred, given the involvement of tax authorities from both countries. The SAT has stated that it is prepared to give more concessions in a bilateral APA than a unilateral one, under the same facts and circumstances.

Under Scenario 2, no bilateral APA is possible, as there is no tax treaty between Wonderland and China; however, LocalCo could apply for a unilateral APA. LocalCo must meet the following criteria:

- annual related-party transactions exceeding CNY 40 million;
- compliance with the relevant related-party transaction disclosure requirements; and
- preparation, retention and provision of contemporaneous documentation under the relevant regulations.

LocalCo must submit an application report documenting the organizational structure, years covered by the application, financial information for latest 3 years, functional and risk analysis of the relevant entities, applicable transfer pricing methodology, comparable analysis and other related information. The application must be submitted to the local office of the SAT in charge of the jurisdiction where LocalCo resides.

Under Scenario 1, a bilateral APA is also possible if LocalCo wishes to obtain a higher level of certainty regarding its related-party transactions and to eliminate double taxation. The application must be submitted to the SAT, with a copy being sent to the local office of the SAT in charge of the jurisdiction where LocalCo resides.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

The Chinese tax authorities would likely perform a desktop audit first. They will review the corporate income tax filings, the annual related-party transaction disclosure forms, and possibly request contemporaneous documentation reports. They may also raise some questions in writing. These questions might include:

- Why did LocalCo incur losses but still pay royalties for distribution rights?
- What is the basis for the 7% royalty? Provide relevant analysis to justify the arm's length nature of the 7% royalty.
- Was the royalty expense calculated correctly? If the policy is 7% of sales, the royalty expense should be CNY 10.5 million instead of CNY 13.3 million.

Upon receipt of the reply, the tax authorities will raise further questions, terminate the audit or initiate a formal audit. See the country chapter China, at [2](#). for the steps in an audit.

5. What would be the areas of concern for the Chinese tax authorities?

The Chinese tax authorities will be particularly concerned about the operating losses and the relatively low profit margin, even though the company is in a start-up stage. They may also argue for disallowance of the royalty payments during the loss-making years.

On the other hand, the Chinese tax authorities may also challenge whether LocalCo should only earn a normal distribution margin. The tax authorities may closely examine whether LocalCo has developed and owned local marketing intangibles. If so, LocalCo should be entitled to part of the residual profits and the royalty rate should be reduced. One possible argument that they may make involves the interaction with local customers. Tax authorities believe that these interactions and local on-site activities contribute part of the residual profit and should be assessed together with the overall marketing strategy developed by the parent company.

6. Is it likely that the Chinese tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

If the Chinese tax authorities were to review this case, it is likely that the royalty expense for 2006 and 2007 is adjusted or even disallowed completely. Depending on the aggressiveness of the in-charge tax authorities, the entire amount of the royalty could be added back on the grounds that the rights were not valuable for those years.

Should the tax authorities manage to establish that LocalCo is a single-function entity, they may further disallow any losses that LocalCo bears and deem a profit to be earned by LocalCo. However, the technical basis for this claim is weak.

For 2008 to 2010, if the tax authorities are of the view that LocalCo developed and owned local marketing intangibles, part of the royalty may be added back. The amount of residual profits earned by LocalCo may be determined according to a residual profit split analysis.

The additional tax payable will be subject to interest plus 5%. The interest rate will be based on the benchmarking lending rate of Chinese currency as published by the People's Bank of China on 31 December of the tax year to which the underpaid tax belongs. The period of interest calculation is from 1 June of the year subsequent to the applicable tax year to the date of settlement.

The 5% surcharge could be waived if LocalCo is able to provide contemporaneous documentation and the relevant materials upon request during the audit.

A refund for turnover taxes paid on royalties, such as the business tax, and refund of withholding tax on the royalties, are explicitly denied under Art. 101 of Circular 2.

Should primary adjustments be made to the import price of the goods, customs duties and import VAT paid are unlikely to be refunded either. This requires a separate proceeding with the Customs Administration, but there is no formal and effective mechanism to attain a secondary adjustment.

Under Scenario 1, the parent company in Wonderland should look for a corresponding adjustment by virtue of the applicable tax treaty, while in Scenario 2, there is no mechanism for relief from double taxation.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

LocalCo could provide objections, in writing, to the local tax authorities within 7 days of the preliminary transfer pricing audit opinion. The tax authorities will review the preliminary opinion and ultimately finalize the transfer pricing audit assessment. If LocalCo is not content with the assessment, it could apply for administrative review or directly appeal to the court. However, in China, these options have not been utilized frequently.

If LocalCo agrees with the adjustment but wishes to resolve the double taxation, the group could apply for a MAP under Scenario 1. There is no proper mechanism for relief from double taxation under Scenario 2.

France Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? And what would be the relative advantages or disadvantages?

(a) *Documentation*

Preliminary comment

Art. L13 AA was introduced in the Tax Procedure Code (*Livre des Procédures Fiscales*, LPF) by the Amending Finance Bill for 2009, and imposes a transfer pricing documentation requirement for tax years commencing on or after 1 January 2010. This requirement applies to legal entities established in France:

- (1) with an annual turnover (exclusive of tax), or gross assets (on the balance sheet) of at least EUR 400 million;
- (2) that hold, at the end of the tax year, directly or indirectly, more than half of the capital or the voting rights of an entity satisfying condition (1);
- (3) which are held, at the close of the tax year, directly or indirectly, by a person satisfying condition (1);
- (4) which benefit from the *bénéfice consolidé* or *bénéfice mondial* (French tax consolidation) regime; or
- (5) which belong to a French tax group that comprises at least a person mentioned in (1), (2), (3) or (4).

Under Art. L13 AB of the LPF (also introduced by the Amending Finance Bill for 2009), where transactions are carried out with associated enterprises established or located in a non-cooperative state or territory, the transfer pricing documentation must include additional information on such companies, including balance sheets and income statements.

The concept of a non-cooperative state or territory was introduced by the Amending Finance Bill for 2009, in line with the guidance of the OECD Forum on transparency and exchange of information. From 1 January 2011, a state or territory is regarded as non-cooperative if (1) it is a non-EU Member State or territory, (2) has not signed an agreement allowing for exchange of information and (3) has not signed such an agreement with at least 12 other states or territories. A list of 18 non-cooperative states and territories was published on 17 February 2010 and is anticipated to be updated every year on 1 January. The current list, effective from 1 January 2010 to 1 January 2011, includes: Anguilla, Belize, Brunei, the Cook Islands, Costa Rica, Dominica, Grenada, Guatemala, Liberia, the Marshall Islands, Montserrat, Nauru, Niue, Panama, the Philippines, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines.

States or territories that may be added to the list on 1 January of each year are those that (1) have not signed an exchange-of-information agreement with France, although France had offered to enter into such an agreement prior to 1 January of the previous year and (2) do not effectively exchange information in line with the guidance of the OECD Forum on transparency and exchange of information. Where a state or territory is added to the list of non-cooperative states and territories, the rules on non-cooperative states and territories are applicable to it as from 1 January of the following year.

As from 1 January 2011, states or territories that may be removed from the list include those that have recently concluded a exchange-of-information agreement with France. Where a state or territory is removed from the list, the rules on non-cooperative states and territories immediately cease to be applicable.

Answer to 1.

If LocalCo's gross assets for a given tax year commencing on or after 1 January 2010 exceed EUR 400 million or if, at the close of a given tax year, LocalCo is for more than 50% held, directly or indirectly, by a legal entity whose annual turnover (taxes excluded) or gross assets exceed EUR 400 million, LocalCo will be subject to the documentation requirements for such tax year. As a result, LocalCo will have to provide (1) general information regarding the group and (2) specific information regarding its activities.

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The general part of the documentation must contain the following information about the group:

- an overview of the group's activities, including changes occurring during the tax year;
- an overview of the group's legal and operational structures, as well as identification of the entities engaged in intercompany transactions;
- an overview of functions, assets and risks relevant for LocalCo;
- a list of the primary intangible assets related to LocalCo; and
- an overview of the group's transfer pricing policy.

The specific part of the documentation must contain the following information about LocalCo:

- a description of the activities, including any changes occurring during the tax year;
- a description of the transactions with related companies, including the nature of such transactions and amounts paid;
- a list of any cost sharing agreements, APAs and rulings dealing with the transfer pricing policy applied by LocalCo;
- a description of the transfer pricing method applied, as well as a functional analysis; and
- where applicable, an analysis of comparables.

If LocalCo is not able to deliver such contemporaneous documentation at the beginning of a tax audit, the French tax authorities may issue a letter requesting the delivery of the documentation within 30 days of receipt. If LocalCo were still not be able to produce the appropriate documentation, it may be subject to a fine of EUR 10,000 or 5% of the profits transferred according to the tax authorities, whichever is greater.

If LocalCo is not subject to the above-mentioned legal documentation requirements, it is still recommended that LocalCo prepare the relevant transfer pricing documentation in order to be able to provide it to the tax authorities in the event of a tax audit. Indeed, in the course of an audit, the tax authorities are likely to request information on LocalCo's transfer pricing policy, and providing appropriate transfer pricing documentation allows for a presentation of the transfer pricing policy in a structured manner. In addition, where the taxpayer does not provide sufficient information and the tax authorities believe that they have gathered information that suggests an indirect transfer of profits, they could request that the taxpayer provide transfer pricing documentation based on Art. L13 B of the LPF.

(b) *APA*

Requesting an APA would allow the LocalCo group to obtain confirmation from the tax authorities that its transfer pricing policy complies with the arm's length principle, and to ensure that the tax authorities will not be able to adjust the prices applied in the intra-group transactions covered by the APA for the period covered by the APA (usually between 3 to 5 years). However, in principle there is no retroactive effect (to the extent that the terms of the APA are complied with by LocalCo and its parent company).

However, as the APA process is regarded as a transparent process by the tax authorities, they may request information that the group might not be willing to disclose, or they may wish to expand the scope of the APA to transactions that the group does not want to be covered. Considering that the parent company is located in a low-tax jurisdiction, the APA team will closely look at the situation and request information on the tax regime and the profits of the parent company.

In addition, negotiating an APA is a lengthy process. Negotiations may last from 6 to 18 months for a unilateral APA, and from 18 to 24 months for a bilateral APA.

If there is no applicable income tax treaty between Wonderland and France, LocalCo would in principle be able to obtain only a unilateral APA.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

French tax law applicable to transfer pricing matters ^[8] does not specify any transfer pricing method to be used by taxpayers. However, French transfer pricing tax law is based on the arm's length principle and recognizes the use of profit-based methods if there are no other reliable methods available. ^[9]

In addition, the tax authorities have issued guidance on transfer pricing issues for small and medium-sized enterprises ^[10] which in fact reflects the view of the tax authorities on transfer pricing issues in general. This guidance mentions that any method chosen by a taxpayer may be accepted, provided that it is justified and consistent with the functions exercised and risks borne, and that the agreed consideration is arm's length. The guidance also indicates that traditional methods based on comparable transactions are the most direct and reliable methods, but that transactional methods (such as the transactional net margin method, TNMM) may be chosen where no data are available or where the available data are not sufficiently reliable.

The resale price method is, as indicated in the OECD Guidelines, ^[11] particularly appropriate for distribution activities but, in practice, the TNMM is widely used and accepted by the tax authorities, especially for distribution functions. In fact, it is also often called the "modified resale price method", for it is still a resale price method but the calculation of the transfer price is based on the net margin instead of the gross margin.

In principle:

- the resale price method should be favoured if the supplier of the products provides unrelated companies with the same products as those distributed by LocalCo; and
- the TNMM should be preferred when there are no such practical comparisons available. In such case, the net profit margin is equal to the net margin of comparable third-party distributors (as established in a benchmark study). Although there are no specific rules in this regard, in practice, it is required that the benchmark study be re-evaluated every 3 years (between two studies, it is advisable to update the data of the companies included in the last benchmark study performed).

In practice, where French distributors are involved, the TNMM is more often applied to limited-risk distributors, whereas the resale price method is more often used for full-fledged distributors. Indeed, a loss situation is not possible under the TNMM.

In the case at hand, LocalCo would be regarded as a full-fledged distributor, as it took the lead in acquiring the necessary approval from regulatory authorities in order to bring Less is More to the local market and introduced the product on the local market by conducting on-site sales activities using its sales staff.

As a result, the resale price method would in theory be more appropriate and consistent with the fact that LocalCo incurred losses during its first years of activity. However, given the payment of the royalties in addition to the price paid for the purchase of the products, the TNMM would probably be applied by the tax authorities to test the net margin of LocalCo.

⁸ E.g. Art. 57 CGI.

⁹ See Art. 57 CGI, last paragraph.

¹⁰ "Guide sur les prix de transfert pour les petites et moyennes entreprises", available at www.impots.gouv.fr/portal/paf_dgi/html/redirect.jsp;jsessionid=XCI2HA5XAVV33QFIEMQCFFOAVARXAIV1?path=http%3A//www2.impots.gouv.fr/documentation/prix_transfert/index.htm.

¹¹ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations adopted by the OECD Council of Ministers on 13 July 1995, as modified subsequently (OECD Guidelines).

3. Could LocalCo apply for an APA in France? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

LocalCo could indeed apply for an APA in France, either unilateral or bilateral, depending on whether there is an applicable tax treaty between Wonderland and France. In line with OECD Guidelines, the tax authorities favour the conclusion of bilateral APAs.

In principle, the APA request must be officially filed with the French competent authority (Bureau CF3) at least 6 months before the beginning of the first financial year during which the agreement is sought to apply for the first time. However, the administrative guidelines state that, as an exception and if expressly requested by the taxpayer when filing the APA request, the APA may apply as from the financial year during which the APA request is filed. Although this exception was used rather extensively in the past, its use has become more restricted in recent months.

Instruction 4A-8-99, ^[12] issued by the tax authorities, provides an indicative list of documents (should be viewed as guidance) that taxpayers must produce upon filing of the APA request. In practice, the tax authorities usually require the following information, which in this case LocalCo would have to produce:

- the corporate structure of the group;
- overview of the group, including activities, organization and primary transactions of companies covered by the APA request;
- a list of the group's competitors;
- for all French entities covered by the APA request: tax returns, auditors' reports and management reports from the last 3 tax years;
- a functional analysis of the entities covered by the request; and
- an economic study supporting the proposed transfer pricing methodology.

During the application process, LocalCo may be requested to produce additional information necessary for the analysis of its file, including accounting or extra-accounting information.

Once the APA is signed, LocalCo must provide an annual compliance report demonstrating that the transfer methodologies applied are in line with the terms of the APA, and that the critical assumptions described in the APA continue to be fulfilled. The exact content of this report would be defined in the APA itself.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

Generally, the tax authorities may request information directly from the taxpayer through a clarification audit (*contrôle sur pièce, demande d'information*) procedure. They may also use their right of communication towards third parties (*droit de communication*, under Art. 81 et seq. of the CGI).

However, with regard to transfer pricing matters, the tax authorities usually resort to a tax audit (*vérification de comptabilité*), starting with the delivery of a notice to the taxpayer. Where transfer pricing is specifically targeted, the tax audit is normally carried out by an auditor who belongs to a dedicated team within the tax authorities (the "30th team").

At the end of the audit, the tax authorities may issue a notice of reassessment.

In practice, a tax audit involving transfer pricing issues can be expected to last from 6 to 12 months overall (from commencement until the issuance of a notice of reassessment).

¹² Instruction 4A-8-99 (7 September 1999).

The taxpayer must respond within 30 days (automatically extended to 60 days upon request). The tax authorities will then respond to the taxpayer (*réponse aux observations du contribuable*, ROC), specifying the reassessments that are retained or abandoned (in practice, most of them are retained at this stage). There is no deadline for such response, which in practice is typically sent within 3 to 6 months.

After the ROC has been received by the taxpayer, discussions can take place with the superior of the auditor (*chef de brigade*) and then with the superior of the *chef de brigade* (the *interlocuteur départemental* or the director or deputy director of the directorate auditing multinational enterprises). This process takes place in the 2 to 3 months following the receipt of the response to the taxpayer (*réponse aux observations du contribuable*).

5. What would be the areas of concern for the French tax authorities?

Generally the tax authorities examine the following main items when assessing a taxpayer's transfer pricing policy, in particular in the case of a taxpayer engaged in distribution activities:

- losses recorded;
- management fees and royalties paid;
- level of compensation for services provided to group companies;
- treatment of expenses connected with business restructuring operations; and
- conversion of an enterprise into a commissionaire, limited-risk distributor and/or contract manufacturer/toll manufacturer.

6. Is it likely that the French tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

In the present case, the tax authorities may seek to challenge the deduction of the royalties paid by LocalCo to its parent company, based on the anti-abuse provision under Art. 238 A of the CGI. Under this provision, royalties (as well as interest and services fees) paid or due by a French company to a non-French company that benefits from a privileged tax regime are deemed unjustified. As a result, any such payments are disallowed as deductible expenses unless the taxpayer can prove that:

- the payments relate to real transactions; and
- the payments are neither abnormal nor exaggerated.

In order to apply this provision, the tax authorities must first show that the beneficiary of the royalties benefits from a privileged tax regime, i.e. is not subject to income tax or is subject to an income tax rate that is less than half of the French corporate income tax it would have been subject to if it had been a resident of France (where the standard corporate income tax rate is 33.33%). Based on the assumptions of this case study, the tax authorities should be able to demonstrate so.

The burden of proof on the taxpayer is substantially more stringent than under French transfer pricing rules. ⁽¹³⁾ Indeed:

- the taxpayer must first demonstrate the reality of the underlying transaction in consideration of which the payments were made. It is not enough merely to produce documents evidencing an obligation to pay. In the present case, as the royalties are in consideration of the grant of an exclusive distribution right, LocalCo should be in a position to prove the reality of the transaction; and
- the taxpayer must show that the payment was reasonable given the value of the services rendered, and did not constitute an "abnormal management decision". In the present case, LocalCo will have to be able to show that

¹³ Art. 57 CGI.

distributors is a comparable situation pay the same level of royalties (based on an appropriate comparables study) or, at least, that its operating profit is comparable to that of comparable distributors. If LocalCo has not prepared any transfer pricing documentation, it may not be in the position to do so.

Moreover, as from 1 January 2011, expenses paid or due to beneficiaries established in non-cooperative states or jurisdictions will be deductible only if the taxpayer can prove that:

- the expenses correspond to real transactions and are not abnormal or unusually high; and
- the main purpose or effect of the transactions is not the accumulation of profits in a non-cooperative state or territory.

In addition, the taxpayer will have to file a detailed statement of those expenses together with its corporate income tax return. The potential penalty in this case is a fine of 5% of the non-declared amount (reduced to 1% if the expense is in fact deductible).

If Wonderland were regarded as a non-cooperative state or territory, there would be a high risk that the royalties paid by LocalCo would be regarded as not deductible, as LocalCo would likely not be able to show that the main effect of the transaction is not the accumulation of profits in Wonderland. In such case and if LocalCo is profitable from a French tax perspective during the year of payment of the royalties, the royalties would be regarded as a deemed dividend and subject to a 100% withholding tax in France.

In any case, the tax authorities will analyse the operating profit of LocalCo and determine whether it is sufficient based on its own comparables (similar companies already audited).

A transfer pricing reassessment at the level of LocalCo would also trigger (1) a withholding tax reassessment, as the transferred profits would be regarded as deemed dividends, ^[14] (2) a reassessment in terms of tax on the added value of companies (*contribution sur la valeur ajoutée des entreprises*), as the tax authorities would consider that the transferred profits should be added back to the value added of LocalCo ^[15] and (3) late-payment interest at the monthly rate of 0.4%. In addition, a transfer pricing reassessment may increase employees' profit sharing. ^[16]

If the tax authorities considered LocalCo to have acted in bad faith, an additional penalty of 40% could be added. ^[17] Generally, transfer pricing reassessments are now seldom sanctioned by such penalty (although this was often the case a few years ago); but, given that the transactions take place with party in a low-tax jurisdiction-of course even more so if such country is classified as a non-cooperative state or territory-the bad-faith penalty might well apply in this case.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

(a) *If LocalCo does not agree with the primary adjustment of the local authorities*

LocalCo would have to respond to the tax auditor's notice of reassessment within 30 days, unless the taxpayer requests, within the 30-day period, an extension of the deadline. If that request is granted, the taxpayer would be allowed to reply in writing within 60 days of receipt of the notice of reassessment. ^[18]

¹⁴ This applies to 100% of the royalty paid if Wonderland is a non-cooperative state or territory; 50% if Wonderland is not a non-cooperative state or territory, is not an EU Member State and has not signed an income tax treaty with France; and a maximum of generally 15/85% if Wonderland is not a non-cooperative state or territory and has concluded an income tax treaty with France (may be 0% or 5% if the Weight Resources group holds more than 10% of the shares).

¹⁵ At 1.5% of the added value of LocalCo for the reassessed year. The position of the tax authorities may be challenged based on the fact that only accounting information should be taken into account for the calculation of the added value of the company.

¹⁶ Art. 1727 CGI.

¹⁷ Art. 1729 CGI.

¹⁸ Art. L57 LPF.

Within the 30-day period following receipt of the response to the taxpayer (*réponse aux observations du contribuable*; see answer to Question 4), LocalCo would be entitled to request that the case be examined by a Special Tax Committee (*Commission départementale ou nationale des impôts directs et des taxes sur le chiffre d'affaires*) under Art. R59-1 of the LPF. LocalCo would also be entitled to seek a meeting with the auditor's superior (*chef de brigade*) and further with the *interlocuteur départemental*. This phase, especially with the *interlocuteur départemental*, is essential, as in many cases settlements can be reached. Under Art. L59 of the LPF, in the absence of settlement, the case would be brought before the Special Tax Committee, which would give a recommendation (not binding on the tax authorities, although the advice of such committee is followed by the tax authorities in 80% of cases).

The tax authorities would be allowed to issue a tax collection notice (*avis de mise en recouvrement*) only after the receipt by LocalCo of the Special Tax Committee's recommendation (to be sent by the tax auditor).

LocalCo would then have two options:

- (1) commence litigation: LocalCo would file a claim against the tax collection notice and request the suspension of its payment (applicable until the judgement of the case by a first-level tax court, and subject to guarantees for the French tax authorities). If the tax authorities do not respond favourably to its claim, LocalCo would have to bring litigation before the first-level tax court within 2 months. If the tax authorities do not respond to LocalCo's claim within 6 months from its filing, LocalCo would be able to commence litigation before the first-level tax court (without any deadline); or
- (2) request the opening of a mutual agreement procedure (MAP) or a procedure under the EU Arbitration Convention in order to eliminate the double taxation (see (b)).

(b) *If LocalCo does agree with the adjustment but does not wish to be subject to double taxation*

LocalCo could request the opening of a MAP as provided under an applicable bilateral income tax treaty (see Art. 25 of the OECD Model Convention), if any, between Wonderland and France, or, if Wonderland is an EU Member State, under the procedure set forth under the EU Arbitration Convention of 23 July 1990.

The deadline to file a MAP is generally 3 years from receipt of the tax reassessment notice (although the applicable tax treaty should be checked for this purpose, as some treaties provide for a much shorter timeframe). As regards the Arbitration Convention, the deadline is 3 years as from receipt of the tax reassessment notice. In principle, a MAP and the Arbitration Convention procedure may not be commenced where a serious penalty (e.g. due to lack of good faith) has been imposed.

If Wonderland is an EU member State that has an applicable tax treaty with France, LocalCo would be better off to file its claim under the Arbitration Convention, as this would guarantee the elimination of the double taxation (whereas tax treaties only provide for an obligation of due diligence for the involved states).

Assuming that such procedures are instituted prior to the collection of the corporate income tax resulting from a transfer pricing reassessment, LocalCo could benefit from suspension of tax collection until the end of the third month following the month during which the outcome of the procedure is ultimately notified to LocalCo.

Germany Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? And what would be the relative advantages or disadvantages?

Based on the due-diligence obligation of the prudent businessman, LocalCo must document all information underlying its business decisions (e.g. licence rates, benchmarks). Moreover, LocalCo must comply with its obligation to cooperate with the tax authorities (bookkeeping, documentation, recordkeeping). ^[19]

¹⁹ Sec. 90, Para. 1 AO, Sec. 140 et seq. AO.

There is a special obligation to cooperate for cross-border cases-specifically the preparation of transfer pricing documentation under Para. 3 of Sec. 90 of the General Tax Code (*Abgabenordnung*, AO), in conjunction with the Decree-Law on Transfer Pricing Documentation (*Gewinnabgrenzungsaufzeichnungsverordnung*, GAufzV) and executive guidelines issued by the Ministry of Finance (*Bundesministerium der Finanzen*, BMF). ^[20]

Regarding the possibilities of concluding a bilateral APA or obtaining an advance ruling from the tax authorities, see the chapter on Germany, at 5.

Advantages of concluding a bilateral APA or obtaining an advance ruling from the tax authorities include:

- upon complying with all requirements, LocalCo can minimize its tax audit risk;
- advance consideration of reliable data and documentation minimizes the possibility of discussions during a tax audit;
- an APA provides security in the framework of a tax audit over the term of the APA, provided that all critical assumptions are met;
- the taxpayer has certainty on its tax position in its financial statements; and
- the taxpayer will be able to reduce time spent in future on transfer pricing documentation.

Disadvantages of concluding a bilateral APA or obtaining an advance ruling from the tax authorities include:

- the process is typically costly and time consuming;
- the process is generally not feasible without external know-how and support (e.g. from attorneys and tax advisors); and
- implementation and enforcement of the APA may be burdensome. If the APA ultimately fails, the taxpayer may have done damage to its situation due to information disclosed during either negotiation of the agreement or the application for the ruling.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

LocalCo may choose the comparable uncontrolled price method as the preferable method. However, given the specifics of the product and the exclusive distribution rights, internal and external comparables might not be readily available. Other standard methods include the cost-plus method and the resale-minus method. The latter method is often especially suited for the requirements of a distribution company. However, in the recent past, the tax authorities accepted profit-based transfer pricing methods, such as the profit split method and the transactional net margin method (TNMM), and Germany subscribed to the revised Chaps. I through III of the OECD Guidelines. Depending on the availability of comparables, the TNMM may be used if no standard method is applicable and an enterprise carries out only routine functions.

3. Could LocalCo apply for an APA in Germany? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

LocalCo could apply for a bilateral APA at the Federal Central Tax Office, provided that there is an applicable income tax treaty between Wonderland and Germany to be relied on, in order to obtain certainty in respect of applying the appropriate transfer pricing method. In the APA application, the scope must be defined regarding the facts, as well as the anticipated duration of the APA. The application must contain all necessary details, and the tax authorities may request additional information at any time.

²⁰ BMF-Schreiben (12 April 2005).

Over the duration of the APA, LocalCo must ensure that the critical assumptions continue to be met. If the critical assumptions cease to be met, the binding effect of the APA on the German tax authorities will cease. LocalCo must prepare and submit an annual compliance report. Any deviation from the agreed terms of the APA must be shown separately and any adjustments made must be reported. If the critical assumptions cease to be met, LocalCo should submit suggestions for a revision of the APA.

4. If the German tax authorities were to look at Local Co's transfer pricing, what would be the process?

The taxpayer files an annual tax return, confirming with its signature that the return respects the principle of true and fair representation. Transfer pricing documentation generally is not filed together with the annual tax return, but may be requested by the tax authorities during the assessment process. Penalties may arise in cases of non-compliance. Appropriate transfer pricing documentation must be provided within 60 days upon request by the German tax authorities. The documentation of extraordinary business transactions must be provided within 30 days upon request by the German tax authorities. ^[21] A tax assessment notice may be issued under the caveat "subject to review" or as a final assessment. A tax audit will be conducted at the discretion of the tax authorities.

5. What would be the areas of concern for the German tax authorities?

It can be assumed that tax authorities would focus on the following topics:

- start-up losses;
- the licence rate. On its face, the license rate of 7% on sales seems to be on the higher side (based on the authors' experience in dealing with German tax authorities). However, each individual case depends on the facts and circumstances. In cases involving licence arrangements, German tax auditors often use the "Knoppe formula" (*Knoppe-Formel*), which implies that the licensor will achieve approximately 25% to 33.33% of the calculated profit of the licensee. However, this approach is not without controversy, as noted by certain scholars; ^[22] and
- the profitability of the business of LocalCo (gross margin and total profitability). In this regard, a functional and risk analysis may be requested, including an analysis of the distribution function. In LocalCo's case, the fact that the group is active in the pharmaceutical industry might lead to a profile with high risks (e.g. market licence costs, start-up costs, costs related to developing clients).

6. Is it likely that the German tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

Depending on the further facts and circumstances, the tax authorities might lean towards making an adjustment in the case at hand. Generally speaking, transactions with low-tax countries tend to attract the attention of transfer pricing officers.

A primary adjustment is possible within the tax balance sheet or outside the balance sheet (in the latter case, more likely than not, with a risk of double taxation). Payments that do not adhere to the arm's length standard may be classified as constructive dividends. A constructive dividend refers to a decrease of, or a prevented increase in, a company's assets that (1) is the result of the shareholder-subsidiary relationship, (2) has an impact on the company's income and (3) does not result from a proper dividend distribution. ^[23]

In cases of deemed constructive dividends, secondary adjustments are possible. Given the foreign parent company and based on the reclassification, the "dividend" to Weight Resources Group could trigger German withholding tax. In general, the applicable withholding tax rate on dividends is 25%; however, there are possibilities for reduction or exemption. The withholding tax possibilities can be summarized as follows:

²¹ Sec. 90, Para. 3, sentences 8 and 9 AO.

²² Cf. Groß/Rohrer, *Lizenzgebühren*, at 566, Para. 759.

²³ Sec. 8, Para. 3 Corporate Income Tax Act (*Körperschaftsteuergesetz*, KStG).

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No applicable tax treaty/non-EU Member State	Withholding tax generally applies
Tax treaty	Potential exemption or reduction under the treaty
Wonderland EU Member State	Exemption within European Union because of Parent-Subsidiary Directive ⁽¹⁾

1. Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

Moreover, the income of LocalCo may be subject to estimation if the company does not sufficiently cooperate, ⁽²⁴⁾ for example if accounting records are missing in whole or in part. In certain cases of estimation within such framework, income may only be determined within certain price ranges, and the option that is most disadvantageous for the taxpayer may be chosen.

If the income is increased due to tax audit adjustments, an interest rate of 6% per annum will be applicable.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

(a) *If LocalCo does not agree with the primary adjustment of the local authorities*

LocalCo has the following options in this scenario:

- lodge an appeal with the Appeal Division of the Tax Office; and
- if LocalCo does not agree with the appeal decision of the Tax Office it may commence litigation before the Lower Fiscal Court. It is possible for the case to proceed to the Federal Tax Court for legal interpretations of tax law; to the Federal Constitutional Court for constitutional matters; and the EU Court of Justice for issues regarding EU law.

(b) *If LocalCo does agree with the adjustment but does not wish to be subject to double taxation*

LocalCo has several options, depending on whether there is an applicable income tax treaty and whether LocalCo is resident in an EU Member State, as follows:

Tax treaty/EU Member State	Domestic procedures to alleviate double taxation	Mutual agreement procedure	EU arbitration
no tax treaty/not an EU Member State	X		
tax treaty/not an EU Member State	X	X	
tax treaty/EU Member State	X	X	X

1. Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

24 Under Sec. 90 AO.

India Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

Current Indian tax law does not provide for an APA mechanism. Thus, any transfer pricing risk management would need to be based on adequate and robust documentation. In the current fact pattern, the documentation justifying the rate of royalty, the payment of royalty, the business strategy and which entity bears the market penetration risk and reasons of the losses are of utmost importance. The documentation should include the expected benefits to LocalCo from use of the intangible and other factors, such as rights obtained by LocalCo under the licensing arrangement (for example the possibility of sublicensing and which party bears the costs and risks of the marketing activities). It is also important that the understanding (including the reasons thereof) between LocalCo and its parent company on the compensation for the marketing activities of LocalCo be clearly documented.

LocalCo should document the reasons for the losses, such as the high level of costs during start-up, unfavourable economic conditions or market strategies.

LocalCo must also maintain robust documentation, describing the selection of the most appropriate transfer pricing method, and the manner in which data from unrelated comparable transactions were chosen to establish the arm's length nature of the international transactions.

It is important to be mindful that the terms and conditions of the licensing agreement are properly structured to ensure that the transaction is not treated as a transfer of a capital asset.

The above documentation is essential to respond to the notices, assertions and analyses of the tax authorities.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

The international transactions under review are the following:

- the purchase of the Less is More product from the parent company; and
- payment of a royalty of 7% of sales to the parent company.

The most appropriate transfer pricing method will have to be determined for each of these transactions separately. One key criterion for the determination of the most appropriate method is the availability, coverage and reliability of data necessary for application of the method. Accordingly, to determine whether any one of the transfer pricing methods can be reliably applied, data must be obtained.

For the import transaction, LocalCo could initially consider the resale price method as an appropriate method, as LocalCo does not undertake processing or value addition to the products before resale. To achieve comparability when calculating the appropriate gross profit margin, LocalCo must analyse the elements of gross margin, sales price and cost of goods sold for differences in accounting treatment. The gross profit of a purchaser/reseller such as LocalCo constitutes compensation for the performance of distribution functions, including an operating profit, in return for the distributor's investment of capital and the assumption of risks. Therefore, because functions performed, risks assumed and assets employed are the most important factors to be considered in determining the expected return of a purchaser/reseller, close physical similarity of the property involved is not ordinarily necessary to establish comparability of the buyer/reseller's gross profit margin. However, appropriate adjustments for functional differences must be made to the gross profit of LocalCo and other buyer/resellers. For this purpose, it is necessary to consider operating expenses associated with the functions performed and risks assumed. Specific factors that may be particularly relevant include: inventory levels and turnover rates; sales, marketing, advertising programmes and services; sales volumes; the level of the market; foreign-currency risks; and extensions of credit and payment terms. For example, if LocalCo has substantial

advertising expenses, but an unrelated buyer/reseller does not, this usually indicates a difference in functions performed by these two distributors. If so, gross profit margins would have to be adjusted accordingly before a meaningful comparison of their gross profit margins can be made. Furthermore, it may be difficult to identify the type or length of warranties provided; the payment terms on which the comparable distributors purchased; and the volumes purchased from any particular manufacturer. It may not be possible to determine the extent of any price protection programmes or other marketing or sales programmes offered by the independent manufacturers to unrelated distributors, or by unrelated distributors to their customers. Also, it may not be possible to determine whether the comparable distributors function as exclusive or non-exclusive distributors. All these factors may lead to the conclusion that the resale price method may not be the most appropriate method. Under these circumstances (and assuming that there are no comparable uncontrolled prices), LocalCo would need to consider the profit-based methods. The profit split method may not be appropriate, as the operations of the parent and LocalCo do not appear to be integrated, nor does LocalCo contribute valuable intangibles. The elimination of the profit split method would leave LocalCo to apply the transactional net margin method (TNMM) as the most appropriate method.

Through Press Note 8 of 2009, ^[25] the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry has dispensed with the requirement of obtaining prior approval for payments of royalties in excess of the previously prescribed limits. Royalty payments are no longer subject to any regulatory restrictions under the exchange control regulations. The extant foreign technology agreement policy prescribed specified limits up to which royalty could be paid to an overseas entity without prior regulatory approval (e.g. 5% of domestic sales or 8% of export sales for technology royalties; 1% of domestic sales or 2% of export sales for trademark/brand name royalties (where there is no technology royalty)). Payments over and above the specified limits required prior approval.

For the payment of royalties, the comparable uncontrolled price method may be considered the most appropriate method for determining the arm's length rate of royalty. However, from an Indian perspective, the non-availability of organized information on trademark licensing arrangements minimizes the appropriateness of the comparable uncontrolled price method.

LocalCo may also need to consider whether the royalty transaction should be combined with the purchase transaction and evaluated on a combined basis, using the TNMM.

Where customs duty is applicable on the imported goods, the valuation may be referred to the Special Valuation Branch (SVB), a special unit set up for investigating related-party imports. These implications will also need to be considered.

3. Could LocalCo apply for an APA in India? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

The current income tax law does not provide a mechanism for APAs. The Direct Taxes Code, 2010 empowers the Board to formulate a scheme for introducing APAs with taxpayers in relation to international transactions. The rules and scheme for APAs are yet to be formulated and published.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

A transfer pricing audit normally involves an examination of books and records of the taxpayer, supplemented by a series of notices and personal hearings. The audit process would typically involve a detailed analysis of the taxpayer's facts and circumstances. The tax authorities could typically request extensive information on transfer pricing policy and practice, and information on methods for determining cost and pricing for transfers of the goods.

Based on the facts of this case study, the key matters the tax authorities could seek to examine include:

- the contractual arrangement between the parent company and LocalCo, in particular the duration of the agreement, the nature of rights obtained by LocalCo in respect of the intangible property, and who bears the costs and risks of the marketing activities;

²⁵ Dated 16 December 2009.

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- whether the level of marketing activities performed by LocalCo exceeds that performed by comparable independent enterprises;
- the extent to which the marketing activities would be expected to benefit the owner of the intangible property and/or LocalCo;
- whether LocalCo is properly compensated for its distribution activities by a normal return on those activities or should share in an additional return on the intangible property; and
- whether LocalCo benefited from intangible property. Detailed information could be sought on the type of intangible, similar arrangements within the multinational group and on the methodology adopted by the LocalCo to arrive at the arm's length price.

5. What would be the areas of concern for the Indian tax authorities?

The areas of concern of the tax authorities in India under the current fact pattern would be the following:

- the high level of costs or the losses incurred by the LocalCo during the initial years. The tax authorities would be interested in determining whether the losses are due to transfer pricing practices of the group;
- the purpose and rate of the royalty (7%) charged by the parent company, to determine whether the rate of royalty charged is comparable having regard to similar uncontrolled transactions;
- the payment of royalties by LocalCo, even during years of losses;
- the level of advertising, marketing and promotional expenditure incurred by LocalCo to determine whether it is in line with what a comparable uncontrolled enterprise would have earned or satisfies the bright-line test. Even if LocalCo achieves operating profit margins comparable with those earned by uncontrolled enterprises, the tax authorities could examine the level of advertising, marketing and promotional expenses to determine if LocalCo has provided a benefit to its parent by enhancing the value of its intangibles (for which it needs separate compensation). See *Maruti Suzuki India Ltd v. ACIT*, 2010-TII-01-HC-DEL-TP; and
- the pricing of the transactions between the parent and LocalCo, particularly as Wonderland is a low-tax jurisdiction. The tax authorities could attempt to establish that the intercompany arrangements have been designed with a motive to shift profits out of India.

6. Is it likely that the Indian tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

It is likely that the tax authorities would make a primary adjustment, due to the following:

- As LocalCo obtains no rights to the intangible other than to market and distribute the branded products, the tax authorities would generally not expect LocalCo to be charged a royalty in addition to the price of the product. Thus, the tax authorities may be expected to challenge the royalty payment. Alternatively, the tax authorities may propose that LocalCo developed the intangible in the local market in Years 1 through 3 by incurring significant advertising, marketing and promotional expenses and by bearing the risk associated with developing the market. Thus, LocalCo should not be required to pay a royalty.
- The tax authorities could question the arm's length nature of royalty payments made by LocalCo during the years of losses by stating that, in an uncontrolled situation, an entity which suffers a loss would be unwilling to make payments for the use of intangible property which would exacerbate the loss of the selling affiliate.
- If the losses are because of certain business strategies (e.g. market penetration), it is likely that the tax authorities would question the rationale and justification of the purported strategy (especially where LocalCo fails to adequately document the strategy).

- The tax authorities could apply the so-called bright-line test and review the level of advertising, marketing and promotional expenses incurred by LocalCo to assess if it is in excess of what a comparable uncontrolled enterprise would have incurred. Should such expenditure be found excessive, the tax authorities could either disallow the "excess" advertising, marketing and promotional expenditure; attribute additional income in the hands of LocalCo; reduce the purchase price of the imported goods; or reduce the royalty rate (assuming that they have not challenged the payment of royalty). See *Maruti Suzuki India Ltd v. ACIT*, 2010-TII-01-HC-DEL-TP.
- The tax authorities could also seek to compare the operating profit margins of LocalCo with that of comparable uncontrolled enterprises to determine if an adjustment is required.
- As a general practice, it is likely that the tax authorities would initiate penalty proceedings where there is an adjustment to the returned income due to the above. In most cases, penalties are generally kept in abeyance until the matter is settled in appeals. If the royalty is disallowed in the hands of LocalCo, the tax authorities are not obliged to give a corresponding adjustment to the parent company of LocalCo on the royalty income. The royalty would be subject to Indian withholding tax on the actual amount paid.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

If LocalCo does not agree with the adjustment

If LocalCo does not agree with the adjustment, it has two options: ^[26]

- appeal against the order before the Commissioner of Income tax (Appeals) (CIT(A)), the first appellate authority; or
- opt for the alternative dispute resolution mechanism, under which LocalCo would need to file its objections against the primary adjustment with the Dispute Resolution Panel and the tax officer within 30 days of the receipt of the draft order. The Dispute Resolution Panel would consider the facts and circumstances of the case and issue appropriate directions to the tax officer within a maximum period of 9 months. The directions of the Dispute Resolution Panel are binding on the tax officer.

The orders passed by the CIT(A) and the tax officer in accordance with the directions of Dispute Resolution Panel are appealable before the Income Tax Appellate Tribunal (the second appellate authority). The alternative dispute resolution mechanism, being time bound, is expected to act as a fast-track mechanism to dispute resolution. The alternative dispute resolution mechanism skips one level of the existing hierarchy (i.e. CIT(A)), as orders of the Dispute Resolution Panel are appealable before the Income Tax Appellate Tribunal.

Assuming there is a treaty between India and Wonderland which is drafted along the lines of the OECD Model Convention, LocalCo may also apply for a MAP to the competent authority in India in the prescribed form (Form 34F). The right of a competent authority to accept or reject an application is purely discretionary. If the treaty does not contain a provision equivalent to Art. 9(2) of the OECD Model Convention, it is likely that the Indian competent authority will not accept the MAP application.

There is no specific procedure under Indian law that prohibits a MAP and domestic tax law appeal from running concurrently. There is also no requirement to exhaust any other administrative remedy in Indian tax law before applying for a MAP. The competent authorities can reach an agreement during the pendency of a domestic law action. However, if the taxpayer accepts the MAP resolution, the taxpayer has to withdraw its domestic tax law appeal for the Indian tax authorities to give effect to the MAP result.

If LocalCo agrees with the adjustment, but does not want to be subject to double taxation

²⁶ Sec. 143 read with Sec. 144C Act.

If LocalCo agrees with the adjustment, it will have to discharge its additional tax liability, including interest, within the time frame prescribed in the order of the tax authorities. Indian tax law also prohibits a corresponding adjustment in the hands of an associated enterprise in a situation where a transfer pricing adjustment is performed in the hands of the other associated enterprise and withholding tax was applicable on that payment. ^[27] The law also does not contain any provisions dealing with secondary adjustments that may result from a primary adjustment.

It is likely that LocalCo may not be able to claim relief under the MAP article of the tax treaty between India and Wonderland. The Indian competent authority might refuse to admit a MAP where LocalCo agrees with the adjustment, as the treaty condition of "any action of the Contracting State not in accordance with the provisions of the Convention" is not satisfied. Thus, any relief from double taxation can only be expected in Wonderland by the parent unilaterally seeking a correlative relief.

Japan Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

When LocalCo is established to start the distribution operations in Japan, the best way to address the transfer pricing risks would be to apply for an APA. If there is an applicable income tax treaty between Wonderland and Japan, it would be a bilateral APA. If there is no applicable treaty, it would be a unilateral APA.

As Japan does not have a contemporaneous documentation requirement, LocalCo would not be required to prepare such documentation. However, it would be recommended to have supporting documents for the transfer pricing method LocalCo would adopt. Schedule 17(4), to be attached to its final tax return, would require it to specify the transfer pricing method it adopts.

The advantage of an APA is that once the transfer pricing method is agreed in the APA, LocalCo would not receive a transfer pricing adjustment during the APA period, and the APA period may be renewed. Also, LocalCo would not be bothered by a transfer pricing audit for the APA period or the rollback period while the APA application is pending.

The disadvantage of an APA is that it may be time consuming and expensive. One should generally expect the APA procedure to take at least 2 years, and the professional fees related to pursuing an APA and preparing the necessary economic analysis may be significant. Also, there is certain risk that the APA LocalCo applies for may not be agreed on.

Furthermore, LocalCo must conduct the transactions before the APA is concluded, and the prices that LocalCo uses in these transactions may be amended by the APA once the APA is agreed on. In such a case, LocalCo will retroactively have to file amended tax returns.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

As unique intangibles (Minimynox patents) are involved, the CUP method is not likely to be applicable. The cost-plus method would not be applied because information on the manufacturing activities is not available in Japan. Either the resale price method, the TNMM or the profit split method could be acceptable to the Japanese tax authorities. The resale price method could be acceptable because LocalCo engages in reselling activities (except for its activities to obtain regulatory approval, which may be independently evaluated). The TNMM could be acceptable, as the parent company makes a unique contribution but LocalCo does not. The profit split method could be acceptable because it is a two-sided approach.

The critical factors would be the Minimynox patents; the trademark "Less is More"; the exclusive distribution rights; regulatory approval of the product "Less is More" under the Pharmaceutical Affairs Law; the marketing strategy

²⁷ Second proviso to Sec. 92C(4).

established by the parent company and used by LocalCo; the functions of LocalCo in the transactions; and the risks (inventory risk, credit risk, foreign exchange risk, warranty risk, PL risk, R&D risk, market risk, etc.) that LocalCo undertakes.

3. Could LocalCo apply for an APA in Japan? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

As stated above, LocalCo could apply for an APA. There are no APA requirements that LocalCo does not meet in this case.

An APA application should contain a general corporate profile; a description of the business and markets; financial information, including segmental profit and loss statements; covered transactions; functional and risk analysis; transfer pricing methodology; term of the APA; rollback period (in the case of a bilateral APA); and proposed critical assumptions. LocalCo should submit supporting documents for the above items.

An APA application must be filed before the start of LocalCo's business year for which it wishes the APA to be applied, although a rollback period is available in the case of a bilateral APA.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

If the Japanese tax authorities indeed wish to look at LocalCo's transfer pricing, they would start a transfer pricing audit after some preliminary examination of LocalCo. The audit team would issue data requests, require personnel interviews of key business people, ask LocalCo to prepare segmental profit and loss statements for the covered transactions only and seek to ask questions regarding transfer pricing matters at face-to-face meetings with LocalCo's tax personnel and its tax advisors.

LocalCo can make its transfer pricing arguments at the face-to-face meetings and by separate writings.

5. What would be the areas of concern for the Japanese tax authorities?

The tax authorities' concern would be how much profits the parent company retains out of its sales and licensing transactions to Japan. This key information is not always available, and there is no effective means to force the non-Japanese parent company to produce the data to the Japanese tax authorities under Japanese tax law, without the cooperation of the parent company. If its shares are listed on a stock exchange (so that its financial information is publicly available) and the parent company's business is relatively simple (so that published financial information discloses the required information), the Japanese tax authorities may ultimately obtain access to the necessary information.

Depending on what transfer pricing method is adopted, the financial information on the parent company may not be absolutely necessary, but the Japanese tax authorities would want to have such information to see whether the transfer pricing method applied is valid.

The tax authorities' concerns about LocalCo's activities would include LocalCo's activities to obtain regulatory approval. They have a tendency to think that local regulatory approval is important because LocalCo cannot sell the products without it. The tax authorities would also focus on LocalCo's sales activities. The marketing strategies developed outside Japan would often require modifications by LocalCo to implement the strategies in Japan, and such modifications would be attributed to LocalCo's contributions.

6. Is it likely that the Japanese tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

It is likely that the Japanese tax authorities would make a primary transfer pricing adjustment. The royalty of 7% of sales only for the exclusive distribution rights in Japan may be too high.

It is not common practice in Japan to charge a royalty for exclusive distribution rights only. In order to support the royalty percentage, the licence of the trademark should probably be combined.

Transfer Pricing and Dispute Resolution -

The parent company can generate its profits not only from the royalty but also from the sales of the products. The parent company's combined profits from the royalty income and sales income would be checked to see if the transfer pricing method applied is valid. If the parent company earns very high profits from the sales, that aspect would be focused on.

LocalCo's losses for the initial few years should not cause a concern for the tax authorities, as such initial losses are common. After LocalCo started to show profits, however, the net profit ratios (2.3%, 4% and 5%) may appear to be too low in the eyes of the tax authorities.

Japan does not impose any special penalties targeted at transfer pricing. The penalties that may be imposed in the case of transfer pricing adjustments are ordinary penalties. These are usually the penalties for understatement, which are 10% or 15% of the additional tax amounts. The delinquency tax (overdue interest) is currently 4.3% per annum.

Japan does not employ secondary adjustments.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

If LocalCo does not agree with the transfer pricing adjustment, it may file either a request for reinvestigation with the Regional Taxation Bureau or a request for reconsideration directly with the National Tax Tribunal (assuming that LocalCo files a blue tax return, as is usually the case). If such administrative appeals do not produce a satisfactory solution, LocalCo may take its case to court.

At the same time, if there is an applicable tax treaty, LocalCo may apply to the tax authorities for a MAP while staying its administrative appeal.

The MAP is also the method to be used for eliminating international double taxation.

Mexico Case Study

Where there is a tax treaty between Mexico and Wonderland drafted along the lines of the OECD Model Tax Convention

1. *Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?*

Various scholars of different countries have pointed at the increased difficulty multinationals face in allocating assets and income attributable to intangible property in today's complex regulatory environment, taking into account both legal title and economic ownership; in this sense, it is crucial to identify the routine activities that are carried out by LocalCo, and any non-routine activities for which LocalCo should receive additional consideration, such as the marketing campaign developed by LocalCo in the Mexican market. Therefore, it is advisable to look into the viability of implementing a bilateral APA (as described in this chapter) to determine the income attributable to LocalCo based on the functions performed in Mexico according to the most appropriate transfer pricing methodology.

Financial projections should be confirmed before the commencement of operations, in order to evaluate the profit potential in Mexico supporting the planned business strategy and to set the purchase price. Thus, a gross margin return can be determined that is consistent with the functions performed.

It is important to have in place supporting documentation that demonstrates that the value of the intangible applicable to the distribution agreement has not been implicitly charged in the product price, which would likely avoid the disallowance of the deduction in the event of an audit by the Mexican tax authorities (on the grounds of a duplicate or excess royalty), considering:

- the business reason for, and economic benefits attributable to, the distribution agreement;

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- the level of competition in the Mexican industry (the more competitive, the higher the benefit to LocalCo if it has assured exclusivity in exchange for royalties);
- the applicable tariff treatment. Royalties are often incorporated in the duty basis if they are part of a product's sale conditions;
- whether commercial practices in Mexico allow the distributor to pay a royalty on an exclusive distribution agreement, particularly in the case of personal consumption goods with a certain international reputation, even if not necessarily known in the local market; and
- if the preceding item applies, an assessment of the viability of an incremental royalty as a function of sales carried out in Mexico or a possible grace period for the first few years, and confirmation that the 7% royalty for exclusive distribution is consistent with the arm's length principle.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

The most suitable method to evaluate the reasonableness of the income attributable to the transactions carried out by LocalCo is the residual profit split method, which determines a return according to the functions, assets and risks assumed in Mexico for both routine and non-routine activities in which LocalCo is involved (development of the marketing intangible generated by the sales and marketing efforts developed in the Mexican market), as well as an appropriate return to the Wonderland parent based on the functions, assets and risks assumed and incurred in the development of the product.

This approach recognizes the fact that R&D might explain the success of a "pioneer" product, while the success of later entrants into the market is primarily attributable to sales and marketing efforts.

Another key aspect to consider is the appropriate application of royalties in terms of the commensurate-with-income standard, which requires that royalty rates be analysed annually to determine whether adjustments are necessary to reflect differences between actual and expected profits earned from the LocalCo's involvement in the production of the intangible.

3. Could LocalCo apply for an APA in Mexico? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

Indeed an APA is possible and advisable, subject to compliance with the requirements established in the applicable law. See the discussion above regarding the residual profit split method.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

The process begins with a review under rules provided in the Code. First, the Central Transfer Pricing Inspection Administration summons the external auditor who audited the taxpayer's financial statements to appear at the SAT offices to review and submit work papers, the transfer pricing study, the integration of balances, the trial balance and all other relevant information requested by the tax authorities.

After the information from the external auditor is reviewed, the Central Administration notifies the taxpayer that it has 15 business days to submit the information requested by the tax authorities. At the taxpayer's request and subject to approval by the Central Administration, the term may be extended for an additional 10 business days. The tax authorities often require that the taxpayer provide all information supporting a transaction, as well as the transfer pricing study. The tax authorities review the information supplied and may request additional information.

Upon conclusion of the inspection process, if the tax authorities believe that there is an error or deficiency in the prices or consideration agreed with related parties, they will issue an observations ruling to notify the taxpayer of the possible irregularities found. The taxpayer has 2 months, subject to extension by an additional month, following notification

of the observations ruling, to file its response and refute the facts determined by the tax authorities as a tax omission or error under the transfer pricing regime. ^[28]

Once the taxpayer responds to the notice, the tax authorities review the information and notify the taxpayer of the outcome in the following weeks.

5. *What would be the areas of concern for the Mexican tax authorities?*

Concerns would include:

- any absence of arm's length compensation for non-routine activities carried out by LocalCo, such as the marketing campaign conducted for the benefit of the Wonderland parent;
- proving that unrelated third parties would have been willing to pay royalties for exclusive distribution in regard of the benefit obtained by LocalCo;
- possible disallowance of deduction of the royalties on the grounds that such royalties are above market values according to comparable contracts;
- challenging the benefit derived from the exclusivity rights of a pioneer product, as such rights should be reflected in higher profit levels than those obtained by LocalCo;
- demonstration of the business strategy carried out by LocalCo pursuant to Paras. 1.59 and 1.60 of the OECD Guidelines; and
- challenging the return derived by LocalCo in the Mexican market with respect to the functions, assets and risks assumed-which implies that LocalCo should obtain gross margin returns higher than 60%.

6. *Is it likely that the Mexican tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?*

It is likely that the tax authorities would make a primary adjustment, for the following reasons:

- the absence of arm's length compensation for non-routine activities carried out by LocalCo, such as the marketing campaign conducted for the benefit of the Wonderland parent, which would probably imply the accrual of the respective income;
- disallowance of the deduction of royalties, considering that unrelated third parties would not be willing to pay exclusive distribution royalties, as LocalCo is not shown to derive any benefit therefrom. In addition, the rate paid is above market rates according to comparable contracts;
- demonstration of the business strategy carried out by LocalCo pursuant to OECD Paras. 1.59 and 1.60 of the OECD Guidelines;
- disallowance of part of the deduction of related-party purchases, considering that they were made at above arm's length values, and requiring LocalCo to obtain gross margins of not less of 60%; and
- possible treatment of royalties as dividends if the deduction of royalties is disallowed.

7. *If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?*

The defence options for LocalCo are limited, as the return obtained in the Mexican market is below the return that unrelated third parties would have been willing to receive for the activities carried out. Furthermore, the Mexican tax

²⁸ Arts. 46 and 48 Federal Tax Code (Code).

authorities would be unlikely to waive an arm's length consideration for the non-routine activities performed by LocalCo for the benefit of the Wonderland parent, such as the contribution in developing a marketing intangible in Mexico. In addition, the tax authorities would probably challenge the exclusive-rights royalty payments. Notwithstanding the foregoing, LocalCo could argue through the available legal proceedings (see 3.2.) that it is acting as a limited or intermediary distributor, and therefore the return expected by the end of the fifth year is reasonable in light of the functions assumed, avoiding the possible disallowance of the deduction of purchases. Nevertheless, if that is the case, the tax authorities would likely not accept the non-inclusion of the income to which it is entitled by reason of LocalCo's involvement in the generation of the intangible by way of its non-routine marketing functions in the Mexican market.

If, as a defence, the position is taken that LocalCo should be characterized as a distributor, the low profitability could be defended on the basis of market penetration, specifically considering the temporary nature of the company's business strategy.

In the case of royalty payments under the CUP method, LocalCo could argue that the royalty paid to the Wonderland parent is consistent with the arm's length principle because it provides a significant benefit in the form of ensured access to the market as a whole, eliminating the existence of competitors.

Notwithstanding the above, the reduced return, along with the multiple functions carried out by LocalCo, undermines such a defence.

If LocalCo accepts the adjustments made by the Mexican tax authorities and an income tax treaty is in force between Mexico and Wonderland, the taxpayer should apply for relief from double taxation for the taxable income or denied deduction under the competent-authority procedure.

If no treaty along the lines of the OECD Model Tax Convention is applicable between Mexico and Wonderland

In the absence of an applicable tax treaty, the same issues apply, except that it is impossible to apply for a bilateral APA. Therefore, a unilateral APA may be sought.

The payment of royalties is an even more critical issue, as Mexican tax is withheld at the 40% rate in the case of a low-tax jurisdiction and 25% in the case of a country that levies a tax similar to Mexican tax.

If Wonderland is an EU Member State

The answers given above apply in this case as well, provided that the country in question has an applicable income tax treaty with Mexico. Nevertheless, a difference could arise for an EU country if the treaty contains a most-favoured-nation clause (implying a lower withholding rate in the case of royalties). In addition, as there is a free-trade agreement with the EU Member States, a lower tariff may apply to the product under the applicable agreement.

If Wonderland is not an EU Member State

The treatment is similar to that described above, except for any higher customs duties that may apply.

Netherlands Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

Regardless of whether there is an applicable tax treaty or whether Wonderland is an EU Member State, LocalCo or the principal in Wonderland should produce transfer pricing documentation, in accordance with Dutch tax law, to justify the transfer pricing policy implemented for LocalCo. A benchmark search for available CUPs for the royalty charged by the principal to LocalCo is optional, but may prove useful (see country chapter Netherlands, at 1.1.1.). Dutch tax law provides for the general obligation to maintain records and provide information to the tax inspector about everything

that can be relevant for the levy of Dutch taxes, if so requested by the tax inspector. ^[29] This obligation includes the duty to keep transfer pricing documentation, in order to secure that the required information is available to assess whether the agreed-upon transfer prices are at arm's length. The required information must be available to the Dutch tax authorities from the moment the transaction has taken place. The company must keep records with underlying documentation, which demonstrate that the transfer prices are at arm's length. If the taxpayer fails to comply with this administrative requirement, the burden of proof as to the arm's length nature of the transfer prices applied will shift from the Dutch tax authorities to the taxpayer. In that case, the taxpayer will have to demonstrate that the transfer prices are at arm's length.

Seeking advance certainty from the tax authorities may also be of use in reducing LocalCo's tax risks and any related liability provisions. For a unilateral APA to be granted by the APA team of the tax authorities, a benchmark search analysis is required (see country chapter Netherlands, at 1.1.1. and 5.2.).

Advantages of obtaining an APA include that the multinational enterprise has greater certainty as to transfer pricing positions taken, and that it may benefit from savings by avoiding future inquiries from and discussions with the tax authorities. The disadvantage of an APA may be that it is quite costly, as it is advisable to seek professional tax advice. Furthermore, when applying for an APA, the multinational enterprise may have to reveal information to the tax authorities that it might otherwise not have chosen to share upfront. Having said this, pursuing an APA is a "spend now, save later" process. Finally, although only a bilateral or multilateral APA may also avoid double taxation, the related APA process is much more time consuming and complex, as it involves two countries with contradicting interests.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

The fact that LocalCo performs the sales function with limited functions, a distribution function and the acquisition of regulatory approval in LocalCo's jurisdiction, indicates that a transactional net margin method (TNMM), with the operating margin as the profit level indicator, may be the best method to determine the remuneration of LocalCo, assuming that LocalCo can be characterized as a company performing routine functions. This should allow LocalCo to earn a steady profit margin which is in line with its functions performed, risks incurred and (intangible) assets employed.

However, if LocalCo is characterized as a key risk taker and manager, and can be said to have developed and employ material intangibles, it should be classified as a co-entrepreneur. In this case, a royalty mechanism based on sales to remunerate the parent for the investment in its research and development (R&D) and marketing strategy development is appropriate, and LocalCo is to be remunerated with the residual profit left after all costs and the royalty have been covered.

The critical factor for making this decision is the characterization of the entity based on an industry analysis; a thorough analysis of functions, risks and (intangible) assets; and an economic analysis. To determine whether LocalCo is to be remunerated with a TNMM operating margin and whether it has to pay a royalty (as a percentage of sales) to the principal company, benchmark searches are recommended to demonstrate the arm's length nature of all these intercompany transactions.

3. Could LocalCo apply for an APA in the Netherlands? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

LocalCo could apply for either a unilateral, a bilateral or a multilateral APA in the Netherlands. Under Dutch tax law, taxpayers are free to opt for an APA, and are in principle free to determine the scope of the APA and whether to pursue a unilateral, bilateral or multilateral APA. The Netherlands has a flexible and well-working APA programme; all APAs are to be issued in accordance with the arm's length principle. Dutch unilateral APAs may be obtained within 60 days of filing a Dutch APA request. However, for cross-border (bilateral or multilateral) APAs, the Netherlands is dependent on negotiations with and cooperation from other countries, and thus the process becomes much more complex, time consuming and costly. Indeed, such APA procedures will take longer than 1 year.

²⁹ Art. 47 GLT.

Furthermore, in order to pursue a cross-border APA, the Netherlands has to have an income tax treaty with the other state containing a clause similar to Art. 25 of the OECD Model Convention.

In all APA cases, the tax authorities would require full transparency from LocalCo, and LocalCo would have to provide the Dutch tax authorities with complete transfer pricing information, documentation, and benchmark searches to demonstrate the arm's length nature of the intercompany transactions (see country chapter Netherlands, at 5.) included in the APA. LocalCo may also have to provide the Dutch tax authorities with documents on the substance of LocalCo.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

If the Dutch tax authorities wish to look at LocalCo's transfer pricing and perform a tax audit, they should inform LocalCo in advance that they will do so. They will announce which time period is under review and provide LocalCo with an information request, which marks the commencement of the audit process and determines the scope of the audit (see country chapter Netherlands, at Figure 2 and 2.3., with special reference to 2.3.4. and 2.3.5.). A tax audit comprises an examination of LocalCo's books and usually covers a number of years, taking into account the 5-year period (which may be extended to 12 years for international transactions) within which the tax authorities may impose an additional assessment. This period is extended for any extension granted for filing the tax return.

LocalCo would have to provide the tax authorities with the requested information. If after this point the tax inspector wishes to change the scope of the audit, the inspector must inform the taxpayer (LocalCo). If the Dutch tax authorities wish to perform the audit at the premises of the taxpayer, they may do so. They will notify the taxpayer in advance of an upcoming field audit. When the tax inspector is at LocalCo's premises, the inspector may, in principle, only look at information that was previously requested and items that are open and readable and are part of the company's books and records.

Upon completion of the (field) audit, the Dutch tax authorities issue two reports—one for the Dutch tax authorities themselves and one for the taxpayer and its advisor(s). The latter will indicate which tax corrections the Dutch tax authorities intend to make, if any. The corresponding tax assessments will then be issued by the Dutch tax authorities. The taxpayer may file an objection against the assessment. If the taxpayer does not agree with the decision on the objection, it may lodge an appeal before the lower tax court (see country chapter Netherlands, at 3.2. for the litigation procedure). 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 the size of the adjustment. Transfer pricing disputes between the Dutch tax authorities and taxpayers are often resolved through negotiation, rather than litigation.

5. What would be the areas of concern for the Dutch tax authorities?

As LocalCo is involved in intercompany transactions with the principal company located in Wonderland, a low-tax jurisdiction, the Dutch tax authorities will be most concerned about the substance of the principal, and will check to see if LocalCo is performing any (risk-taking) functions other than simply the distribution function that it is to perform. The tax authorities will also try to determine whether LocalCo receives sufficient compensation for the functions it performs, risks it assumes and assets it employs. Additionally, the tax authorities will determine whether there is any local intellectual property that LocalCo has generated for which it needs to be compensated, especially if LocalCo pays a royalty.

6. Is it likely that the Dutch tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

It is not likely that the Dutch tax authorities would make a primary adjustment if the results earned by LocalCo are within the arm's length range. Nor would they make any corporate tax adjustment. Some start-up losses might also be accepted.

In accordance with Para. 4.9 of the OECD Guidelines (2001), the Dutch Transfer Pricing Decree of 30 March 2001 (IFZ2001/295M) states that whenever the Dutch tax authorities undertake a transfer pricing audit, they should start from

the perspective of the method adopted by the taxpayer at the time of the transaction. The implication is that taxpayers are in principle free to choose a transfer pricing method, provided that the method adopted leads to an arm's length outcome for the transaction in question. Although taxpayers may be expected to base their choice of a transfer pricing method on the reliability of the method for the particular situation, taxpayers are definitely not expected to assess the advantages and disadvantages of all of the various methods and then explain why the method that was ultimately adopted generates the best results in the prevailing conditions (i.e. the best-method rule).

If the Dutch tax authorities are to make an adjustment, they must first investigate the facts and then come to a conclusion and state their position. In the Netherlands, the burden of proof is with the tax authorities, provided that contemporaneous transfer pricing documentation is available. The tax authorities must show that the taxpayer's position is incorrect before making an adjustment.

Tax penalties "for intent" are levied for transfer pricing-related corporate tax issues, in the case of gross negligence or (conditional) intent (see country chapter Netherlands, at 1.1.2.).

If the Wonderland company has no substance in Wonderland, it may be deemed that a permanent establishment of the Wonderland company exists in the Netherlands, and that corporate tax and withholding tax may be levied from this permanent establishment. This may be subject to tax treaty protection, if there is an applicable treaty.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

If LocalCo does not agree with the adjustment, it may file an objection and enter into dispute resolution proceedings (see country chapter Netherlands, at 1.2. and 1.3.), which could include MAP proceedings, and arbitration of some sort if allowed under an applicable tax treaties. If LocalCo objects to the Dutch tax authorities' assessment of LocalCo's tax return, a court case between the taxpayer and the tax authorities could follow.

In order to alleviate double taxation, LocalCo may request that the Dutch tax authorities commence a MAP with the relevant competent authorities (see country chapter Netherlands, at 4.). While the MAP process may result in the elimination of double taxation, it can be a time-consuming and costly process, and absent an arbitration clause in the tax treaty there is no guarantee for success.

South Africa Case Study

1. Based in the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

Whilst there is no statutory requirement to undertake a transfer pricing study, SARS Practice Note 7 on transfer pricing confirms that if a taxpayer can demonstrate that it has developed a sound transfer pricing policy under which transfer prices are determined in accordance with the arm's length principle by documenting the policies and procedures for determining those prices, the Commissioner is more likely to conclude that its transfer pricing practices are acceptable and the risk of possible adjustments will be diminished.

Therefore, LocalCo should have undertaken a transfer pricing study, including a detailed analysis of the functions and risks taken on by LocalCo and an economic analysis to determine the acceptable range of transfer pricing margins for independent distributors in a similar position as LocalCo. The results of such a study should have been documented in a transfer pricing policy document and supplied to SARS with LocalCo's tax return.

Such a transfer pricing study should be undertaken in accordance with the OECD Transfer Pricing Guidelines (OECD Guidelines), which are acceptable to SARS and effectively repeated in SARS Practice Note 7. In particular, SARS Practice Note 7 states that the Commissioner regards the guidelines contained in Chap. VI of the OECD Guidelines as

being relevant, and recommends that the taxpayer follow those guidelines to establish transfer pricing policies relating to the supply of intangible property.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

SARS Practice Note 7 mentions the same methods as referred to in the OECD Guidelines. It emphasizes that there is no prescribed method, but that the traditional methods are generally preferred, unless insufficient information is available to apply those methods, in which case the TNMM could be the most appropriate.

SARS Practice Note 7 observes that the resale price method is most appropriate where the reseller does not add substantially to the value of the product or does not possess valuable marketing intangibles. Therefore, it may be appropriate in the case of a distribution arrangement. However, the additional functions performed by the distributor should be taken into account and the resale margin should be adjusted by the value of such additional functions. The adjustments would determine the value of such functions by applying the cost-plus method to determine an appropriate additional margin for such functions.

3. Could LocalCo apply for an APA in South Africa? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

It is not possible to obtain an advance tax ruling on transfer pricing matters. ^[30] Therefore, APAs are not available in South Africa.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

SARS would first review the information supplied with the taxpayer's tax return (see the information required by SARS in respect of transactions with connected, non-resident persons, described in the country chapter South Africa, at 1.1.1.).

If SARS required further information, it would address a letter to the taxpayer, requesting particular information. SARS may also request a meeting with the relevant personnel of the taxpayer who deal with cross-border transactions with connected persons. Such an inquiry must be limited to a request for information, which the taxpayer need not supply immediately if the information is not at hand. The taxpayer must be given reasonable time to supply such information. If SARS wishes to cross-examine personnel of the taxpayer, this may be done only under a formal inquiry, which must be authorized by a judge who would issue a warrant (provided that certain strict conditions were met).

SARS would then undertake a detailed audit of the transactions involved and review the transfer pricing method applied. If it came to a different conclusion in respect of the prices of the relevant supplies, it would issue a revised or additional assessment reflecting the adjustments to the prices in question. It may also add additional tax up to 200% of the tax underpaid, plus interest on the outstanding tax.

5. What would be the areas of concern for the South African tax authorities?

In the context of payments for exclusive distribution rights, SARS will consider whether the payments were incurred to produce income or to acquire an income-producing asset. In *Commissioner, SARS v. Kajadas Cosmetics (Pty) Ltd*, ^[31] the Court held that where an annual fee was incurred by a franchisor for the exclusive distribution rights of a product in South Africa, the expenditure was of a capital nature, as the franchisor paid for the acquisition of exclusive rights, which created its income-earning machine. ^[32] However, in the recent decision in *Commissioner for SARS v. I-Net Bridge (Pty) Ltd*, ^[33] the Court held that a franchise royalty for exclusive franchising rights was revenue in nature.

If the expense could be regarded as an expense of a recurring nature which provided no enduring benefit to the licensee, the expense should be tax deductible.

³⁰ Sec. 76G(1)(a)(iii) ITA.

³¹ 2002 (4) SA 709 (T).

³² See also *SIR v. Cadac Engineering Works (Pty) Ltd* 1965 (2) SA 511 A.

³³ Case 413/07 (15 September 2010).

Assuming that the royalty payable by LocalCo was deductible, SARS would consider whether the royalty rate was within the range that, in its view, reflected an arm's length range. In this context, it would cooperate with the Financial Surveillance Department of the South African Reserve Bank, which must give formal approval for such licensing agreements.

6. Is it likely that the South African tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

As indicated above, SARS would conduct its own functional and economic analysis and come to a conclusion about the acceptable range of margins for LocalCo. If the actual margins reflected in the tax returns of LocalCo were lower than the acceptable margin determined by SARS, SARS may issue a revised or additional assessment to impose additional tax (corporate income tax plus secondary tax on companies) in respect of such adjusted margin. It may also impose additional tax up to 200% of the tax imposed, unless the taxpayer can provide convincing reasons why such penalty should not be imposed. It would also charge interest on the outstanding tax.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

If LocalCo did not agree with the assessment, it may object to the assessment, stating its grounds for such objection. It should set out detailed reasons why it did not agree with the margins determined by SARS. The dispute would then take its course as outlined above.

An adjustment of the profit margin of LocalCo should not cause double taxation for LocalCo, but it may cause economic double taxation for the Weight Resources Group, as the foreign parent company would already be taxed on that adjusted portion. The foreign parent should not be subject to tax in South Africa. Therefore, South Africa would not provide any relief for such economic double taxation. Wonderland should grant relief in the form of a corresponding adjustment of the price charged by the parent company to LocalCo.

United Kingdom Case Study

Preliminary observations

UK tax law (Part 4 Taxation (International and Other Provisions) Act 2010) requires "provisions" between associated enterprises to be treated for corporation tax purposes as if the arm's length provision had been made. The relevant "provisions" in the present case are (1) the sale of the branded weight loss pill on a principal-to-principal basis by the parent company to LocalCo and (2) the licence agreement between the parent and LocalCo for exclusive distribution rights in LocalCo's home territory, assumed here to be the United Kingdom. As LocalCo acts as principal, it should not represent a dependent agent of the parent. Thus, the parent should not be regarded as establishing a UK permanent establishment by virtue of the activities of LocalCo.

LocalCo contributes to the overall result of the multinational enterprise by handling local regulatory requirements and by marketing the product. That said, it seems debatable whether or not LocalCo can be said to be providing any specific value to its parent through these activities; the activities are really those which are natural for a principal on-risk distributor seeking to establish and then develop its own market. Consider, however, the interaction between the duration of the regulatory approval and the terms of the licence, including its duration. Suppose the former exceeds the latter in duration: LocalCo could then perhaps be said to be providing services (in procuring this regulatory approval) which in part benefit the parent, and similarly to be developing a marketing intangible which the parent will in due course enjoy.

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

When LocalCo first established operations, it could have sought to minimize transfer pricing risks by endeavouring to ensure that the prices paid by it (1) by way of purchase price for the branded goods and (2) as royalties for the licence were demonstrably set at arm's length rates. This exercise would be aided by a rigorous comparability study (taking care to make appropriate adjustments where necessary) to arrive at a range of arm's length prices and thus to ensure that the prices paid by LocalCo to its parent fell at a reasonable point within the range. LocalCo should also have been careful to ensure that the other terms of the respective supply and licence contracts were consistent with arm's length dealings, for example as to the duration of the agreements and also as regards contractual restrictions or positive obligations assumed. The production of contemporaneous documentation explaining the approach taken to setting the price will indeed be of significant assistance in defending any challenge to the transfer pricing arrangements from the UK tax authority, HMRC.

LocalCo could have documented its longer-term financial forecasts, the assumptions on which they were made and the evidence in support of those assumptions. This is particularly important where a quite long period of start-up losses is anticipated. It could become important for the forecasts to confirm that, despite the start-up losses, the net present value of LocalCo's profit before interest and tax (PBIT), over the lifetime of the licence agreement, was expected to be within the arm's length range of comparable independent distributors. From the forecasts provided, it appears that LocalCo will not recover its start-up losses by the end of the forecast horizon even before any discounting back of the eventual profits.

Where a prolonged period of start-up losses is anticipated, LocalCo could document the forecast profits and share of profits from LocalCo's market of both itself and of its parent company, and an explanation of how this profit split was in line with their relative contributions to that profit. It could also document its reasons for concluding that no market penetration subsidy from the parent company was merited. These comments reflect the resistance of HMRC to accepting the concept of a single "tested party" the profits of which should be considered in isolation from the related parties with which it transacts. It would also have been possible for LocalCo to enter into some form of engagement with HMRC to discuss its pricing arrangements. This could either be on a relatively informal level through its HMRC Customer Relationship Manager (who would most probably involve HMRC transfer pricing specialists), or through the formal APA programme. A unilateral APA may well be appropriate given that the parent company is resident in a low-tax jurisdiction (and in any event if Wonderland has no APA process).

Notwithstanding the low-tax environment, if Wonderland has concluded an income tax treaty with the United Kingdom which contains a mutual agreement procedure article, HMRC may be prepared to entertain an application for a bilateral APA. Updated HMRC guidance on the APA procedure is close to finalization at the time of writing. Broadly speaking, one would want to balance the degree of certainty afforded by obtaining an APA against the time, expense and heightened profile of the transfer pricing issue that entering into the process will lead to.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

As regards transfer pricing methods, to the extent that comparable uncontrolled prices for the branded goods and the distribution rights are obtainable (recognizing that if the United Kingdom is for any reason a unique market, exclusive distribution rights may mean that there is no perfect comparable), these will be highly persuasive if indeed they represent appropriate comparables. It may, however, be more appropriate (and HMRC may well be amenable to this; see INTM 463040) to use the resale price method to the extent that gross margins earned by independent distributors in comparable uncontrolled transactions (CUPs) can be benchmarked. This may be an appropriate method given the uniqueness of the product (and thus the possible unavailability of CUPs for LocalCo's purchases), given that a lesser degree of product comparability may be insisted upon (and given also that LocalCo does not add substantially to the value of the product, as it is ready for market).

If neither the CUP method nor resale price method is appropriate (due to a lack of true comparables), use of a transactional profit method may be necessary. With regard to supporting the level of the royalty, the CUP method would be most acceptable, with a first preference for "internal comparables" where these are indeed properly comparable

(adjustable if necessary); see Para. 3.28 of the OECD Guidelines. Where reliance must be placed instead on "external" comparables, HMRC is likely to view such examples as only relating to a subset of situations in which it was commercial for the licensee to enter into a licence agreement; they are likely to request evidence that this is the case for LocalCo in the form of a residual forecast profit split analysis, in which the rewards to the licensee's routine activity (in this case, distribution) and its non-routine assets (in this case, apparently none, but potentially a contribution of intangible assets) are deducted from the total PBIT margin of the licensee and compared with the PBIT margins of "routine" but otherwise comparable distributors. HMRC may well argue that a deal would have been struck between the parties such that even a proportion of the residual profit arising from the licensor's intellectual property would have been captured by the licensee.

3. Could LocalCo apply for an APA in the United Kingdom? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

As noted above, LocalCo could apply for (at least) a unilateral APA. In considering whether to entertain an APA application, HMRC would look for at least one of the following: (1) "complexity", i.e. there is doubt as to how the arm's length standard should be applied (if LocalCo's position is straightforward, for example so that the resale price method can readily be applied to it, HMRC would be unlikely to regard the complexity threshold as met); (2) absent an APA, LocalCo's transfer pricing position would not be seen as "low risk" (the location of the parent in a low-tax territory may be regarded as indicative of risk); and/or (3) LocalCo seeks to use a "highly tailored" pricing method. HMRC guidance describes in detail the information and documentation required to support an APA application, to include (among other requirements) details of the parties; recent accounts (generally for the previous 3 years); the worldwide organizational structure, ownership and business operations of the group; all major categories of transaction flows to be covered by the APA; a description of records which will be maintained to support the pricing method and information that will be supplied annually to demonstrate compliance; the assumptions which are critical to reliability of the method; and details of any current enquiries or claims relevant to the issues to be covered.

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

Assuming no prior engagement with HMRC, LocalCo's transfer pricing policies would be expected to come under HMRC's scrutiny via the filing of LocalCo's self-assessment return. In that return, LocalCo is obliged to apply the arm's length standard to its pricing of transactions with associated entities. Transfer pricing, like any other corporation tax issue, may be the subject of enquiry by HMRC, leading to requests for information, ongoing dialogue between taxpayer and HMRC and eventually HMRC's taking a position which LocalCo is entitled to appeal against. Transfer pricing enquiries are subject to specific governance; no such enquiry may be opened without the approval of HMRC's Transfer Pricing Panel or Board. HMRC provides detailed guidance on the way in which it performs transfer pricing enquiries; see INTM 462000.

5. What would be the areas of concern for the UK tax authorities?

Key areas of concern in this field might include the fact that Wonderland is a low-tax jurisdiction, and the fact that the intercompany transactions include a licence relating to intangibles (and indeed that the branded goods supplied effectively contain the benefit of an embedded intellectual property licence). This leads to inherent difficulty in establishing valuations and thus pricing. Note also that the import of goods where inherent intellectual property is of high value may create tensions between the transfer pricing and customs duties analysis; in the present case, it is assumed that the import price will be the (high) integral price of the product. Apart from the prolonged period of start-up losses, and the payment of royalties while reporting a loss, HMRC may be concerned by the level of operating expenses in relation to sales if they perceive this to be relatively high, and may ask for confirmation that LocalCo did not have "thick" functions which could be indicative that it was contributing more to local profit generation than the current transfer pricing model allowed for (e.g. by making a contribution to research and development, or by spending more on marketing and advertising than would an independent distributor in the same situation). HMRC may also question pronounced increases from year to year in the level of operating expenses, asking whether they were the result of increases in any head office charges from the parent company and, if so, how these could be explained.

6. Is it likely that the UK tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

If the time horizon of the financial forecasts is equal to the term of the licence agreement, it is likely that HMRC will seek a primary adjustment. Assuming that the level of the gross margin and of the royalty rate could be shown to be at arm's length, the basis of such an adjustment would probably be that a market penetration subsidy should have been paid. There would be no secondary adjustment if such a payment were deemed to have been received. The UK penalty regime (see INTM 434040) provides for tax-g geared penalties of up to 30% of the additional assessment for failure to take reasonable care, up to 70% for deliberate wrongdoing and up to 100% for deliberate wrongdoing with concealment. There is also a penalty of up to 10% (using the same formula) of the value of the reduction of any losses following a transfer pricing adjustment to a company that is not paying tax in the relevant period, and this could potentially apply to LocalCo. There is not enough information in the assumed facts of this case study to indicate the company's exposure to any such penalties.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

If LocalCo does not agree with an adjustment imposed by HMRC, it is free to appeal that adjustment in the ordinary manner. Any appeal would go to the independent Tax Tribunal and eventually through the court system, potentially and ultimately to the Supreme Court. If Wonderland is located in an EU Member State, it is conceivable that the compatibility of UK transfer pricing law could be taken to the European Court of Justice. LocalCo may also wish to consider submitting the case to the respective competent authorities of the United Kingdom and Wonderland (assuming Wonderland has an income tax treaty with the United Kingdom), or possibly submitting the case to arbitration, either under a tax treaty provision based upon Art. 25(5) of the OECD Model Convention (if there is a United Kingdom-Wonderland treaty) or, if Wonderland is situated in the European Union, pursuant to the EU Arbitration Convention. Those latter remedies may also be available in circumstances where LocalCo accepts the UK adjustment imposed by HMRC but wishes to obtain relief from double taxation via a corresponding adjustment in Wonderland.

United States Case Study

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute "Less is More" through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

Similar to cross-border dividend payments between related corporations, royalty payments can give rise to erosion of the tax base in the contracting state from which the royalty payment is made (in this case, the United States), because under Art. 12(1) of the OECD Model Convention royalty payments are subject to tax exclusively in the contracting state in which the royalty payments are received (in this case, Wonderland). Art. 12(3), however, provides a knock-out rule under which the royalty payment will instead be treated as business profits of the payer/licensee if the payer/licensee is a permanent establishment of the payee/licensee and the subject property is effectively connected with such permanent establishment. Generally, under Art. 5 of the OECD Model Convention, preparatory or auxiliary activities, or activities in the capacity of an independent distributor will not give rise to permanent-establishment status.

Accordingly, to ensure that under Art. 12(3) LocalCo is not treated as a US permanent establishment of its parent and the royalty payment is not treated by the IRS as effectively connected with LocalCo, LocalCo and its parent should take the following steps:

- ensure that the licensing agreement between LocalCo and its parent specifies that LocalCo will only act as an independent distributor on behalf of its parent;
- clearly state in the licensing agreement that LocalCo is only permitted to engage in certain preparatory or auxiliary activities on behalf of its parent, such as obtaining the necessary regulatory approvals; and

- ensure that the licensing agreement does not include any clause giving LocalCo an ownership stake in the subject property, such that the subject property could be considered an asset of LocalCo or otherwise effectively connected with LocalCo.

If there is no tax treaty between the United States and Wonderland, there would be a risk of double taxation of the royalty payment made from LocalCo to its parent. In all cases, to reduce its transfer pricing risks, LocalCo and its parent should prepare and maintain contemporaneous transfer pricing documentation, as discussed above, because such documentation may decrease the likelihood of an extensive audit and may allow LocalCo to take advantage of the reasonable-cause defence to the primary transfer pricing penalty in Code Sec. 6662(e), which penalty is discussed above and in response to question 6, below. The transfer pricing documentation should address the method LocalCo and its parent used to establish the amount of the royalty and how the parties determined that the transfer pricing method used was the appropriate method. LocalCo should also consider entering into an APA with the IRS as discussed above and in response to question 3, below.

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

The Treasury regulations issued under Code Sec. 482 list the "comparable uncontrolled transaction" (CUT) method as a permissible method for determining arm's length consideration for the right to use an intangible, such as the Less is More diet pill. The CUT method evaluates whether the amount charged for a controlled transfer of intangible property was at arm's length by reference to the amount charged in a comparable uncontrolled transaction. ^[34] The Treasury regulations issued under Code Sec. 482 provide a number of examples applying the CUT method to intangibles. ^[35]

The Treasury regulations provide that under the best-method rule, the method used to test the appropriateness of related-party prices should be the method that produces the most reliable measure of arm's length results. ^[36] Accordingly, the use of the CUT method is subject to the best-method rule, and alternative permitted methods just be considered.

In response to the release of the Obama Administration's "General Explanations of the Administration's FY 2010 Revenue Proposals" (the FY 2010 Green Book), which proposed revising the US transfer pricing rules on intangibles, the Joint Committee on Taxation proposed limiting the application of the CUT method to transfers of unique, high-value intangibles. The proposal would limit the application of the CUT method to transfers in which exact comparables are available and would increase the use of the income method to determine arm's length prices for transfers of intangibles.

3. Could LocalCo apply for an APA in the United States? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?

The IRS offers taxpayers the opportunity to enter into an APA to establish the appropriate transfer pricing method to be applied to related-party transactions. In addition to specifying the covered transactions and the appropriate transfer pricing method, an APA specifies the agreement term, operational and compliance provisions, appropriate adjustments, critical assumptions regarding future events, required records and annual reporting responsibilities. The APA process is voluntary; currently, a taxpayer makes a request for an APA by submitting an application, together with the applicable user fee, to the APA Programme, in the manner set forth by Rev. Proc. 2006-9. ^[37]

4. If the tax authorities were to look at LocalCo's transfer pricing, what would be the process?

IRS transfer pricing audits generally begin with an IDR. If the audit team believes the taxpayer is not providing it with the information requested, the IRS may implement other methods, including formal document requests, summonses and, if applicable, tax treaty exchange-of-information provisions. In addition to any transfer pricing documentation prepared by the taxpayer, the IRS may also seek information a taxpayer is required to retain under Code Secs. 6038A

³⁴ Treas. Reg. Sec. 1.482-4(a)-(c).

³⁵ Treas. Reg. Sec. 1.482-4(c)(4).

³⁶ Treas. Reg. Secs. 1.482-1(c) and 1.482-8.

³⁷ 2006-9 IRB 278.

and 6038C. If unagreed issues remain after the examination process, the IRS will issue a 30-day letter. Upon receipt of the letter, the taxpayer can choose to either take the issue to IRS Appeals, or refuse the administrative appeals process and ask for a notice of deficiency. As discussed below in response to Question 7(a), if the administrative process is ultimately unsuccessful, the taxpayer can either litigate the issue in Tax Court or pay the proposed deficiency and file a refund suit in either a District Court or the Court of Federal Claims.

5. What would be the areas of concern for the US tax authorities?

As noted above, the IRS has recently increased its scrutiny of transfers of intangibles. Since December 2009, the IRS has announced several initiatives to increase its scrutiny of transfer pricing issues. The IRS announced the creation of a Transfer Pricing Practice in LMSB, which will be realigned and renamed LB&I to reflect the IRS's increased focus on international issues. The Transfer Pricing Practice will consist of a group of IRS experts in the transfer pricing area who will coordinate the IRS's handling of the most important transfer pricing issues, identify emerging issues and trends and provide consistency in outcomes in transfer pricing cases. To centralize transfer pricing resources, the IRS is creating a Transfer Pricing Centre intranet site for IRS employees. The IRS has also recently announced the creation of an executive-level Transfer Pricing Council to focus on allocating resources, developing guidance and implementing initiatives with respect to transfer pricing issues. The Transfer Pricing Council consists of the LB&I Deputy Commissioner (International), two senior advisors who report to the LB&I Deputy Commissioner (International), LB&I Director of Competent Authority & International Coordination, LB&I Director of International Business Compliance; LB&I Director of Pre-Filing and Technical Guidance; LB&I Director of Field Specialists; LB&I Directors of the Communications, Technology and Media and the Retailers, Food, Pharmaceuticals, and Healthcare Industries; LB&I Division Counsel; Associate Chief Counsel (International); and the Director of the APA Programme.

6. Is it likely that the US tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

The IRS is increasing its scrutiny of transfer pricing issues. The IRS's broad power to make a primary adjustment under Code Sec. 482 is discretionary and not mandatory. The statutory standard for making a primary adjustment is "necessary in order to prevent evasion of taxes or clearly to reflect the income" of the parties involved. In the case of intangibles, the standard for making a primary adjustment is ensuring that the income with respect to the transfer of an intangible is "commensurate with the income attributable to the intangible".

As discussed above, the primary penalty in the transfer pricing area under the Code is the 20% "substantial valuation misstatement" penalty in Code Sec. 6662(e), which may increase to a 40% penalty under Code Sec. 6662(h) in the case of a "gross valuation misstatement". Moreover, a host of additional penalties may apply under the Code. These penalties include the 20% penalties for substantial understatement or careless, reckless or intentional disregard of rules and regulations, and the 75% civil fraud penalty. ^[38] Another relevant penalty is the penalty for failure to maintain adequate records under Code Secs. 6038 and 6038A(d).

The Treasury regulations under Code Sec. 482 and IRS guidance provide that the IRS must make a secondary, or conforming adjustment, to the account of a taxpayer subject to a primary adjustment. ^[39] Rev. Proc. 99-32 provides relief with respect to how the IRS will make a secondary adjustment if certain conditions are satisfied, which relief will decrease the adverse tax consequences to the taxpayer of a secondary adjustment.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

As discussed above, LocalCo would have the opportunity to challenge any proposed deficiency arising from a primary adjustment by taking the issue to IRS Appeals. If the issue is not resolved at the administrative level and the IRS

³⁸ Code Secs. 6662(b)(1)-(3) and 6663.

³⁹ Treas. Reg. Sec. 1.482-1(g)(3); Rev. Proc. 99-32, 1999-2 C.B. 296.

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makes a primary adjustment, LocalCo could litigate the issue in Tax Court, the exclusive pre-payment forum, or pay the proposed deficiency arising from the primary adjustment and file a refund suit in either a District Court or the Court of Federal Claims. Any court proceeding could then be appealed to the relevant Court of Appeals and, ultimately, to the Supreme Court.

If LocalCo agreed with the primary adjustment, but wanted to avoid double taxation arising from the primary adjustment, LocalCo and its parent could seek relief through the competent-authority process under Art. 9(2) of the OECD Model Convention. Under Art. 9(2), the parent of LocalCo could seek a correlative adjustment from the tax administrator of Wonderland to account for the US-initiated primary adjustment. In addition to the competent-authority relief provided by Art. 9, LocalCo or its parent could seek relief with respect to any double taxation through the arbitration and other mutual agreement procedures provided for under Art. 25 of the OECD Model Convention.

If Wonderland were a member of the European Union, Wonderland would have to coordinate the scope of its participation in arbitration under Art. 25 with its obligations under the European Arbitration Convention according to the commentary to Art. 25 of the OECD Model Convention. In the absence of any tax treaty between the United States and Wonderland, there would be a risk of double taxation.